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# EXAMINING THE ROLE OF CREDIT RATING AGENCIES IN THE CAPTIAL MARKETS

## HEARING

BEFORE THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

EXAMINATION OF THE ROLE OF CREDIT RATING AGENCIES IN CAPITAL MARKETS

FEBRUARY 8, 2005

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# C O N T E N T S

## TUESDAY, FEBRUARY 8, 2005



## WITNESSES



### Additional Material Supplied for the Record

# EXAMINING THE ROLE OF CREDIT RATING AGENCIES IN THE CAPITAL MARKETS

**TUESDAY, FEBRUARY 8, 2005**

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Committee met at 10 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

## OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing shall come to order.

Since their inception nearly a century ago, credit rating agencies have come to occupy a prominent role as gatekeepers to the capital markets. These entities wield extraordinary power in the marketplace, and their ratings affect an issuer's access to capital, the structure of transactions, and portfolio investment decisions. A high rating effectively serves as a "seal of approval" that can save an issuer millions of dollars in interest payments. Conversely, a low rating or a ratings downgrade can trigger a sell-off of an issuer's stock and a drop in its bond prices, while making future financing more expensive.

As new corporate and municipal issuers seek to access an increasingly global market and as issuers develop innovative and complex financial products, there is every reason to expect that the importance and influence of credit rating agencies will continue to grow. Given investors' reliance on these agencies, I believe that it is important for this Committee to carefully examine the industry, the ratings process, and the regulatory landscape.

In 1975, the SEC began using the designation of a "Nationally Recognized Statistical Rating Organization," or "NRSRO," for the purpose of determining the appropriate amount of capital that a broker must hold to protect against trading losses. Although the SEC initially created this designation for a narrow purpose in the "Net Capital Rule" that applies to broker-dealers, the designation now serves as a universally accepted benchmark for investment quality, and has been used in legislation, various regulations, and financial contracts.

Some contend that the NRSRO designation has evolved into a quasi-official stamp of market credibility that acts as a barrier to entry. Although there are approximately 150 credit rating firms worldwide, there are only four firms with the designation. Not surprisingly, revenues are concentrated in the firms with the designation. Moody's, S&P, and Fitch represent 95 percent of the market share. Some assert that the SEC has effectively granted these companies a franchise and that meaningful competition is nearly impossible without the designation. There seems to be a "catch–22" because a firm cannot compete nationally without the NRSRO designation, but it cannot obtain the designation without a national reputation in the first instance. Understanding the level of competition in this industry and the impact of the NRSRO designation is an important element of this Committee's inquiry.

We will also examine the SEC's role in regulating the industry. The SEC has never adopted a formal approval process or promulgated official recognition criteria for obtaining the NRSRO designation. Instead, the SEC makes determinations on a case-by-case basis that leads many to question the transparency and fairness of the entire approval process. Further, once the SEC grants the designation, it does not maintain any form of ongoing oversight. Some believe that there is a misperception in the market that NRSRO's are regulated because they initially received the SEC's stamp of approval. We will evaluate the SEC's authority and regulatory actions concerning the industry and consider whether additional oversight is necessary. In the coming months, we will ask Chairman Donaldson to appear before this Committee to address these particular issues.

Further, we will review the structure and operation of the rating agencies. Some have raised concerns regarding the transparency of the ratings process and the information that rating agencies make available to issuers and the public at-large. Typically, rating agencies do not disclose their methodologies and analysis for determining a particular rating, identify the information they reviewed in making a rating, or disclose the qualifications of the lead analyst. This lack of transparency leads some to question the reliability and credibility of ratings and whether the ratings process is too subjective. Some contend that the marketplace needs to more fully understand the reasoning behind a ratings decision and the information on which it is based.

Finally, we will address the potential for conflicts in this industry. Too often, this Committee has held hearings on industry practices where corporate insiders exploit conflicts that ultimately hurt investors. In the ratings industry, most agencies rely on payments from the issuers that they rate. Some suggest that there may be a strong incentive for ratings inflation. This situation is reminiscent of the analyst independence charges that were the focus of the Global Settlement. A second potential conflict involves the sale of consulting and advisory services by rating agencies to their ratings clients. This practice is analogous to an auditor's sale of consulting services to an audit client: A conflict that was a focal point of the Sarbanes-Oxley Act. The underlying concern is that these conflicts could undermine the independent and objective status of rating agencies and their ratings, leading investors to make important investment decisions based on compromised ratings.

To discuss these important issues with us this morning, we have a panel of leading industry participants: Ms. Kathleen Corbet, President, Standard & Poor's; Mr. Sean Egan, Managing Director, Egan-Jones Ratings Company; Mr. Micah Green, President, Bond Market Association; Mr. Yasuhiro Harada, Executive Vice President, Rating & Investment Information, Inc.; Mr. Stephen Joynt, President and Chief Executive Officer, Fitch Ratings; Mr. James Kaitz, President and Chief Executive Officer, Association for Finance Professionals; and Mr. Raymond McDaniel, Jr., President and Chief Operating Officer, Moody's Investors Services, Inc.

Each witness will have the opportunity here to make a short opening statement. Given the number of witnesses this morning, I would ask you to limit your statement to no more than 5 minutes, and I look forward to your testimony.

Senator Sarbanes.

**STATEMENT OF SENATOR PAUL S. SARBANES**

Senator SARBANES. Thank you very much, Mr. Chairman. I want to commend you for holding this hearing. During the past two Congresses, this Committee has undertaken continuous review of the securities markets and sought to respond to problems which have occurred in those markets. Today, under your leadership, we resume this very important oversight function.

Credit rating agencies have played an important role in the capital markets for almost a century by providing analytic opinions to investors on the ability and willingness of issuers to make timely payments on debt instruments over the life of those instruments. Issuers pay for the ratings in order to lower the cost of and increase their access to capital. Investors trust the agencies' impartiality and quality, and rely on these ratings. The SEC created the designation of Nationally Recognized Statistical Rating Organization, NRSRO, which it applies to only four agencies, and many institutional investors buy only debt rated by a NRSRO.

In recent years, concerns have been raised about the industry. In late 2001, the major credit rating agencies maintained an investment grade rating on Enron debt after its major financial restatements and up until 4 days before Enron's declared bankruptcy. As a result, as *Business Week* reported, there was "a barrage of criticism that raters should have uncovered the problem sooner at Enron, WorldCom, and other corporate disasters."

This subject was raised during hearings before this Committee, as well as before the Senate Governmental Affairs Committee. Section 702 of the Sarbanes-Oxley Act, a section on which Senator Bunning provided important leadership, directed the SEC to study the role and function of credit rating agencies. The SEC issued a report in compliance with that requirement and, in June 2003, published a concept release on which they have received public comments. I understand the SEC is continuing its analysis of the issues. It has not yet proposed a course of action.

Questions have been raised about the Federal regulation of credit rating agencies. James A. Kaitz, a witness today, who is President and CEO of the Association for Financial Professionals, has said, "Here we have a huge issue that has a significant impact on the U.S. economy and the global economy, and nobody seems to be paying attention."

Well, Mr. Chairman, you are paying attention and this Committee is paying attention. Today's hearing gives us an opportunity to hear testimony from the industry on issues that have been raised both in the concept release of the SEC and in the press, including: The extent of the SEC's authority to regulate, examine, or imposed requirements on Nationally Recognized Statistical Rating Organizations; whether the NRSRO recognition process should be more transparent; conflicts of interest that arise because rating agencies are paid by and sell consulting services to the issuers they rate; the influence of issuers on the ratings they receive; alleged anticompetitive processes; corporate governance and the potential for conflicts of interest when the director of a rating agency also sits on the board of an issuer that is rated; and analyst compensation. And obviously there are many others as well.

Mr. Chairman, I look forward to hearing the testimony of the witnesses this morning. You have assembled a very good panel, and I look forward to hearing testimony from the SEC and Chairman Donaldson on a future occasion.

Thank you.

Chairman SHELBY. Thank you.

Senator Sununu.

## STATEMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman. I am anxious to hear the testimony of the panel. I do not know a great deal about this industry, but anytime you have an industry where two firms comprise 80-percent market share, I think it is safe to say that there probably has not been enormous motivation or incentive for dramatic changes. And I think a lot of the issues raised by the Chairman and Ranking Member attest to that. So this will be not only an opportunity for further education of our Members, but also to understand how and why certain decisions are made at the rating agencies regarding not just firms that are out there competing in the private equity and bond markets, but also some of the recent decisions to speak out on legislation that is before this Committee.

So, I anxiously await the testimony. Thank you.

Chairman SHELBY. Senator Reed.

## STATEMENT OF SENATOR JACK REED

Senator REED. Mr. Chairman, thank you for holding these hearings, and I am, like my colleague from New Hampshire, eager to listen to the witnesses. And you have assembled a very good group of witnesses today.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Martinez.

## COMMEMTS OF SENATOR MEL MARTINEZ

Senator MARTINEZ. Thank you very much. I appreciate your holding the hearing and look forward to the witnesses' testimony. I have had a little experience in the rating world with municipal credit, but I look forward to learning more and hearing the witnesses.

Thank you.

Chairman SHELBY. Senator Dodd.

## STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman, and let me commend you and Senator Sarbanes. This is a tremendously important hearing, and you just cannot overstate the importance that these credit agencies have on capital markets. And the Good Housekeeping Seal of Approval that the SEC gives, whether intended or not, has huge implications. So this is very important, and I am very grateful to you for holding it.

Let me associate myself with your remarks and the remarks of Senator Sarbanes as well. Thank you.

Chairman SHELBY. Ms. Corbet, we will start with you, if you will sum up your testimony. All of your written testimony will be made part of the record in its entirety, if you will just sum up your top points.

**STATEMENT OF KATHLEEN A. CORBET PRESIDENT, STANDARD & POOR'S**

Ms. CORBET. Thank you. Mr. Chairman, Members of the Committee, good morning. I am Kathleen Corbet, President of Standard & Poor's, and I welcome the opportunity to appear at this hearing to discuss the important role of credit rating agencies, such as S&P Ratings Services, in the capital markets. This morning I will briefly focus my remarks on three topics: First, our ongoing initiatives to safeguard the independence, integrity, and transparency of our ratings process; second, our management of potential conflicts of interest; and, third, our support for greater transparency in the SEC's NRSRO designation process and for the reduction of regulatory barriers to entry in the credit rating industry.

As background, a credit rating is our opinion of the creditworthiness of an issuer or of a specific issue. Unlike equity analysis, a credit rating is not a recommendation to buy, hold, or sell a particular security. Credit ratings have provided benchmarks for issuers and investors around the world, facilitating efficient capital raising and the growth of new markets. S&P also publishes credit research on new markets and new asset classes; and it is through this process that there is more information, a wider array of tools for understanding credit, and far greater transparency in the marketplace today.

At S&P, independence, transparency, and quality have been the cornerstones of our business for nearly a century, and they have driven our longstanding track record of analytical excellence and effectiveness in alerting the market to both deterioration and improvements in credit quality.

The unprecedented corporate misconduct that has been revealed in recent years has resulted in constructive responses by market participants, including S&P. Many of these cases have involved issuer fraud. In Enron, for example, key personnel have expressly admitted their role in deliberately misleading S&P and other rating agencies.

While we believe that the credit rating system works effectively, we have, consistent with our tradition of self-evaluation, reviewed our ratings process from top to bottom in order to ensure that ratings are responsive to evolving market needs. We have also taken a number of actions as part of this effort, including updating our policies and procedures and aggregating them in a newly published Code of Practices and Procedures, which is publicly available on our website. Among the other measures described in my written testimony, we have added specialized forensic accounting expertise and expanded the scope of our published commentary.

We have had a longstanding commitment to ensuring that any potential conflicts of interest do not compromise our analytical independence. Our code contains a significant number of policies, procedures, and structural safeguards.

For decades, issuers have generally paid for our rating opinions, and these opinions have been published for the benefit of all investors and the public without cost.

Numerous market participants, including the great majority of witnesses before the SEC and IOSCO, as well as economists at the Federal Reserve Board, have reached the same conclusion: There is no evidence that the issuer-paid model undermines the objectivity of these ratings.

Indeed, the value of our ratings lies in their objectivity and independence; without these essential attributes, our rating opinions would cease to be credible.

As the Committee is aware, the SEC developed the NRSRO designation in 1975, and S&P Ratings Services is one of four credit rating agencies designated by the Commission. As you also know, the Commission is currently in the process of reviewing this system and considering possible changes. We support greater transparency in the designation criteria and the reduction of regulatory barriers to entry into the credit rating industry.

The Commission is also considering whether and to what extent it should engage in enhanced regulatory oversight if the designation system is retained. And as we have expressed to the Commission, we believe that it is imperative to avoid overly intrusive Government supervision of credit rating agencies, particularly supervision that may suggest a substantive role for Government in the ratings process itself.

Let me conclude by saying that independence and objectivity are critical to the effectiveness of the credit rating agencies in serving the marketplace and the investing public, and great care should be taken to ensure that the principles and the structures that have so greatly benefited the market are not compromised.

Thank you for the opportunity to participate in this hearing. I look forward to your questions, comments, and the ensuing discussion.

Chairman SHELBY. Mr. Egan.

## STATEMENT OF SEAN J. EGAN

## MANAGING DIRECTOR, EGAN-JONES RATINGS COMPANY

Mr. EGAN. Thank you. Chairman Shelby, Members of the Committee, good morning. I am Sean Egan, Managing Director of Egan-Jones Ratings Company, a credit rating firm. By way of background, I am co-founder of Egan-Jones, which was established to provide timely, accurate credit ratings to institutional investors. Our firm differs significantly from other rating agencies in that we have distinguished ourselves by providing timely, accurate ratings and we are not paid by issuers of debt, which we view as a significant conflict of interest. Instead, we are paid by approximately 400 firms consisting mainly of institutional investors and broker-dealers. We are based in Philadelphia, Pennsylvania, although we have employees throughout the world.

The rating industry is in crisis. At a time when the capital markets have become increasingly reliant on credit ratings, the rating industry is suffering from a state that is hard to characterize as anything other than dysfunctional. The problems are:

One, severe consolidation. The Department of Justice personnel referred to the industry as a "partner monopoly" since S&P and Moody's control over 90 percent of the revenues and do not compete against each other for the two ratings which are normally required. This is important. They do not compete against each other.

Chairman SHELBY. Explain.

Mr. EGAN. What I mean by that is that if S&P is brought into a transaction, Moody's is soon to follow, so they both get paid for the issuance of bonds. That is a key difference. Everyone refers to this as an oligopoly. It is not an oligopoly if you just look at 90 percent of the revenues. It is a partner monopoly.

Number two, severe conflicts of interest. Issuers' payment for ratings create conflicts of interest that are similar to those experienced by the equity research analysts.

Number three, freedom of speech defense. There is no downside to bad rating calls by the two dominant firms. Basically there is no place else for the issuers to go.

Manifestations of the flawed structure are:

Failure to warn investors about credit problems such as Enron, the California utilities, WorldCom, Global Crossing, AT&T Canada, and Parmalat. Enron was rated investment grade by the NRSRO's 4 days before bankruptcy. The California utilities were rated A minus 2 weeks before defaulting. And WorldCom was rated investment grade 3 months before filing for bankruptcy. Parmalat was rated investment grade 45 days before filing for bankruptcy.

Chairman SHELBY. What was Parmalat rated before bankruptcy?

Mr. EGAN. I think it was rated BBB minus, and I can confirm that later.

Chairman SHELBY. Who issued that rating?

Mr. EGAN. S&P. Moody's was not involved in it.

Losses from the Enron and WorldCom failures alone were in excess of $100 billion—some people have estimated it at $200 billion—thousands of jobs, and the evaporation of pensions for thousands. It is likely that some of these failures could have been avoided had the problems been identified and addressed sooner. This is basically the "nail in time saves nine" concept. Enron was left with only Dynergy as an acquirer by the time the alarm was sounded.

Another problem in the industry is under-rating credits. Firms such as Nextel, American Tower, and Tyssenkrupp were assigned credit ratings which were too low, thereby significantly increasing their cost of capital and restricting growth.

Another problem with the industry is insider trading. CitiGroup and probably other institutions were given advance information about the Enron downgrade. Additionally, S&P and Moody's request advance information about transactions and other major events which creates opportunities for insider trading. S&P analyst Rick Marano and his associates traded on confidential information relating to the acquisition of ReliaStar and American General, two insurance companies.

Another problem is investor fraud. The NRSRO firms pulled their ratings on an Allied Signal entity so Allied could repurchase the debt more cheaply. This is outrageous.

Another problem is issuers coercion, forcing issuers to pay rating fees. There is a *Washington Post* article elaborating on Hanover Re's experience.

Two other problems are punishment ratings—we have that in the municipal area—and expansion of the monopoly. S&P and Moody's are getting into corporate debt ratings, governance ratings, and also consulting.

You will hear today that the rating agencies were misled by Enron and the others. They have defenses for why they did not take action.

The first defense is basically "they did not tell us" that is, it was an issuer misdeed.

The second one is the Jack Grubman defense, that they have little incentive for not taking action since they are a relatively little portion of the overall revenue base.

The next one is the Arthur Andersen defense: Our reputation is key. We do not buy that.

The next defense is the committee approach. We refer to that as the Lemming defense.

There are a few others, too.

What we recommend in this industry is to recognize some rating firms that have succeeded in providing timely, accurate ratings.

Number two, wean the rating firms from issuer compensation. It is fine that S&P and Moody's get paid for their analysis, but the SEC should not give them their seal of approval if they have a conflict of interest.

Also, adopt the Code of Standard Practices for Participants in the Credit Rating Process issued by the ACT, AFP, and AFTE—you will hear that later today on this.

Also, prohibit rating firms from obtaining insider information.

The last thing is sever the ties between rating firm personnel and issuers and dealers. Moody's Chairman was sitting on—this is outrageous—WorldCom's board basically 6 months before the bankruptcy.

I have some additional comments, and you can refer to the written material. Thank you for your time.

Chairman SHELBY. Mr. Green.

**STATEMENT OF MICAH S. GREEN**
**PRESIDENT, BOND MARKET ASSOCIATION**

Mr. GREEN. Thank you, Chairman Shelby and Members of the Committee, for the opportunity to testify today on credit rating agencies.

My name is Micah Green. I am President of the Bond Market Association. As you know, the Association represents securities firms and banks that underwrite, distribute, and trade debt securities in the United States and internationally—a global market that is estimated at about $44 trillion today. Our efforts include outreach to retail investors as well, among other things through our family of websites. Last week, in fact, we launched a new version of our *Investinginbonds.com* website which offers a wide range of investor education information, and for the first time ever real-time bond price information—which, frankly, this Committee deserves a great deal of credit for—that is free to any user on the site. And an important element included in that investor education material is the credit rating attached to the bond.

The past 15 years have seen dramatic growth in the number of issuers and the range and complexity of fixed-income securities. The importance of credit ratings to investors and other securities market participants has increased proportionally. Rating agencies are critical to the efficient functioning of the fixed-income markets.

What credit rating agencies do is offer an opinion, known in the market as a rating, the credit risk of a bond. The credit rating process employs both quantitative and subjective judgment. Factors such as a security's yield, maturity, call features, and covenants specific to a bond can be objectively determined from the issuer's mandated disclosure. Independent analysis of an issuer's credit quality, however, involves individual judgments of professional credit analysts. It is a valuable complement to an investor's own credit analysis precisely because it is independent.

As Chairman Shelby correctly pointed out earlier, credit ratings also guide the market's pricing decisions. Bonds with lower ratings are viewed as riskier than higher-rated bonds by investors who demand a yield premium as compensation. Conversely, higher-rated bonds will offer a relatively lower yield as a reflection of their stronger credit standing.

In order for credit ratings to have credibility as a pricing guide, rating agencies must be viewed by the market as independent. Recently, regulators in the United States and in Europe have stepped up their focus on rating agencies and question the need to make changes in the current approach to regulatory oversight. In 2003, the SEC issued a concept release intended to draw a response on several rating agency-related issues.

Last year, the International Organization of Securities regulators, commonly known as IOSCO, drafted a comprehensive Code of Conduct for rating agencies. Currently, the European Commission has requested public comment on whether to develop rating agency regulation.

The Association's response to these initiatives in both the United States and in Europe is fundamentally the same. We have attached our comment letters on the subject as part of our written testimony.* While those are detailed in the written testimony, I will briefly summarize those positions.

We believe that the criteria adopted by regulators for approving designated rating agencies should be flexible enough to allow increased competition, while ensuring that designated rating agencies have the expertise to produce accurate ratings. In the United States, we favor eliminating the current requirement that a rating agency be widely recognized rather than accepted in a defined sector of the market, either by product or by geographic specialization.

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* Held in Committee files.

We believe credit rating agencies should have policies and procedures to ensure the independence of the credit rating process. In fact, the IOSCO Code of Ethics details a number of different measures that can be taken by the rating agencies to deal with many of those inherent conflicts. Again, it is about managing those conflicts. A good example of how this can be done can be seen by the Bond Market Association's own comprehensive guiding principles on research in the fixed-income marketplace. In the aftermath of the settlement in the equity marketplace, our members believed that they needed to come up with a very tough, very comprehensive way of managing those conflicts, and our guiding principles provided that.

We believe that credit rating agencies should publish their rating methodologies for various types of securities so that both issuers and users will understand the agencies' requirements and standards, and so that different rating analysts in the same agency will produce consistent ratings.

We do not believe that regulation of the credit rating process is necessary or desirable, since Government regulation would tend to result in less diversity of opinion and would be less responsive to the changing marketplace and new product developments.

We believe issuers should be given an opportunity to correct factual misstatements in rating agency reports, but not to appeal rating designations outside the rating agency. This should not be a lobbied rating agency. It should not be a subjective influence from the outside. It should be an objective independent rating.

We believe rating agencies should publish information on the historical accuracy of their rating assessments.

In conclusion, as the capital markets develop and mature globally, the need for a measured approach by regulators toward the conduct of rating agencies grows in importance. The Association does support those actions by regulators that we believe will help enhance competition among rating agencies. We do not support steps that would limit the independence of rating agencies to determine their opinions of the creditworthiness of issuers. This would make the fixed-income markets less efficient, ultimately harming investors, issuers, dealers, and regulators.

Again, thank you for the opportunity to testify. I look forward to answering any questions that you have.

Chairman SHELBY. Mr. Harada.

**STATEMENT OF YASUHIRO HARADA**
**EXECUTIVE VICE PRESIDENT,**
**RATING AND INVESTMENT INFORMATION, INC.**

Mr. HARADA. Thank you, Chairman Shelby, Ranking Member Sarbanes, and Members of the Senate Banking Committee, for your kind invitation to present testimony at today's hearing. My name is Yasuhiro Harada. I am the Executive Vice President of Rating and Investment Information, Inc., a Japanese rating company.

We are very pleased to offer our thoughts on this topic as well as some more specific information about the challenges faced by our company as we have sought to clear the hurdles necessary to become a new competitor in the U.S. market. Even though our company is the most recognized credit rating agency in Japan and the broader Asian markets, obtaining designation in the United States as a national recognized statistical rating organization has been an exercise in delay and disappointment.

R&I is a respected independent source of financial information for the overwhelming majority of United States broker-dealers and financial institutions that conduct operations in Japan. Market participants particularly appreciate that R&I calculates and publishes a default ratio based on a 27-year record which indicates the probability that an issuer that has been given a publicly released rating will fall into default within that given period of time. Our company's ratings are regularly announced and published by the leading financial electronic and print media in Japan, and in the United States as well.

In order to compete effectively in the U.S. market, a designation by the SEC as a NRSRO is a critical factor. From a procedural standpoint, the problem is that the NRSRO application process has little regulatory structure and no established timetables for agency decisionmaking. The substantive problem for us is the entry barrier presented by the SEC requirement that a new NRSRO be "nationally recognized" by the predominant users of such ratings in the United States before it can gain such a designation to enter the U.S. market. As Chairman Shelby indicated, this is a circular test. It was precisely this circular standard which the Antitrust Division of the U.S. Department of Justice singled out in 1998 as likely to preclude new competitors in this credit rating market. Moreover, concern about the lack of new competitors in this market led the Justice Department to recommend to the SEC in 1998 that NRSRO designation be specifically awarded to some foreign rating agencies.

For over a decade, our company, R&I, and its predecessors have engaged in an effort to receive NRSRO designation. In 2002, R&I submitted an amended request for NRSRO designation that was limited in scope in that R&I sshould be recognized as an NRSRO solely with respect to yen-denominated securities. Such recognition on a limited basis is considered appropriate if a rating agency can demonstrate that it possesses unique expertise in rating particular securities, or securities of a particular currency denomination.

R&I is well-qualified to contribute to the flow of information and expert analysis so valuable to U.S. investors and issuers. Therefore, the lack of progress on our company's application harms both R&I and investors. If allowed to enter the market, U.S. investors, especially institution investors such as life insurance companies, would benefit from having an additional source of proven credit analyses and U.S. issuers benefit from having more providers of rating services in the Samurai bond market.

Without the NRSRO designation, we operate at a competitive disadvantage every day under the current regulatory scheme. Until such time as a new regulatory scheme is implemented with respect to credit rating agencies, we respectfully suggest the SEC should be focusing on approving qualified NRSRO's. We encourage the Committee to advise the SEC not to neglect pending NRSRO applications nor require such applicants to await further rulemaking prior to approval.

Thank you for the opportunity to present these views.

Chairman SHELBY. Mr. Joynt.

**STATEMENT OF STEPHEN W. JOYNT**
**PRESIDENT AND CHIEF EXECUTIVE OFFICER, FITCH RATINGS**

Mr. JOYNT. Thank you, Mr. Chairman and Members of the Committee. I am pleased to be here this morning. I would like to share some brief comments on competition, regulatory recognition and oversight, and conflicts of interest.

After an ownership change and capital injection in 1989, Fitch worked continuously to build its reputation for a credit research, modeling, and analysis in the corporate finance, public finance, and securitization markets in the United States. By 1997, we were well-respected and prominently recognized for our contributions, especially in the rapidly expanding mortgage- and asset-backed markets. Subsequently, in 1997 and also in 2000, we merged with the fourth, fifth, and sixth largest NRSRO's to create the product breadth and geographic coverage demanded by today's global investors. At Fitch, we firmly believe in the power of competition. Fitch's emergence as a global full-service rating agency capable of competing with Moody's and Standard & Poor's across all products and market segments has created meaningful competition in the ratings market. Fitch's expanding business profile has enhanced innovation, forced transparency in the rating process, improved service to investors, and created price competition.

Regarding regulation, Fitch has been actively participating in a dialogue with many United States and international organizations, such as the SEC, the United Kingdom's FSA, the Committee of European Securities Regulators, and the aforementioned IOSCO committee, about the role and function of the rating agencies in the global capital markets. In September 2002, IOSCO, with the important involvement of the SEC, published its Statement of Principles, and in 2004 also published its Code of Conduct Fundamentals for Credit Rating Agencies.

Fitch supports the four high-level principles outlined by IOSCO and presented in the code. These four principles include transparency, symmetry of information to all market participants, independence, and freedom from conflict of interest. We believe that our present operating policies and practices exemplify the principles of the IOSCO code, and we expect to embody them clearly in a Fitch Code of Conduct.

Regarding the U.S. recognition structure, we believe there is value in the NRSRO system that assures recognized organizations possess the competence to develop accurate and reliable ratings. Many investment practices and guidelines interwoven in the fabric of the capital markets reference this system. However, this recognition is only the beginning as one's market reputation and usefulness to investors must be built over time. In fact, after 15 years of effort, only this year has Fitch Ratings been recognized by several global bond indexes.

Given the importance of credit ratings in the financial markets, Fitch concurs that there is a strong need for credit rating agencies to maintain high standards, and we do. Fitch culture emphasizes the importance of integrity and independence as critical foundations of our most important asset—our reputation. Fitch goes to great efforts to assure that our receipt of fees from issuers does not affect or impair the objectivity of our ratings. Our analyst compensation philosophy reflects quality of effort and individual accomplishment in research and ratings. Individual company fees, revenue production, and individual department profitability do not factor into analyst compensation, and analysts may not own securities in companies they rate.

We are aware of the potential for conflict that is inherent in our business model, and we do our utmost to maintain our objectivity and preserve our reputation in world markets. For each of these themes, we are, of course, open to all ideas that help us improve the quality of our product and the business practices and profile of our company.

Thank you.

Chairman SHELBY. Mr. Kaitz.

**STATEMENT OF JAMES A. KAITZ PRESIDENT AND CHIEF EXECUTIVE OFFICER, ASSOCIATION FOR FINANCIAL PROFESSIONALS**

Mr. KAITZ. Good morning. I am Jim Kaitz, President and CEO of the Association for Financial Professionals. AFP represents more than 14,000 finance and treasury professionals representing more than 5,000 organizations. Our members are responsible for issuing short- and long-term debt and managing corporate cash and pension assets for their organizations.

AFP believes that the credit rating agencies and investor confidence in the ratings they issue are vital to the efficient operation of global capital markets. Yet as evidenced by AFP's research, confidence in rating agencies and their ratings has diminished over the past few years.

Why is reforming the credit rating system so important? Along with the SEC and other regulators that have incorporated the NRSRO designation into their rules, institutional and individual investors have long relied on credit ratings when purchasing individual corporate and municipal bonds. Further, nearly every mutual fund manager that individuals and institutional investors have entrusted with over $8 trillion relies to some degree on the ratings of nationally recognized agencies. Rating actions on corporate debt also have an indirect but sizeable impact on the stock prices of rated companies.

Debt issuers rely on the credit rating agencies to issue ratings that accurately reflect the company's creditworthiness. These ratings determine the conditions under which a company can raise capital to maintain and grow their business.

Finally, while credit rating agencies have long played a significant role in the operation of capital markets, the Administration's recent single-employer pension reform proposal would tie pension funding and Pension Benefit Guaranty Corporation premiums to a plan sponsor's financial condition as determined by existing credit ratings. In some cases, plan sponsors would be prohibited from increasing benefits or making lump sum payments based on their credit rating and funded status. Such a proposal would further codify the NRSRO designation and increase the already significant market power of the rating agencies.

More than 10 years after it first began examining the role and regulation of credit rating agencies and despite the increased reliance on credit ratings, the Securities and Exchange Commission has not taken any meaningful action to address the concerns of issuers and investors. These concerns include questions about the credibility and reliability of credit ratings and conflicts of interest and potential abusive practices in the ratings process. Chairman Shelby and Members of the Committee, these issues are far too important for the SEC to remain silent while investors and regulators worldwide wait for it to take action.

Now I would like to briefly outline some of our concerns.

When the SEC recognized the first Nationally Recognized Statistical Rating Organization in 1975 without outlining the criteria by which others could be recognized, it, in effect, created an artificial barrier to entry to the credit ratings market. This barrier has led to a concentration of market power with the recognized rating agencies and a lack of competition and innovation in the credit market. Only the SEC can remove the artificial barrier to competition it has created. Therefore, we strongly recommend that the SEC maintain the NRSRO designation and clearly articulate the process by which qualified credit rating agencies can attain the NRSRO designation.

The SEC must also take an active role in the ongoing oversight of the rating agencies to ensure that they continue to merit NRSRO status.

The Commission further empowered the rating agencies when it exempted them from Regulation Fair Disclosure. Through this exemption, the rating agencies have access to nonpublic information about the companies they rate. The Commission has done nothing to ensure that those who are granted this powerful exemption do not use the nonpublic information inappropriately. The SEC must require that NRSRO's have policies in place to protect this valuable and privileged information. This must be part of the SEC's ongoing oversight of the rating agencies.

As highlighted in some recent media reports, rating agencies continue to promulgate unsolicited ratings which are issued without the benefit of access to company management or nonpublic information about the issuer. The resulting ratings are often not an accurate reflection of an organization's financial condition. Credit ratings are critical to an organization's ability to issue debt, and issuers often feel compelled to participate in the rating process and pay for the rating that was never solicited. The potential for abuse of these unsolicited ratings by the rating agencies must be addressed by the SEC.

Finally, an NRSRO is also in a position to compel companies to purchase ancillary services. These ancillary services include ratings evaluations and corporate governance reviews. Further, the revenue derived from these services has the potential to taint the objectivity of the ratings. You need look no further than the equity research and audit professions to understand why these potential abusive practices and conflicts of interest must be addressed by the SEC.

Chairman Shelby and Members of the Committee, we strongly recommend that you hold the SEC accountable on the issues that have been raised here today. With credit ratings being so important to investors in this country, Congress should also not allow the SEC to cede oversight of the agencies to an organization outside the United States that has no binding authority, including oversight authority, of the rating companies.

Finally, it has been 10 years since the SEC has considered regulating credit rating agencies, and as reported in today's *Washington Post,* we find it incredible that they have now concluded they do not have oversight authority over the rating agencies.

In conclusion, Mr. Chairman, AFP commends you and the Committee for pursuing this issue.

Chairman SHELBY. Mr. McDaniel.

**STATEMENT OF RAYMOND W. McDANIEL, JR.**

**PRESIDENT, MOODY'S INVESTORS SERVICE**

Mr. MCDANIEL. Good morning, and thank you, Mr. Chairman, Senator Sarbanes, and all the Members of the Committee for inviting Moody's to participate in today's hearing.

Moody's offers forward-looking credit rating opinions and credit research about entities active in the debt capital markets globally. As the oldest and one of the most established credit rating agencies, we have more than 1,000 analysts in 18 countries worldwide. Moody's distributes our opinions broadly and free of charge to investors in the form of credit ratings. We also public credit research about the debt obligations and issuers we rate. We sell this research to about 3,000 institutional investors.

Our opinions are communicated to the market through a symbol system originated almost 100 years ago. The system ranks relative credit risk on a scale with 9 broad letter categories from Aaa to C. Most of the letter categories are further refined with numbers, 1 through 3. Overall our ratings have consistently done a good job in predicting the relative credit risk of debt securities and debt issuers. Ratings are not pass/fail assessments of an entity's future performance or performance guarantees, investment recommendations, or statements of fact; rather, Moody's ratings intend to predict the relative probability that debt obligations will be repaid on a full and timely basis with the probability declining at each lower level in the rating scale. The attributes of ratings as offered by major rating agencies include their predictive content, public availability, and free distribution. The combination of these attributes has encouraged use by diverse groups, including issuers, intermediaries, parties to financial contracts, institutional investors, and regulators.

For these users, ratings must meet demands for accuracy, stability, and timeliness. Accuracy is measured by the predictive content of the ratings, the ability of the rating system to properly rank order the relative riskiness of credit from low to high. Moody's publishes on our website a quarterly report card of the accuracy of our ratings reaching back 20 years. Moody's rating stability is an important attribute because ratings volatility has consequences for, among other things, the composition of investment portfolios and capital adequacy calculations. As a result, rating reversals, a rating downgraded followed shortly by an upgrade, or vice versa, may add unnecessary volatility and costs. It is, therefore, important for Moody's to manage its ratings so that ratings are changed only after judicious deliberation and in response to changes in fundamental creditworthiness, not transitory events.

In order to balance the market's demand for accuracy and stability with its demand for timeliness, Moody's uses additional public signals called watchlists and outlooks through which we communicate our opinion on possible trends in future creditworthiness. Rating outlooks and the watchlists permit rating agencies to signal developing trends and preliminary views without disrupting markets. In an effort to learn from our mistakes and to keep pace with complex credit markets, we continue to augment our analytical process. Some of the initiatives we have instituted include formation of analytical specialist teams in areas such as accounting and financial disclosure; mandatory professional development programs; introduction of new credit monitoring tools; the expansion of our centralized credit policy function; and the appointment of chief credit officers.

Most of Moody's revenue comes from fees paid by debt issuers. Issuers request and pay for ratings from us because of the broad marketability of their bonds that ratings facilitate. Issuers pay these fees rather than investors because we broadly distribute our ratings to all investors simultaneously free of charge. The issuer-payment business model has potential conflicts of interest, as does a subscription-based business that some firms use as an alternative. The critical question is not which model is used, but whether potential conflicts of interest are prudently and effectively managed and disclosed. In Moody's case, we have a range of policies and procedures in place to achieve this goal, including that rating decisions must be taken by a committee and not by an individual analyst; that analyst compensation must not related in any way to the fees received from the issuers they evaluate; and that analysts may not own securities in the issuers they rate.

Finally, Mr. Chairman, turning to the regulatory environment, over the past 3 years much attention has been focused on the global financial services industry, including rating agencies. To the extent that here in the United States the NRSRO designation is seen to limit competition, Moody's supports its discontinuation. Moody's has consistently supported competition in the industry and eliminating barriers to entry caused by, for example, vague or difficult to achieve recognition standards. A healthy industry structure is one in which the role of natural economic forces is conspicuous and where competition is based on performance quality to promote the objectives of market efficiency and investor protection.

The obligation to assure that the U.S. financial market remains among the fairest and most transparent in the world is one that all market participants should share. I look forward to answering any questions the Committee may have. Thank you.

Chairman SHELBY. Thank you.

Ms. Corbet, Mr. Joynt, and Mr. McDaniel, I will pose this first question to the three of you. About 2 years ago, this Committee held a hearing on the Global Settlement and examined potential conflicts of interest with research analysts. Essentially, analysts were being paid to tout a banking client's stock. Some contend that a similar conflict of interest exists in the credit ratings industry.

How do you respond to concerns that this conflict compromises the independent and objective analysis of the rating agencies?

We will start with you, Ms. Corbet.

Ms. CORBET. Thank you, Mr. Chairman——

Chairman SHELBY. How do you defend that, in other words?

Ms. CORBET. Sure. The conflicts of interest are indeed ones that we must be vigilant in terms of managing, and similar to the provisions in our Code of Policies and Procedures, which are similar to those raised by Mr. McDaniel, we also would add that analysts are not engaged in any commercial or business matters with respect to ratings. In addition to strict procedures prohibiting trading and securities ownership in the companies that they rate, we also prohibit any board representation by analysts.

Chairman SHELBY. Mr. Joynt.

Mr. JOYNT. As I mentioned, I think the culture of our company is probably the first line of defense, instructing all our employees and our analysts and building over time on the importance of integrity and independence.

As was mentioned earlier, but I think it is a positive, the ratings are done by a committee and not by individuals, so it is harder for individuals to sway the rating by themselves, although I would concede that a primary analyst and a secondary analyst that lead those committees would have more knowledge and information and I suppose could try to have undue influence, and also compensation of analysts, which is probably the most direct issue. From the beginning of our development we have focused all compensation away from any kind of revenue production activity on the part of the analyst. I think those are all important ingredients.

Chairman SHELBY. What about serving on boards that you rate?

Mr. JOYNT. None of our analysts or executives nor do I serve on any boards.

Chairman SHELBY. Mr. McDaniel.

Mr. MCDANIEL. In addition to the actions that were listed by Ms. Corbet and Mr. Joynt, Moody's has published a set of core principles which guide our behavior. The core principles include the independence of the analyst from the issuer, that there is not permitted to be any link to the analyst compensation from either the ratings or the fees received from the issuers that they are responsible for reviewing.

Chairman SHELBY. What about perception? You say link, but what about perception?

Mr. MCDANIEL. We have publicly disclosed that the analyst compensation is unrelated to the issuers that they rate. That is how we try to manage the perception issue, sir.

In addition, commercial considerations with respect to issuers are prohibited from being discussed or considered in rating committees. We have a codification of all of our methodologies which are available publicly, and there is a requirement that those methodologies be followed by the rating committees. We have a rating compliance unit. We publish our quarterly ratings performance, which is available in verifiable formats. And we avoid concentration of fees from issuers so that no one issuer is material to Moody's commercial interests.

Chairman SHELBY. A second question to all three of you. Collectively, Moody's, S&P, and Fitch account for about 95 percent of the market share in the ratings business. Some people contend that by designating these firms as NRSRO's, the SEC has granted them a franchise that deters new competitors.

How does this market concentration that has developed—discuss whether it is good thing for investors, and how would you propose to increase competition, if you would? We will start with you, Mr. McDaniel, and go back.

Mr. MCDANIEL. As I mentioned——

Chairman SHELBY. Ninety-five percent is a lot of concentration.

Mr. MCDANIEL. As I mentioned in my opening, Senator, this is an important issue. We recognize that. I believe that there are natural economic forces that are important in guiding the structure of this industry. However, the issue is very distractive if it is not dealt with, and I believe that one of two solutions should be pursued: Either the elimination of the national recognition designation as currently used, or the opening of the industry to more nationally recognized agencies.

Chairman SHELBY. Okay. Mr. Egan, do you have any comment here?

Mr. EGAN. I do not think it is a natural monopoly or oligopoly. I think it is far from it. The case of the equity research analysts, you had some 20-odd analysts following AT&T as Jack Grubman, who had the most bullish opinion, and the equity research firms were fined $1.4 billion for their poor behavior.

I think that what has happened is that there are some natural ways that the two major firms are able to maintain and extend their monopoly. It is very interesting that the poor investment banker that would try to recommend any other rating firm to rate securities would find it very difficult to go in front of S&P and Moody's the next time they come around. As I said before, there is no problem with these firms getting paid by the issuers. It is just that the SEC should not be in the business of encouraging a basic conflict of interest.

Chairman SHELBY. Mr. Kaitz.

Mr. KAITZ. Senator, one of the recommendations I heard from Mr. McDaniel was to eliminate the NRSRO designation. I would suggest if you do that, you have eliminated an artificial barrier to competition, and you have erected a permanent barrier to competition. As we have all discussed, the ratings are embedded in banking law, insurance, mutual funds, and potentially into the pension area. So that would create a permanent barrier to competition from any other organizations.

Chairman SHELBY. Three with a stamp of approval, and no one else, right?

Mr. KAITZ. Yes, sir.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

I just want to underscore that last point that was being made. Since 1931, the Federal Reserve Board, the Comptroller of the Currency, and Federal and State laws have regulated the debt held by banks and other financial institutions using credit ratings assigned to the debt. Pension funds, banks, and money market funds are barred from buying debt issues that carry ratings below a certain level. So the ratings have in a sense kind of a life-and-death impact. I think it is pretty clear.

Let me ask the people at the table just a very general question. Does everyone think that there is a problem here that needs to be addressed? Or do some at the table think there is really not a problem and the situation is pretty good, and whatever there is, we are fixing it up okay? How many think that there is a problem that really needs to be dealt with?

Mr. EGAN. I think there is a huge problem.

Mr. GREEN. Senator Sarbanes, I think there is a problem of competition, and I think expanding the scope of designated rating agencies would be a very good thing for the marketplace. The one thing we have not talked about and that I think was implied by Mr. Harada, the marketplace has become inherently global now. There has been growth of the capital markets in Asia, tremendous growth most recently with the development of a comprehensive European economy. That really does raise the opportunity for new entrants into the marketplace, and the SEC really should review the designation process to be more open.

But make no mistake about it. Opening up——

Senator SARBANES. How do I get some assurance that the process, even if more people are participating in it, is going to be objective? Gretchen Morgenson had an article in *The New York Times* on Sunday entitled: "Wanted, credit ratings, objective ones, please." How do I get some assurance—and now the credit—as I understand it, the credit rating agencies are now beginning to do consulting for the companies with respect to whom they issue ratings. Is that correct? Mr. McDaniel, are you doing consulting?

Mr. MCDANIEL. No. Moody's does not engage in consulting. There is one activity which we believe is part of the core rating process called a rating assessment service, where we answer hypothetical questions that companies have for a fee. That is the only activity we engage in that might be considered consulting. It is less than 1 percent of our business and will remain so.

Senator SARBANES. Mr. Joynt.

Mr. JOYNT. We also would only have a few cases of rating assessments, but no broad consulting practice.

Senator SARBANES. Do you have a narrow consulting practice?

Mr. JOYNT. Pardon me?

Senator SARBANES. Do you have a narrow consulting practice?

[Laughter.]

Mr. JOYNT. No. However, I might add that our parent company has recently acquired a company called Algorithmics, which is an enterprise risk management, and they are a financial software company and often would consult with people on the installation of the financial software.

Senator SARBANES. Ms. Corbet.

Ms. CORBET. Senator, within our rating services practice, we have no consulting or advisory business. Indeed, we similarly have a ratings evaluation service that we provide to issuers at their request.

Senator SARBANES. Well, am I to draw from that is that these concerns some are raising that there is consulting going on are without any foundation or basis, Mr. Egan?

Mr. EGAN. No. It is an extension of the monopoly. Fannie Mae had a corporate governance rating from S&P of 9 on a scale of 1 to 10 up until just a week ago. Basically they said Fannie Mae was fantastic, and we all found out that it was not. What were the problems? They had the same Chairman and CEO. They had accounting problems, CFO problems, evaluation of securities, regulatory problems, on and on and on. And it is a 9 on a scale of 1 to 10, 10 being the best.

Basically these firms are using their SEC-sanctioned monopoly in one area, and extending it to the other areas, and there is no check on them.

By the way, the conflicts cannot be managed. They simply cannot be managed. If I am selling a company and I am representing Company A and instead I am getting paid by Company B, which is buying Company A, I cannot say, well, I am going to set up barriers or Chinese walls and somehow manage that. That does not work.

If I am hiring a litigator and I find out that the litigator is paid by the other side, you have a basic conflict there.

The Philadelphia Eagles just lost the Super Bowl. If my son found out that Philadelphia coach Andy Reid was paid by the New England Patriots, he would hit the roof. You know, it does not work.

Senator SARBANES. That is a very understandable example.

[Laughter.]

Mr. EGAN. Thank you.

Senator SARBANES. I do not understand why you would get any consulting fees. The reason I am concerned about this, over a period of 25 years consulting services have replaced audits as the principle source of accounting firms' revenues. Now, the legislation we passed, as you know, precluded certain consulting services altogether, set up a rigorous process for any others that they might want to engage the auditor for. There is one other thing, just a little thing that does not amount to much. You said you limit it to 1 percent.

In 1977, core auditing and accounting fees accounted for 70 percent of revenues of the auditing firms while management advisory services accounted for just 12 percent. By 1998, a little more than 20 years later, the pattern had been reversed. Just 34 percent of revenues came from auditing and accounting services and over 50 percent from management advisory services.

I do not understand why you should do any consulting services if you are doing the rating. I mean, we have other issues here to discuss. Who pays you to do the ratings? How do you do it? I see I have used up my time. I want to take just this one narrow area. Why should you get any fees from consulting services?

Ms. CORBET. Senator, if I may, the ratings evaluation service that we provide to issuers at their request is truly an extension of the ratings process. It helps a company evaluate certain financial decisions that they may take with respect to potential acquisitions, with respect to financial policy in terms of dividend or share buyback policies. And so, someone described it as a what-if scenario in terms of what the issuers may undertake, and we provide that evaluation for them in this particular service. It is truly an extension of the ratings process.

Senator SARBANES. Mr. Harada.

Mr. HARADA. Thank you very much. R&I does not carry out any consulting business which is closely linked to the rating activities. We strictly refrain from those kind of activities to keep the independence of the rating performance.

Senator SARBANES. Mr. Joynt.

Mr. JOYNT. The alternative to receiving fees on this kind of consulting assignment for rating assessments would be to charge all issuers more, spread across the advice, because essentially we have free-flow information back and forth from the analytical committees to the issuers. They come in and present their financial information. We describe our process, our standards, their expectations. And so there is a regular dialogue. So the identification of specific dialogue and assigning a consulting fee to that could be replaced by just higher fees.

Senator SARBANES. It would get you out of this potential conflict, would it not?

Mr. JOYNT. I do not think it would because the dialogue would continue anyway. I think part of what we want to do is have a transparent dialogue with everyone in the market, including all issuers, investors, and so describing our rating process I think is important.

Senator SARBANES. Mr. Kaitz.

Mr. KAITZ. Senator, all of these are commendable, except there is no competition. Where else are these companies going to go other than Moody's, S&P, and Fitch? So in a perfect world, maybe consulting would be fine, but this is hardly a perfect world when it comes to the competitive nature of this business.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Sununu.

Senator SUNUNU. I am amazed to see an industry with three-firm concentration of 95 percent where there is a regulatory status conferred by the Government that bars all entrants, actually coming before the Committee and saying, you know, if we are not allowed to engage in any line of business we want, we are going to raise prices. But I have another line of questioning I want to engage in, and maybe that will just be food for thought for further questions for the rest of the Committee Members.

Ms. Corbet, less than a year ago, one of your analysts, Michael DeStefano, suggested that the GSE legislation we were considering before this Committee would cause S&P to reconsider the AAA rating it had for GSE unsecured debt. I read this account to mean that if we included receivership provision in that bill, then you would basically downgrade the credit rating of the GSE's. What was the process that S&P used to arrive at that conclusion?

Ms. CORBET. First of all, Senator, if I may, let me start by saying that Standard & Poor's does not advocate positions on any legislation. And indeed in that particular case that you reference, consistent with our published commentary on the GSE's, which dates back to the early 1980's, we have always stated that any change in the relationship between the GSE's and the Government would necessarily be an important factor in our ongoing ratings assessment.

Indeed, back in March, I believe, a statement was made by our senior analyst that our analysis of any legislation would be to examine each individual proposal as well as the legislation as a whole. We have never said that any specific factor within proposed legislation would result in an automatic downgrade.

Senator SUNUNU. What data was the analyst using to make the statement he made?

Ms. CORBET. He was using and referencing our published commentary on our position on the GSE's. We have published commentary during the course of 2004, in January, in May, and most recently in December 2004. And that commentary has been consistent.

Senator SUNUNU. Is it still S&P's position then the legislation being considered would result in a weakening of the credit rating?

Ms. CORBET. In May 2004, our ratings committee concluded that we no longer had the highest degree of confidence of Government support and determined that our ratings on GSE's would reflect both the financial strength of the GSE's and the degree of confidence in Government support. And based on this combined criteria, not simply the Government support criteria, we affirmed the GSE ratings at AAA.

Senator SUNUNU. You say that it is not your intention or your policy to have analysts comment on or lobby for or against specific pieces of legislation. But do not you think weighing in with a perspective on how this affects the credit of a particular company is a de facto position on legislation?

Ms. CORBET. As I said, we do not advocate positions on any legislation. What we did do is reaffirm our position that we have taken on the GSE's for many years, and we did comment on that in March.

Senator SUNUNU. Mr. McDaniel, you talked about volatility and your concerns about volatility in issuing credit ratings, that if they moved back and forth, that would have undesirable consequences, and I certainly would not disagree with that.

Do you think that is worse than the alternative, which is to lag behind, as was obviously the case in Enron and MCI, and shift position or in this case downgrade credit too slowly and as a result not give markets a clear indication of what might be happening at a company?

Mr. MCDANIEL. The situations such as Enron are clearly situations that Moody's was unhappy with. We do not benefit, we do not have our reputation enhanced by having investment grade companies of the size of an Enron default. That obviously was a matter of serious concern for us.

We do believe that timeliness is extremely important to the rating process. As I said in my opening statement, we try to balance the need for stability with the need for timeliness by using additional signals in the marketplace, the signals being watchlists and outlooks, which are more forward-looking in terms of potential credit trends. And we think that those are important elements of the management of the rating system to provide responses to both demands for stability and for timeliness.

Senator SUNUNU. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Ms. Corbet, I think Senator Sununu touched on this question, which is comments made by S&P analysts about the possible legislation affecting the Government Sponsored Enterprises. In fact, I think a quote from a report by Mr. DeStefano and Ms. Wagner would be, "The slightest evidence that Congress would in any way agree to lessen its authority or cede it to others would in itself necessitate a rethinking of how much confidence bondholders should have that their interests would be taken into consideration in the case of a failed GSE." And I think your response was you do not comment on legislation, but can you comment on that quote?

Ms. CORBET. Sure, happy to. Thank you, Senator.

Indeed, again, as that quote indicated, and as other published criteria about our ratings opinion on the GSE's indicted we take into consideration all and each factor in any legislation, whether proposed or actual legislation, to determine whether or not it would result in any change in our ratings opinion.

Indeed, we furthermore stated—and this is most recently—in our publication in December 2004 that, whatever the course of any legislative change in the relationship between the GSE's and the Government, whatever change it may take, our analysts consider the credit implications and will be responsive to the intent of Congress.

Senator REED. Thank you. I think we all recognize why this is an important issue since we are actually contemplating changes, which you apparently will take into consideration.

Mr. Joynt, Fitch Ratings, do you have a position with respect to this issue of potential changes with respect to issues like receivership and others?

Mr. JOYNT. We would. Actually, we follow the same credits. We have ratings on the GSE's, their mortgage securities as well as their unsecured obligations and preferred stock. We would have offered our opinion around that same time also, focused on the credit impact of whatever the change might be.

Senator REED. Again, this may be from popular reporting, but the impression that I received was that you would not necessarily make changes based upon statutory changes. Is that fair?

Mr. JOYNT. I think that was the conclusion that we presented, yes, that at that time we did not see the impact. We see the potential, and it is, of course, a complicated set of legislation and influences.

Senator REED. And, Ms. Corbet, is that a fair summary of where you are today, that you would not necessarily make changes but you would look very carefully at what we did?

Ms. CORBET. That is correct, Senator.

Senator REED. And just for the sake of completeness, Mr. McDaniel, Moody's position on this issue of statutory changes affecting GSE's?

Mr. MCDANIEL. We do not believe that the proposed legislation would have an effect on our credit rating opinion of the GSE's.

Senator REED. Thank you very much.

Mr. Green, again, because we are very near to considering legislation—in fact, I think we are having a hearing later this week—what would be the impact from an economic standpoint across the economy as a whole if, in fact, there was a downgrade of the GSE's based upon statutory changes or based upon their performance in the marketplace, or a combination?

Mr. GREEN. Senator Reed, as you have heard, there is not necessarily agreement that there would be a downgrade. But obviously with the amount of securities outstanding by the GSE's directly and through their mortgage portfolio as well, any question as to their creditworthiness would have a significant impact on the marketplace. And I would add it is a marketplace that is vastly global in nature with investors of differing degrees of knowledge and understanding, so they would look to the credit rating as a very key element of information with which to make an investment decision.

To the extent that any business practice, legislative or regulatory activity would affect their credit rating, because of the amount of debt outstanding, it would have a market effect.

Senator REED. Thank you very much.

Does anyone else want to generally comment on this line of questioning? Mr. Egan.

Mr. EGAN. From our perspective, neither Fannie Mae nor Freddie Mac are AAA-rated credits. They are far from a AAA. If you speak to anybody in the Government, they will not give you the confidence that there is the full faith and credit of the U.S. Government behind them, number one. Number two, they have 2 percent and possibly even less than 2 percent equity to assets, and the typical A or A plus-rated bank has 8 percent.

So we have told our clients and will continue to tell our clients that these are not AAA-rated credits, we do not care what our competitors say. Some people claim the Government will step in. Yes, they might step in, but that will be for the new capital. It is not for the existing capital. It would be like the airlines.

We think right now you have an untenable situation with Fannie Mae and Freddie Mac. Something has to be done and done quickly. Really probably the best model is the Sallie Maes. Sallie Mae is doing very well. It does not have any support, either implied or not implied, from the U.S. Government, and that is the right way to look at it. But get there quickly. You know, the lesson learned from Enron and WorldCom and all these other failures is you have to address the problem quickly. You do not wait until everybody panics. We have had our rating, maintained it for 2 years. You know, people are adjusting, our clients and others are adjusting to it. But do not keep up this falsehood that they are AAA-rated because they are not. And if they continue to grow, it creates a bigger problem in another 2 years. So address it as quickly as you possibly can.

Senator REED. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Bunning.

**STATEMENT OF SENATOR JIM BUNNING**

Senator BUNNING. I just want to ask a general question since I have had some experience in this business since 1961. Is there anyone at the table currently rating credit that has a relationship with the corporation they are rating and/or any kind of fiduciary responsibility other than independent credit rating?

Mr. EGAN. At Egan-Jones, we do not sit on any board, serve on any committees. It is public knowledge that in the case of Moody's, Clifford Alexander, the ex-chairman——

Senator BUNNING. I will let Moody's speak for itself.

Mr. EGAN. Okay.

Ms. CORBET. As my earlier testimony indicated, we prohibit analysts from sitting on any corporate boards.

Senator BUNNING. For how long has that been happening?

Ms. CORBET. It has been as long as I know, but we have codified that in our policies and procedures that are publicly available.

Senator BUNNING. Is that just recently, or has that been in the past 30 years?

Ms. CORBET. I can only speak for the period of time that I have been involved at S&P, and I know that since that time, and even before that, it has been our policy.

Senator BUNNING. How long has that been?

Ms. CORBET. I joined Standard & Poor's in April of last year.

Senator BUNNING. How about officers of your company?

Ms. CORBET. In terms of myself, I do not participate in the ratings process, but I do sit on the board of a university.

Senator BUNNING. No, no, no. How about officers of your company that are involved with other companies?

Ms. CORBET. There are no officers of the company that are involved in the ratings process who sit on any issuer or any public board that issues debt.

Senator BUNNING. You are missing the point. Do you have any officers of Standard & Poor's that sit on any other boards of any other companies? Not that are involved in the rating system.

Ms. CORBET. We do not have any officers at Standard & Poor's, that I am aware of, that sit on any public boards.

Senator BUNNING. At McGraw-Hill?

Ms. CORBET. At McGraw-Hill, we are part of McGraw-Hill. Standard & Poor's is a division of McGraw-Hill, and there are members of that board of directors——

Senator BUNNING. Joint.

Ms. CORBET. Excuse me?

Senator BUNNING. They are joint board of directors.

Ms. CORBET. They are not joint board of directors. They are directors of McGraw-Hill Companies.

Senator BUNNING. And Standard & Poor's?

Ms. CORBET. Standard & Poor's is a division of the McGraw-Hill Companies.

Senator BUNNING. Well, okay. It is publicly held.

Does anyone else have anything to say about this?

Mr. MCDANIEL. For Moody's, employees at Moody's do not sit on the boards of any rated companies. We do have members of the Moody's——

Senator BUNNING. Now. And how long has that been?

Mr. MCDANIEL. I believe that is an accurate statement through our history.

Senator BUNNING. Through your history.

Mr. MCDANIEL. I would have to go back and confirm that.

Senator BUNNING. Mr. Joynt.

Mr. JOYNT. Since I have been involved with Fitch, 1989, none of the analytical people, whatever level, have been involved on any public boards. I am not sure it was a written requirement, but it has certainly been our practice and continues to be our practice.

Senator BUNNING. In the Enron case, are the two on the ends the Enron rating people of the debt?

Ms. CORBET. We did rate Enron.

Mr. MCDANIEL. Moody's rated Enron, yes.

Senator BUNNING. Moody's and S&P.

Mr. JOYNT. Fitch did as well.

Senator BUNNING. Fitch did as well.

Mr. EGAN. And Egan-Jones.

Senator BUNNING. And Egan-Jones. What was the first time that you notified the public that there was a problem?

Mr. EGAN. We had it listed as part of our——

Senator BUNNING. No, the three people that are rating them——

Senator HAGEL. He rated them, too.

Senator BUNNING. Oh, I apologize. Go right ahead.

Mr. EGAN. It is in our written testimony.

Senator BUNNING. I have three meetings today, so the written testimony did not get read.

Mr. EGAN. By the way, as far as that last question, you should ask it very carefully and you are not. These people are deferring it. You want to ask: Are there any directors, officers, or anybody affiliated with the rating firm, do they serve on any other corporations?

Senator BUNNING. That is exactly the question I asked.

Mr. EGAN. Well, it was not answered that way.

Senator BUNNING. You mean I was deceived in the answer?

Mr. EGAN. You may want a written request because you did not get the answer that——

Senator BUNNING. Well, that was my question.

Mr. EGAN. Okay. It was not answered accurately. They misunderstood the question.

Senator BUNNING. Well, speak up, Mr. Egan, if you know others that are then.

Mr. EGAN. Well, it is public knowledge that the chairman—and they make the distinction between credit officers versus chairmen. The Chairman of Moody's, Clifford Alexander, sat on the board of WorldCom. And he sat on the predecessor board, MCI. Now it is back to the MCI name, but it was MCI, then WorldCom, because WorldCom acquired MCI. And Clifford Alexander was on the board for about 8 years, resigned probably about 9 or 12 months before it went bankrupt. He was an insider's insider. He was one of the three people on the nominating committee. And so they answered the question there is no rating officer or credit officer. That is true. But, you have to ask a broader question.

The second point is that the prior President of Moody's current chairman, served on the board of the NASD. The NASD overlooks all the broker-dealers. That is a cozy relationship. Also, the chairman sat on Wyeth, and I think there is another corporation. It is part of the writeup in *The Washington Post* as of November of last year. But that question was not answered. I do not know if

McGraw-Hill directors or chairmen sit on any other boards, but that would not be unusual. But that question was not answered.

Senator BUNNING. I will get my second round in then. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Stabenow.

**STATEMENT OF SENATOR DEBBIE STABENOW**

Senator STABENOW. Thank you, Mr. Chairman, and thank you to each of you for being here. It is a very important topic.

I would like to go back to the catch–22 that was talked about earlier today. There would appear to be a significant hurdle to many firms who are seeking the NRSRO status, and I would like to talk more about that. The fact that a firm cannot be nationally recognized until they have had wide acceptance in the market but cannot get wide acceptance in the market until they are nationally recognized places incredible hurdles in the path of qualified firms. Of course, since the SEC issues the NRSRO designation, it has taken on a quasi-governmental stamp of approval in this process.

So my question would be: How do you feel, could you speak about the SEC issuing guidance in terms of the designation process? What would the standards look like to achieve status? What would the provisions look like from your perspective that would address this obvious catch-22? I would be happy to have each of you answer that. Yes, we will start here.

Mr. MCDANIEL. From Moody's perspective, I think there are probably several solutions to the question that you pose. We certainly support greater transparency in the recognition process. We support competition in the industry. And we think that transparency in the standards necessary to become an NRSRO will invite more competition, and that will contribute to, in our opinion, a healthy industry structure.

Senator STABENOW. Get a little more specific for me, if you would. What does that look like?

Mr. MCDANIEL. The SEC has in the past identified criteria that it felt were relevant to national recognition, and I think that those criteria, if they were used formally, would certainly add to the transparency of the process. But one of the things that gets away from the chicken and egg or catch-22 problem that you have identified is whether or not, in fact, national recognition is necessary or whether there are other more limited forms of recognition or a lower hurdle for recognition, in fact, that would open the industry to competition. And there is some precedent for this historically where smaller agencies were nationally recognized for their particular industry expertise.

Mr. KAITZ. Senator, I again would reiterate that if you eliminate that NRSRO designation without any SEC involvement, you erect a permanent barrier to competition. AFP has laid out with our counterparts in Britain and in France a code of standard practice in the credit rating process that addresses the regulatory issues we believe the SEC needs to address. But I think just for a quick answer, we need to have credible and reliable ratings, and that really needs to be the criteria by which they start to look at rating agencies.

Again, we have laid this all out in our standard code of practice, and we think it is critically important that the SEC do this.

Senator STABENOW. Thank you.

Mr. JOYNT. Senator, as I mentioned in my opening remarks, Fitch is a combination of four rating agencies that merged together, and in fact, as of 8 years ago, the SEC had designated other rating agencies. There were more. There were six different rating agencies. And some of the companies that we merged with were designated for individual disciplines. For example, IBCA, International Bank Credit Analysts, was recognized for their expertise in bank analysis, and Thompson Bank Watch, another firm that we acquired, was recognized for its expertise in bank analysis as well.

So it has only been recently—the combination of those mergers was to deal with an economic reality about the requirement for investors to have a rating agency that had a global presence and could offer credit opinions on corporations and structured financings globally, not just in the United States. So that is an economic reason for the mergers. But it seems like there would be a pattern and an availability for the SEC to approve based on their past precedents to open up the approval process, and I do not think anything is necessarily stopping them from doing that at this point.

Mr. HARADA. May I?

Senator STABENOW. Yes, please.

Mr. HARADA. R&I as a foreign rating agency, as you suggest before, the requirement of national recognition is very hard to overcome to us. But, nevertheless, we did some efforts, that is, we have already received 10 letters of support from the very established, leading financial institutions in the United States. So, I think to some extent such effort to be recognized by the national financial institutions might be necessary, but I do strongly ask the SEC, first, to set the clear requirements as far as possible and to the foreign rating agencies, I think that such a barrier or such a standard or such a requirement should be lowered, taking into consideration the avoidance of such a catch–22 problem.

Thank you.

Mr. GREEN. Senator, the hurdle is too high, but it does not mean the hurdle should be low. The fact is you can broaden the number of participant designated rating agencies and not necessarily—and not at all—lower the quality of the rating because there are lots of rating agencies that have particular specialties, particular markets that they have expertise in, that the currently "widely accepted," as you correctly stated, just sets too high of a burden.

If you step back from the "widely accepted" but still maintain the quality, because it is all about credibility, I think you could have many more participants in the marketplace, and that is particularly important now as these markets have become global, and the four designees right now all come from North America. And as the markets grow in Europe and Asia, it is not necessarily the most healthy situation. So, I think they can do a better job.

Senator STABENOW. Yes, thank you.

Mr. EGAN. We have no problem with the SEC's national recognition. In fact, there is a firm that was recognized in the past year, year and a half, DBRS. It is a Canadian firm. There are independent surveys done. We have about three times recognition of that firm as of about 2 years ago, and it has grown since then. So we do not have a problem with that issue.

We have had an application in, now I guess it will be 7 years—I guess we are on the fast track—8 years this August with the SEC, and the hang-up appears to be the SEC looking at our staffing and saying it is not large enough.

Now, keep in mind we are early and right with Enron, WorldCom, Global Crossing, and Genuity. We have to take issue with the process that the SEC is using for evaluating it. It is hard not to conclude that the ultimate objective might be maintaining the status quo, which is fantastic for the existing firms.

Senator STABENOW. So from your perspective there is not a catch-22. Is that what you are saying?

Mr. EGAN. No, it is not. But even if we were recognized—and hopefully we eventually will be recognized. I think the market is really being mis-served by not recognizing firms like ours, others that are early and right with these ratings, that is not going to solve the problem. The problem is the fundamental conflicts of interest.

There were seven firms, seven NRSRO firms 10 years ago or so. You still have the problems of the fundamental conflict of interest. What happens is that there is a separation between the interests of the country, in terms of enabling these companies to grow, encouraging jobs, reducing costs of capital, and a few bad apples, the Bernie Ebbers of the world who had $400 million positioned with WorldCom. He wanted to do everything possible to keep that company afloat. And the rating firms that were paid millions of dollars, too, would give him the benefit of the doubt. That is the problem. And by the time it comes to light, you have no alternatives.

Enron might have been able to be saved, it really could have, if the problems came to light a year or 2 years earlier. You know, we rated it and we downgraded the company. But by the time S&P, Moody's, and Fitch cut it from investment grade to noninvestment grade, they had 4 days before filing for bankruptcy. Basically the bankruptcy attorneys were already in there drafting the papers. There had just one firm that they could deal with, and that is Dynergy. If that deal went away, there is nobody else. That is a real problem.

It is like a child. If you have a child that has a speech impediment, you are better off taking that child to the speech therapist and getting them on the right track so they are not criticized in school. Or if you have a child that has a music talent. Give them the extra instruction, do it early. And it is not being done right now. And it is because of the SEC's approach to this industry which has had the effect of severe limits on competition.

Ms. CORBET. Senator, to your original question, we also support—and I think what you have heard collectively across all the participants and more broadly throughout the market—increased competition, and we believe we can get there through more transparency in the designation criteria and the process. And indeed, with rating agencies that either focus on specific areas or geographic areas, we think the opportunity for them to compete is potentially very good.

Senator STABENOW. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Hagel.

**STATEMENT OF SENATOR CHUCK HAGEL**

Senator HAGEL. Mr. Chairman, thank you.

I wanted to go back to a point that Senator Sununu raised on GSE's, and then we will move on to a couple of other areas. But one of the specific points that I wanted to cover is this—and I think, Ms. Corbet, you were the only one of the three rating agencies that responded to Senator Sununu's question. But in the past few months, all three of the major rating agencies placed Fannie Mae's subordinated debt and preferred stock on watches or outlooks, for possible downgrades. But yet all three rating agencies continued to reaffirm Fannie's AAA rating, AAA ratings with long-term debt with a stable outlook.

Why is that? Is that because of the implied Government backing? Or why would that be the case if you would put them on a watch or an outlook but continue to list them as AAA credits? And you mentioned to some extent, Ms. Corbet, why Standard & Poor's would do this. But in light of the specific rating you have given them, explain, if the three of you would, why that would be the case. Would you do that with some other company? For example, Fannie Mae has a situation, which we all now know, of $9 billion of income restatement. I do not know if you consider that serious. I do.

Ms. CORBET. Indeed.

Senator HAGEL. But yet you still have them as a AAA rating. Now, there may be justifiable reasons for that, but would you explain to this poor Senator?

Ms. CORBET. Sure.

Senator HAGEL. Thank you.

Ms. CORBET. Thank you, Senator. Indeed, after reviewing the situation involving the senior unsecured debt of the GSE's, indeed, we combined now both the financial strengths of the GSE's with the degree of confidence that we had in the Government support. Indeed, after going through our evaluation and the ratings process, the rating committee concluded that while it no longer had the highest degree, which it had earlier, it did have some degree of confidence that a combination of both the financial strength of the GSE's—and I would point out we do not—on a financial strength basis, we do not have them as AAA. We have them as AA minus, combined with the Government support or degree of confidence in the Government support, resulted in an affirmation of the ratings at AAA, and we hold that view today.

Senator HAGEL. So it just essentially meets the threshold, as you said, some degree of confidence.

Ms. CORBET. Correct.

Senator HAGEL. So that merits AA minus.

Ms. CORBET. On financial strength alone, we have published our opinion that the GSE's, Fannie Mae and Freddie Mac, would be AA minus for their senior unsecured debt.

Senator HAGEL. Thank you. Mr. McDaniel.

Mr. MCDANIEL. It is very important to our thinking to consider the status of the GSE's and their relationship to the Government, their strategic position and role in housing finance policy, and those are critical supports to why we have a AAA rating on Fannie Mae and Freddie Mac and why that is a stable outlook from our perspective.

Senator HAGEL. A $9 billion income restatement does not trouble you that much?

Mr. MCDANIEL. Not for the GSE's given, as I said, their Government-sponsored status and their strategic position in the housing market. That is correct.

Senator HAGEL. Thank you.

Mr. Joynt.

Mr. JOYNT. Maybe I could just possibly read this short paragraph from one of the public releases we made, which I think addresses the issue:

> Importantly, the subordinated debt and preferred stock of Fannie and Freddie, respectively, are primarily based on their stand-alone financial profiles and prudent management of risks. Their AAA senior debt ratings reflect the benefits they receive from their GSE status, principally with access to capital markets and favorable pricing. Their GSE status is an extension of the role that Government has played in all areas of social interest, a role that Fitch believes will not be changed by the legislative and regulatory proposals under consideration.

Senator HAGEL. All right. Thank you.

I would like to ask each of you very quickly the issue of transparency. Starting with you, Mr. McDaniel, in answer to Senator Stabenow's question about, I think you said, supporting greater transparency in the process. How are you doing that? Isn't it a reality that lack of transparency cuts to the credibility and the reliability of ratings organizations? What have you done, what are you doing? And why don't, for example, your agencies develop public—any methodology or how you get to where you are with these rating agencies? Can you start there and give us some brief answers? I know there are no brief answers, but if you could in the interest of time—and I would like to hear from all of you because I think the transparency issue is pretty critical here. And you said you think it is important for the process, but what are you doing?

Mr. MCDANIEL. We certainly agree that lack of transparency undermines credibility and reliance on rating agencies. Among the things that we are doing, we publish and make available on our website all of our rating methodologies. We have rating methodologies for all industries and sectors that Moody's rates. We have added to our research specific commentary that says what will move the ratings up and what will move the ratings down.

When we are considering changing methodologies, we are now publishing on a request for comment basis from the market our thinking about the reasons for the change and seeking the best information we can from the best thinkers in the marketplace about what would most inform a change in methodology before we are implementing that.

I think those are probably three of the most important things we are undertaking. As I mentioned earlier, we have been, since 2003, publishing on a quarterly basis our ratings performance so that can be judged for accuracy and stability.

Senator HAGEL. Thank you. Mr. Kaitz.

Mr. KAITZ. To the extent that Mr. McDaniel has laid out that they are looking at publishing methodologies, we commend that. That is something, I think, that we feel very important, especially those of us that are—we represent the issuers of debt, but we also feel this is something that the other rating agencies need to do as well as part of the process.

Senator HAGEL. Mr. Joynt.

Mr. JOYNT. I think that was a quote from a reporter, and actually I think that may not be representative of the market view. I think the market view is that rating agencies have been very transparent over time. We also have published our criteria on all areas of ratings consistently for 15 years. I am surprised by that comment. On individual company credits, individual securitizations, we put our information also on the Web, freely available, so I think we are actually quite transparent.

Senator HAGEL. Thank you. Mr. Harada.

Mr. HARADA. Yes, Senator, R&I also discloses almost all the criteria and the methodology at the website so that everybody can check and can read our methodology, and if such methodology might be changed, very soon we disclose such change, and we also disclose all of the outcomes of our rating performance. We disclose every material with which every outsider can check our rating performance.

Senator HAGEL. Thank you. Mr. Green.

Mr. GREEN. Senator, the Bond Market Association completely supports transparency of the methodology and consistent application of that methodology, as well as communicating as quickly as possible any changes in the methodology, keeping in mind, though, that we also need to make sure that there is enough flexibility for rating agencies to adapt to differing markets and new products as quickly as possible, too. But transparency is very, very important to the marketplace.

Senator HAGEL. Thank you. Mr. Egan.

Mr. EGAN. We provide issuers with the supporting materials for our ratings. Typically, we get a lot of grief from those issuers where we are different, significantly lower than the other rating firms. That is normally not the case. In fact, we have been more bullish than the other rating firms for the past 2½ years or so. But they will take issue with the ratings we assign. We give them what our projections are and explain why we assume these different things. They offer to provide us with inside information. We say we do not want that, in contrast to the other rating firms. We want it to be released to the market, and then they can give it to us. So we provide all the support that they need on how we base our ratings decisions.

Senator HAGEL. Thank you. Ms. Corbet.

Ms. CORBET. Transparency is critical. We publish our ratings methodology, our criteria, our default and transition studies, and we also publish any changes in methodology.

Senator HAGEL. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Corzine.

## STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman. I have a statement for the record which I would like to submit. That statement deals with opaque or transparent issues, barriers to entry, lack of oversight on the SEC, which I will follow on in a question, and also potential conflicts. I am also just a little worried about asking tough questions. If you ever show up as someone who is responsible for asking for a rating, you might get in trouble with these guys. The conflict works both ways.

The questions I have are really three parts, and different ones of you will work. First of all, I think it is the Investment Company Act that is the governing statute with regard to oversight of the rating agencies. Is that how you all understand it? Is there any pattern, regular or random, of the SEC or other regulatory authorities ever coming in and checking the kinds of questions that one might ask about whether your ratings actually match up or you are actually following through on the calculations that you make? Is there any outside observer to the processes that go on?

The second question I have, really on an entirely different issue but an important one, I would love to have people's written responses if they do not have time to answer here. Do any of you believe that requiring stock options to be expensed is a sound policy and one that allows you to have a sense of the underlying economic fundamentals of a company? Or are you handicapped if that were not the case? I would love to hear your views on that.

And third, I have a particularly parochial question. A number of you—S&P, Moody's, and Fitch—I believe all decided to opine on New Jersey's Homeownership or Predatory Lending Act that was implemented, signed into law in May 2003, and I just want to clarify that after some toing-and-froing that you all think this is an act which is not inhibiting markets and it is on sound footing. I would be more than happy to accept that in written form, but I want to make it clear there continues to be a debate in my State about whether the Predatory Lending Act is too far reaching, somehow handicapping mortgage markets. And I think you all, either in public writing or other, have said that you are satisfied with where the law is, but I would like to hear it.

So, first of all, I will go through and ask on the oversight process, because I think it is the most general of the questions about who is watching whom and is there any check and balance to the rating agency activity. Is the SEC doing its job? Stock option expensing. And then the predatory lending issue, if you have time. I will start with Mr. McDaniel.

Mr. MCDANIEL. Thank you, Senator. To answer your first question, yes, Moody's does file under the Investment Adviser Act. We are periodically inspected by the Securities and Exchange Commission.

Senator CORZINE. When is the last time?

Mr. MCDANIEL. The last time was approximately 18 to 24 months ago.

Senator CORZINE. Not since the WorldCom and Enron scandals?

Mr. MCDANIEL. Yes, it was following Enron, and I think it was following WorldCom, but I would have to come back to you with a specific date.

With respect to expensing stock options, Moody's Corporation, the parent of Moody's, does expense stock options.

Senator CORZINE. I would like to know, by the way, when the previous review by the SEC was.

Mr. McDANIEL. I will have to make that available to you. I do not know when the prior inspection before that was. As I said, Moody's Corporation does expense stock options.

In terms of whether the expensing impairs our ability to conduct credit analysis, I think the question is really not whether the options are expensed per se, but whether there is enough information for us to evaluate the cost of the stock options in a company that we are looking at from a credit rating perspective. So as long as there is sufficient disclosure to be able to work back to what the costs are, we are able to work with that.

Senator CORZINE. I take it you think there are real costs.

Mr. McDANIEL. Yes, we do. Because I am not an expert on the Predatory Lending Act, I would request that Moody's submit information to you in writing on that.

Mr. KAITZ. Sir, I can give you an opinion on the first question on the oversight of the rating agencies. Our testimony is pretty clear on this. We believe it is wholly inadequate. It has been 10 years since the SEC has taken any action, and it is time for them to do something. So we hope that this hearing is the start of the Senate taking some firm action, to get the SEC to act on oversight of the rating agencies.

On the other two issues I have no opinion.

Mr. JOYNT. On the first question, I do not believe there is another regulatory body that would come in and inspect us in any kind of way, at least not in the United States. However, we have frequent contact with people that use our ratings, like the Federal Reserve and the FDIC, where they expect us to come present to them and talk to them about how we run our business and also, of course, our opinion on many important issues to them. Outside of the regulatory framework, we would do the same thing in the United States and everywhere with important institutional investors. So, I think there is a lot of public market scrutiny of us, if it is not directly a regulatory response. And then, of course, internationally, more international regulators have become involved in meeting with the rating agencies, in the United Kingdom the FSA and in France, their regulatory body as well, and others, as a part of the IOSCO process, the securities regulatory process, CESR process that was mentioned earlier, and then individually as well.

Senator CORZINE. When is the last time you have had an SEC review?

Mr. JOYNT. I do not have that information, but I will be happy to provide it to you.

Senator CORZINE. Actually, the last two would be interesting.

Mr. JOYNT. No problem.

Senator CORZINE. Thank you.

Mr. JOYNT. Again, I am not an expert on the predatory lending either, and I would be happy to provide written answers on both the other questions.

Senator CORZINE. Thank you.

Mr. HARADA. As a foreign rating agency, R&I is registered with SEC as an investment adviser pursuant to the Investment Advisers Act of 1940, and, if we have a very substantial change of the corporate structure, we will make a report to the SEC under the requirements of the Investment Advisers Act. And apart from such kind of contact with the SEC, as the Japanese rating agency we have very close contact with FSA in Japan with regard to the IOSCO Code of Conduct Fundamentals, and the recent Basel II for the capital adequacy requirements as well.

Mr. GREEN. Senator, I think the oversight of the credit rating agency process is the credibility of the report itself. What is being bought by either issuer or investor or dealer is the credibility of the particular rating agency, and that is one reason why we are calling for greater competition in opening up the designation so that there is more competition, and that will ensure that the marketplace is measuring the credibility in a more competitive environment.

We also do believe that transparency of the historical record of the rating agencies is very important to that process. On stock options, the Bond Market Association, I do not believe, would necessarily have an opinion, but on the predatory lending issues, there is no question that we have an opinion. We oppose predatory lending, but we have opposed the concept of assigning liability, which creates uncertainty in the securitization process around certain noninvestment grade lending that goes on across the country. And we believe very strongly that clarity of the liability is very important for underwriters to be able to accept the liability that they are willing and knowledgeable of accepting, and that has entered into the credit rating agency process when various States, and in certain cases localities, have passed various ordinances and statutes that have created uncertainty in that market process. We have testified both, I think, before this Committee and certainly before the House Committee as well on the issue of providing some kind of national standard so that we can deal with the predatory lending issue without creating these uncertainties in the marketplace leading to rating agencies not giving ratings in certain high-cost-loan situations, which I believe is the case in New Jersey. So it would be our hope that we could work with this Committee in trying to adopt some standard that helps deal with this issue.

Senator CORZINE. Mr. Green, I believe that my point was that I think the law was modified to deal with the assignee, not to the perfection of everybody's wants but in a way that the rating agencies were comfortable. And that is what I want to get on record, because it does set a pattern that we can discuss when we deal with it on a national level, if that were, in fact, the case.

Mr. EGAN. We are not a registered investment adviser. We have advised the SEC that if we are awarded the NRSRO designation—also, we think of it as the "no room/standing room only." That is the only way I can remember it quickly. But we would register.

We do, however, have some outside observers regarding the quality and timeliness of our ratings. In fact, there have been two recent independent studies. One was conducted by the Kansas City Federal Reserve Board, and I quote from it: "Overall"—and they wanted to know is there stickiness at the investment grade versus noninvestment grade level, and they said, "Overall, it is robustly the case that S&P regrades from BBB minus"—which is the lowest rung of investment grade—"moved in the direction of EJR's earlier ratings. It appears more likely that this result reflects systematic differences between the two firms' rating policies than the number of lucky guesses by Egan-Jones Ratings."

And then there is another study, a joint one by Stanford and the University of Michigan. This is in my written testimony. "We believe our results make a strong case that the noncertified agency"—Egan-Jones—"is the leader, and the certified agency"—Moody's—"is the laggard." We have huge competitive pressures on us. S&P, Moody's, after they failed with Enron and WorldCom, Moody's operating income over the last 4 years has grown about 250 percent. They do not have the pressures. We do, and we have to get to the truth quickly, and it shows it with these independent studies.

Your other question—expensing stock options, we do not care. We can handle it either way. We are sophisticated enough to deal with it, and I do not have a comment on the predatory lending practices.

Ms. CORBET. Senator, to your original questions as well, we are governed by the Investment Advisers Act, and the last SEC inspection was in 2002, but it was post-Enron, and we will get back to you as the previous review. That said, we often talk to the SEC about our policies and procedures and subjects covered by any and all inspections.

On the point regarding stock options, we do view them as costs, and they are taken into consideration in terms of our credit analysis.

And, finally, we, too, would be willing to submit a written form of our view on predatory lending and particularly the New Jersey statute.

Senator SARBANES. [Presiding.] I think we have two Members who have not yet had a first round.

Senator BUNNING. That is correct.

## STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman, Mr. Ranking Member—Mr. Acting Chairman.

[Laughter.]

Senator SARBANES. Do not get carried away.

Senator SCHUMER. I hope soon we will strike that "acting" and get rid of the adjective.

Anyway, I want to thank everyone for their testimony. I just want to make a brief statement and then ask a few questions.

I appreciate the opportunity to examine the credit ratings industry. I think that is a good idea. Many of the companies we are talking about have been around for close to a century. They provide a vital service to our capital markets by sharing their opinions on the credit worthiness of a particular company or the risk of default on a security. These companies aid small and large investors alike in making informed decisions to better serve individual investment needs.

I understand that some concerns have been raised regarding the transparency surrounding the ratings process and the information that rating agencies make available to issuers and the public at-large. I have always believed in transparency and disclosure. These elements are fundamental to every industry, and so I am joining others here in encouraging the SEC to develop an oversight regime that clarifies the steps needed to be taken to provide greater transparency, but I do believe this must be done with a level of care to ensure that the responsible regulatory policies are put in place.

While I do support regulation, I have to be clear I do not support the SEC altering the business model or the rating products that these companies utilize. The regulation of these entities should not mean dictating the content of their businesses. Credit rating agencies serve a special purpose to the capital markets, providing relevant information in the form of opinions to contribute to fair and efficient markets.

Looking at regulatory policies, as we do that, it is important to remember that these companies are just, you know, these companies do just that—give their opinions. I strongly oppose an oversight structure that would allow market participants to sue in the event that they disagree with the ratings or a company fails to live up to that rating. I think that would be a mistake.

I will end here. I look forward to hearing the SEC's plans for the credit rating agencies. I hope they will move more quickly than they have so far. And while I have not had a chance to speak at length about the issue of competition, I am also interested in how the SEC plans to encourage more competition in an industry that provides an important service to our capital markets.

My first question is for you, Mr. McDaniel. You stated in your testimony, as high-profile corporate frauds in recent years have demonstrated, if issuers abandon the principle of transparency, truthfulness, and completeness in disclosure, neither rating agencies nor any other market participants, including regulatory authorities, can properly fulfill their roles.

I agree with you, obviously. I have always believed disclosure is vital to any industry's success. In light of the recent corporate scandals, from Enron to WorldCom, we have seen the firsthand dangers of nondisclosure. What specific steps has your company taken to improve the quality of information you receive from companies in order to conduct responsible rating analysis. Obviously, some of these companies sent you false information. I do not blame you for that. That is really not ultimately your job, but what are you doing to assure that that does not happen again?

Mr. MCDANIEL. Thank you, Senator.

The most critical action we have taken in the post-Enron environment, in order to try and better vet the information that we are receiving from companies, is what we call our Enhanced Analysis Initiative. We have hired over 40 specialists in, accounting financial disclosure, off-balance sheet risk transference, and corporate governance, who do not have separate rating responsibilities for companies. Their job is to sit alongside our credit-rating analysts in meetings with the companies, and outside of meetings with the companies and provide their particular expertise to demonstrate and find better insight into the information we are receiving to ask more probing questions about the information we are receiving and, as a result of that process, hopefully, to find more vulnerabilities in the information we are receiving.

Senator SCHUMER. Would you like to answer that, Ms. Corbet?

Ms. CORBET. Sure, Senator. Thank you.

As well, Standard & Poor's has also expanded a number of initiatives, in terms of analytical information. They include additional specialized forensic accounting expertise, which includes new chief accountants in both the United States and in Europe.

Also, we have, at the request of investors, expanded our liquidity analysis and our recovery assessment and have published it in our ratings analyses.

We have, also, enhanced the use of quantitative tools and models in both the ratings and the surveillance process, and we have increased our commentary on issuers and industry sectors.

Senator SCHUMER. Mr. Joynt.

Mr. JOYNT. We, also, have hired additional expertise, and centralized in our credit policy and credit research area, a function that allows us to look across all the analytical areas and make sure that we are consistently seeking all the best-quality information.

I think there are two parts to the information. One is publicly disclosed information. We have been encouraging deeper and wider public disclosure of information. And the other is our own ability to go in and meet with companies and collect information on our own. So we have materially strengthened our training from the top to the bottom of the analytical organization, so that when we have the ability to go interview companies, we can screen and interview better than ever.

Senator SCHUMER. Next question. Mr. McDaniel, there has been some talk here about what happened with MCI.

Senator SARBANES. Why do we not take that question——

Senator SCHUMER. I do not mind waiting. Jim has been waiting.

Senator BUNNING. Fine. I have been waiting a while.

Just so there is no misunderstanding about the question I was asking, I am going to ask all of you to respond in writing.

Do any of your company's officers or employees sit on any corporate boards or Government boards or agencies like the NASD, like the New York Stock Exchange, like Nasdaq, like the SEC? And I would like that information for the past 20 years.

Senator SARBANES. Do you include directors within the phraseology of officers and employees?

Senator BUNNING. Officers and directors.

Thank you very much, Mr. Chairman.

Chairman SHELBY. [Presiding.] I have a few questions. Ms. Corbet and Mr. Joynt, I will direct it to you, and then anybody else can comment if you want to.

Recent press accounts have detailed the practice of rating agencies providing unsolicited ratings to issuers. The ratings agency will issue an opinion based on publicly available information, such as SEC filings, without talking to the issuer or reviewing relevant confidential information. If a ratings company can issue an opinion without the issuer's permission and cooperation, then what is the incentive for an issuer to pay for a rating? How does an unsolicited rating benefit investors if it is not based on complete information? Ms. Corbet.

Ms. CORBET. Thank you, Senator.

Indeed, as a publisher of information, we will rate and issue, without request, if really two factors; the first, if there is meaningful market interest, and this largely depends on——

Chairman SHELBY. And how do you define that.

Ms. CORBET. This largely is defined on terms of size and significance of the issue.

Second, if there is adequate public disclosure to support the initial analysis and then the ongoing surveillance. Just to qualify, it does not necessarily mean that there is not communication with the issuer or discussion with the issuer. We do believe that the market benefits from our objective opinions even if we are not paid. And we will always indicate in our credit opinions when a rating is unsolicited.

Typically, in developed markets, where ratings are well-accepted, unsolicited ratings are a very small percentage of the overall business, but entry into new markets and new asset classes largely start with unsolicited ratings.

Chairman SHELBY. Mr. Joynt.

Mr. JOYNT. We have had a program of initiating Fitch-initiated ratings, also, for issuers or issues we feel have significant interest to the investor community broadly or investors that are interested in Fitch's opinion.

I think regarding the quality of the rating, we can rely on the public disclosure as being adequate for a reasonably knowledgeable bond rating agency to reach a good conclusion in almost all situations. So, if we did not feel like we had enough public information to be able to arrive at what we thought was a reasonable rating conclusion, we would not issue or initiate a rating.

It is true that we feel there is significant benefit from meeting with management. We call management and ask to meet with them, but it is not required to meet with management nor to reach a reasoned conclusion.

Chairman SHELBY. But your information would be incomplete.

Mr. JOYNT. Pardon me?

Chairman SHELBY. Your information would not be complete, would it?

Mr. JOYNT. I think, if the public disclosure of information companies in the United States that we expect investors to be able to make their own conclusions based on that being adequate disclosure, I would think that we would be knowledgeable enough to reach a reasonable conclusion.

Chairman SHELBY. Mr. Egan.

Mr. EGAN. This is a very subtle area, and it is important that it be understood properly.

Chairman SHELBY. Lay it out, then. Take your time.

Mr. EGAN. I will not hesitate. None of our ratings are solicited. We do not get paid by the issuers. They do not come in and solicit it, and we do not want to get paid. They have offered to pay us, and we say, no, we do not want any payment from issuers. Again, that is a conflict of interest.

And so we rely on public information. Companies offer to provide us with nonpublic information, but there are two problems with that: Number one, it does not help us in getting to the rating on a timely, accurate basis and, number two, it increases our liability; that is, we worry about how that information is used. In the case of the auto companies, they said we will give you the whole slew of nonpublic information, and we said, no, make it public and give it to us, and we would be happy to review it. So that is one aspect.

The second aspect is, with the firms that get most of their compensation from issuers which is S&P, Moody's, Fitch, and DBRS, we have some real problems with their approach to this area. And it was detailed in a November 24 article in *The Washington Post.* I refer to this as the "hobnail boots" approach to marketing. It goes through how, in the case of Hannover Re, Moody's was not paid by Hannover Re. S&P was paid. And Moody's went to Hannover Re and said, "We are going to rate you. You do not have to pay us, initially, but we would appreciate it if you did."

And Hannover Re said, "No, we do not have any need for it at all. Moody's rated them."

And they went back another 6 months later.

Chairman SHELBY. Did they get a good rating?

Mr. EGAN. They got an okay rating. It was one notch below S&P, but it did not stay there. They went back 6 months later, "Please pay us," and Moody's took a negative action. They went back another 6 months later and said, "Well, we have new people. Please pay us again." They did not get paid. They took another negative action, and another negative action, and another negative action all the way to the point where they are noninvestment grade. This is Hannover Re. They are still rated at investment grade by S&P.

Finally, Hannover Re said, "This is absolutely ridiculous. It is hurting our stock price, and so we will pay you Moody's."

Chairman SHELBY. Did the rating improve after they paid them?

Mr. EGAN. I think they put it on positive outlook and I think they are heading up.

Senator SCHUMER. So it improved.

Mr. EGAN. It improved, and nothing else major had happened in the meantime. And I am sure, if you speak to the analysts, they will say, well, four things happened here, there and there, but the reality is nothing really happened. So, I refer to it as the "hobnail boots" approach because, again, there is no place else to go. S&P and Moody's have incredible influence in the marketplace, and they are using this unsolicited rating process to extend their monopoly. It is different in our case or in other firm's cases that are not paid by the issuer.

So, when you are handling this issue, be careful how it is applied. In the case where the companies are regularly getting paid by the issuer, they will abuse it.

There is another case where they abused it, where they had a rating, and this is in the case of Allied Signal. Allied Signal acquired a company, Grimes Aerospace. It had a rating, but Allied Signal wanted to buy in those bonds cheaply, and so it asked the rating firms to withdraw the rating on Grimes, so that they could buy the bonds more cheaply. That is if there is not a rating, there were a number of institutions that cannot hold it. We rated it to help out those investors, but we do not have the market power of S&P and Moody's. So the corporation was able to buy the bonds more cheaply than they would have. So it is amazing the steps that they go through to enhance their business position.

Chairman SHELBY. Mr. Harada, do you want to come in here?

Mr. MCDANIEL. Mr. Chairman.

Chairman SHELBY. Just a minute. I will get to you.

Mr. HARADA. As far as the rating of R&I is concerned, in principle, we do not to carry out any unsolicited rating. In principle, we are now conducting solicited rating.

But there is same possibility that we might conduct some unsolicited ratings. Because, if there is some very influential issuers that exist, and also they disclose very substantial degree of information, and if the investors have strongly asked us to rate this very big corporation in that case, although it is a very much exceptional case, we might carry out such an unsolicited rating, but we have not yet such concrete example at this moment.

Chairman SHELBY. Thank you.

Mr. McDaniel, you wanted to comment.

Mr. MCDANIEL. Yes, Mr. Chairman. I just wanted to point out that the information that was just communicated with respect to Hannover Re was not accurate, and I think that the Committee should be aware of that.

Chairman SHELBY. Corrected. Corrected.

Mr. MCDANIEL. We had a solicited rating relationship, a paid relationship with Hannover since 1999. We did not downgrade any of Hannover's debt until 2001, and there was never any linkage between paying and the maintenance of ratings at any level. That would be a violation of our ethics. It would be subject to severe sanction, in my opinion dismissal, of any individual who did that.

Senator SARBANES. Was your rating of Hannover, the initial rating solicited or unsolicited?

Mr. MCDANIEL. The initial rating was unsolicited.

Senator SARBANES. And when was that?

Mr. MCDANIEL. In 1998.

Senator SARBANES. So you started rating them on an unsolicited, unpaid basis; is that correct?

Mr. MCDANIEL. They received a financial strength rating on an unsolicited, unpaid basis in 1998. They decided, through Hannover Finance, to access the bond markets, in 1999, and approached Moody's for a rating, which we gave.

Senator SARBANES. And they paid.

Mr. MCDANIEL. Yes.

Senator SCHUMER. Wait. Let me just make that clear, if I might.

Chairman SHELBY. If I could, let Mr. Kaitz, and then I will call on you, Senator.

Mr. KAITZ. Obviously, they have to answer these questions, but this is clearly an issue that needs to be addressed by the SEC. You only have three rating agencies.

They have no place else to go. We represent the issuers. The reason I am testifying here today, as the President and CEO, is because there is not anyone in our organization who is going to get up here and testify and be concerned about what is going to happen to their bond rating. I mean, this is a serious issue here that has to be addressed. We need transparency. When these are unsolicited ratings, the public needs to know they are unsolicited ratings because they only have access to public information.

So there are a lot of issues involved here where, hopefully, either the Senate is going to get involved or the SEC really has to clarify this issue.

Chairman SHELBY. Senator Schumer.

Senator SCHUMER. What Mr. Egan said is very serious. So, what you are saying is you gave an unsolicited rating in 1998. They then paid you in 1999.

Mr. MCDANIEL. For a different bond rating.

Senator SCHUMER. Bond rating.

Mr. MCDANIEL. They had a financial strength rating in 1998.

Senator SCHUMER. And your rating went down after they paid you, not up.

Mr. MCDANIEL. In 2001, that is correct.

Senator SCHUMER. So are you alleging that——

Mr. EGAN. The article——

Senator SCHUMER. Wait. Let me just ask the question because this is serious stuff, and it is easy to throw it around. You are a competitor of theirs.

Mr. EGAN. Right.

Senator SCHUMER. And you want to break into the big leagues and so let us make sure——

Mr. EGAN. We are already there.

Senator SCHUMER. Okay. You want to break into the bigger leagues.

[Laughter.]

Again, this is serious.

Mr. EGAN. Right.

Senator SCHUMER. Are you alleging that they change the rating based on whether they were paid or not?

Mr. EGAN. I am referring to a November 24, 2004, article——

Senator SCHUMER. I am not asking what *The Washington Post* wrote, okay? I am asking because we all deal with reporters all the time.

Senator SARBANES. Especially Senator Schumer.

Senator SCHUMER. Especially me, exactly.

[Laughter.]

Senator SARBANES. I could not resist that.

Senator SCHUMER. I am serious here. I am happy to deal with reporters. I want to know are you, Mr. Egan—you did not mention *The Washington Post* article——

Mr. EGAN. I certainly did.

Senator SCHUMER. When you gave your little peroration here about this company——

Mr. EGAN. You can check the record. I did say the November 24 article of *The Washington Post.* I have a copy of the article right here.

Senator SCHUMER. Yes, I have it in front of me, too.

Mr. EGAN. We were not directly involved in Hannover Re.

Senator SCHUMER. Right.

Mr. EGAN. We were directly involved in Allied Signal and Grimes——

Senator SCHUMER. I did not ask that. I am asking you, in Hannover Re, are you alleging that the payments that were made affected the rating, are you, Mr. Egan, of a competitive company?

Mr. EGAN. I am referring to——

Senator SCHUMER. I did not ask what you are referring. I asked are you alleging that? You are a rater. You know these things. You have a pretty sharp view of this, and I understand that. That is capitalism.

Mr. EGAN. Right.

Senator SCHUMER. But I am asking you are you alleging that the payments affected their ratings, yes or no?

Mr. EGAN. I will respond in this way. We were not involved in Hannover Re. When I started, when I raised this issue, I referred to *The Washington Post.* I can say that there have been many instances where it is hard to draw the conclusion that the payments do not affect the rating.

The latest example of this was a—well, there are constant examples of it, and you do not have to follow the market for very long.

Senator SCHUMER. But I listened to you, and it seemed to me pretty clear that you were saying this happened, this happened, and you were implying that there was a relationship. That was my sitting here. I heard your whole statement.

Mr. EGAN. It is hard to draw anything else.

Senator SCHUMER. But now you are not saying that there was a relationship.

Senator SARBANES. You do not know.

Senator SCHUMER. You are saying you do not know. That is right.

Mr. EGAN. No. It would be difficult to draw any other conclusion, when they were not paid, and then all of a sudden they were paid, they were not paid, and they took a series of negative actions, and the other rating agency did not take the negative action, that there is a high probability that the payment had something to do with it. And I was referring to *The Washington Post* article.

Now, there have been other instances where it is difficult to draw the conclusion, when they are getting paid millions of dollars for ratings, they delay in taking an action, that that does not have some impact, despite all the Chinese Walls and everything else.

In fact, in the case of the equity research analyst, that was the core issue, that they were getting paid via investment banking fees, was it Citigroup and Salomon Brothers were getting paid, via investment banking fees, for a much more bullish opinion than what they truly believed. That is the core issue here.

Senator SCHUMER. Yes, it is the core issue, and the bottom line is you are saying you have no proof of it. You just think it might occur; is that fair to say?

Mr. EGAN. It would be hard to draw any other conclusion based on the evidence.

Senator SCHUMER. Do you agree with that, Ms. Corbet, about what Moody's did on——

Mr. EGAN. No one else will who is getting paid on the other side.

Senator SCHUMER. Yes, okay.

Go ahead. Do you agree?

Ms. CORBET. No, I do not agree.

Senator SCHUMER. Could you explain that.

Ms. CORBET. Well, I think Mr. McDaniel outlined specifically that rating downgrades actually happened after they were paid.

Senator SCHUMER. After they were paid, yes. I do not get it.

Mr. EGAN. I referred to the article, and it suggests that it was not getting paid after. You, also, have to be careful about what rating is paid——

Senator SCHUMER. Mr. McDaniel, were you paid in 1999 by this company?

Mr. MCDANIEL. Yes, we were paid for the bond rating.

Senator SCHUMER. And did you then lower their rating on whatever it was after that?

Mr. MCDANIEL. Let me be as clear as I can. We had two ratings outstanding, a financial strength rating and a bond rating. The financial strength rating was initially assigned on an unsolicited basis and remained an unsolicited rating. The bond rating was assigned on a solicited basis or a requested basis, and both ratings continue to be outstanding, both ratings were downgraded in 2001.

Senator SCHUMER. So why did you not mention that, Mr. Egan?

Mr. EGAN. I was referring to——

Senator SCHUMER. When you went through your little litany, you did not mention that the same company, after they were paid, downgraded the rating. You said they upgraded it after they were paid probably later, right, in 2003 or something?

Mr. EGAN. This is an issue. Let me read from *The Washington Post.*

So we told Moody's, "Thank you very much for the offer. We really appreciate it. However, we do not see any added value," said Herbert Haas, Hannover's Chief Financial Officer at the time. As Haas recalled it, a Moody's official told them, if Hannover paid for a rating, it could have a positive impact on the grade.

This is from *The Washington Post.*

Haas, now Chief Financial Officer at Hannover's parent company, Talanx AG, laughed at the recollection. "My first reaction was this is pure blackmail." Then, he concluded that, for Moody's, it is just business. S&P was already making headway in Germany and throughout Europe in rating the insurance business. Moody's was lagging behind and Haas thought Hannover represented a fast way for the credit rater to play catch-up. Within weeks, Moody's issued an unsolicited rating on Hannover, giving it a financial strength rating of Aa2, one notch below that given by S&P. Haas sighed with relief. Nowhere in the press release did Moody's mention that it did the rating without Hannover's cooperation, but Haas thought it could have been worse.

Then, it got worse. In July 2000, Moody's dropped Hannover's rating outlook from stable to negative. About 6 months later, Moody's downgraded a notch to Aa3. Meanwhile Moody's kept trying to sell Hannover its rating service. In the fall of 2001, Zeller, Hannover's Chairman, said he bumped into a Moody's official at an industry conference in Monte Carlo and arranged a meeting for the next day at the Cafe de Paris. There, the Moody's official pressed his case, pointing out that the analyst who had been covering Hannover, a man whom the insurer disliked, had left Moody's. Zeller still declined Moody's services.

Senator SCHUMER. But they were paid by this company in 2001. Is that not the point? You are going on after this, but they were paid at some point. They were not, I mean, do you want to respond, Mr. McDaniel?

Mr. EGAN. This article suggests that it was not paid.

Senator SCHUMER. Let us get the truth.

Mr. EGAN. It has, "Two months later—"

Senator SCHUMER. Wait. Let us get the truth. Excuse me.

Mr. EGAN. "Two months later, Moody's cut the insurer's ratings by two notches."

Senator SCHUMER. Excuse me. Let me just ask Mr. McDaniel.

Chairman SHELBY. Let us put the article in the record in its entirety.

Senator SCHUMER. Yes. But I just want to give Mr. McDaniel, I mean——

Mr. MCDANIEL. Perhaps the most constructive thing that Moody's can do, I should say, when we read this information in the *Post,* we were more concerned, I think, than anybody else because there were actions alleged in that article that were violations of our policies, practices, and ethics. I think that perhaps the most constructive thing we can do is to submit a written report of our investigation of that to the Committee, if you would find that helpful.

Senator SARBANES. That is a good idea.

Chairman SHELBY. That would be a good idea. If you do that, we will accept it.

Senator SARBANES. Mr. Chairman.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Let me just say, Mr. Egan, you, of your own knowledge, do not know about, I mean, you are just citing a story in the *Post.*

Mr. EGAN. Yes, and I said that at the beginning.

Senator SARBANES. All right. I think we should be clear about that.

Mr. EGAN. I am familiar with Allied.

Senator SARBANES. Yes, a different case.

Mr. EGAN. I was, personally, involved in Allied.

Senator SARBANES. Now, the Chairman has asked for the article to be put in the record, and I think, Mr. McDaniel, you should be able to put in whatever report you have——

Chairman SHELBY. Absolutely. Anything you want to put in, we will——

Senator SARBANES. —that deals with the record.

Mr. MCDANIEL. We conducted an internal investigation, and I would be happy to make it available.

Senator SCHUMER. I have just one question.

Senator SARBANES. That may lay out a different——

Senator SCHUMER. Excuse me. And did the article—you have read it—did the article mention that they paid you, rather, in 2001?

Mr. MCDANIEL. No. While I do not recall the whole article, but I do not know what it said with respect to that.

Senator SCHUMER. Did it, Mr. Egan? You are familiar with it.

Senator SARBANES. If we are going to pursue this, let us be clear about this. You were getting paid for one rating, but not getting paid for another rating; is that correct?

Mr. MCDANIEL. That is correct, yes.

Senator SARBANES. That is right. And the rating that was downgraded was the rating you were not getting paid for?

Mr. MCDANIEL. Both ratings were downgraded.

Senator SARBANES. Both ratings, all right.

Mr. Kaitz, I want to put a question to you. You said earlier that if you drop the rating system, that would be the worst thing you could do. And I want you to elaborate on that. I take it what you mean by that is that those who have already the rating are so far ahead of the game that if the ratings were dropped, there would be no way anyone else could become a competitor; is that correct?

Mr. KAITZ. Yes, Senator, that is correct because the ratings have been embedded in insurance regulation, mutual fund regulation, and potentially pension fund. So it is so embedded in regulated industries, if you did away with the designation, I think it would be a permanent barrier to competition for anyone to break into that market.

Senator SARBANES. And then the question is how would somebody else get into the competitive pool. At the moment, at least they have maybe a chance to get in the pool by being given the designation; is that correct?

Mr. KAITZ. Yes.

Senator SARBANES. I take it that is what you are seeking, Mr. Harada; is that correct? Are you seeking that designation?

Mr. HARADA. Yes, we are seeking the designation.

Senator SARBANES. Yes, and you are seeking it, Mr. Egan.

Mr. EGAN. Yes, and we are also seeking that the industry be cleaned up, that the conflict of interest be addressed.

Senator SARBANES. Let me ask this question. I want to ask the people of the panel, anyone who wants to respond to this, do you think that the SEC has the power and the authority to regulate the rating agencies?

Mr. KAITZ. Well, the SEC—I hesitate to quote anything from *The Washington Post* at this point——

[Laughter.]

Senator SCHUMER. They are sometimes right.

Mr. KAITZ. Yes, I know. It makes me a little bit nervous, but it appears that they are saying, no.

Senator SARBANES. I want to ask the rating agencies whether they think the SEC has the authority to regulate them.

Ms. Corbet.

Ms. CORBET. In my view, I think they have the appropriate authority with respect to the NRSRO designations, but we have publicly said that we would like that designation criteria to be more transparent.

We think that we are not in favor of any additional regulatory oversight that would increase the barriers to entry or to compromise the independence of the ratings process. Furthermore, we think that any further regulation might have the potential of encouraging standardization and deferring the diversity and innovation within the credit rating industry.

Senator SARBANES. So does that mean you think that they cannot take any measures that affect how you do your activities?

Ms. CORBET. We think that what they currently have in terms of oversight in the NRSRO designation process is sufficient.

Senator SARBANES. Mr. Joynt, what do you think?

Mr. JOYNT. As a technical matter, I am not sure whether they have the authority, but we would be fully—and have been—responsive to all requests for information, changes in our practices. We have had open discussion and dialogue with them.

Senator SARBANES. Mr. McDaniel.

Mr. McDANIEL. The Commission, I certainly believe, has the authority to define what a NRSRO is and to identify the standards that would accompany a NRSRO.

As to the scope of authority in areas of the content of the work we do, I think that we would work as constructively as we can with the Commission.

Senator SARBANES. You think they have the authority to effect that?

Mr. McDANIEL. I am sorry, sir?

Senator SARBANES. Do you think they have the authority to, in effect, pass on those practices and establish standards for it?

Mr. McDANIEL. I believe that they do simply because the NRSRO designation is a SEC designation, and they determine who is one and who is not one.

Senator SARBANES. Was it only to determine who is a NRSRO or can they also affect the practices of an entity that has been so determined?

Mr. McDANIEL. Well, they could, as far as I understand, they could determine what the criteria are to be a NRSRO, and if a rating agency chose not to follow that criteria, it could be de-designated or delisted.

Senator SARBANES. No, I know. But the criteria to become designated may differ from overseeing the practices once you have been designated, otherwise it is a sweetheart deal for you all, is it not? You get designated. So now you get the special status conferred upon you by the SEC, a rather unique status.

Mr. Kaitz says, well, we cannot drop the designation because, if you do that, the ones who have already been designated, it is all theirs. There is no way anyone can compete with them. So we have to keep the designation, which has given you a very privileged position, and I just want to make certain because I think the SEC needs to move in this area—I think there are some problems, and they need to address them—that we are then not going to run into the argument, by those who have been favored by the designation, who say, well, you cannot really address our practices. I mean, it would seem to me to almost follow logically that if they can give you this designation and establish this special status for you, that encompassed within that grant of a privileged position would be the authority to pass on your practices to assure that they are adhering to appropriate standards.

Now, do you disagree with that?

Mr. McDANIEL. I think I would agree with Mr. Joynt that the matter of technical authority is one that I am probably not best positioned to opine on, but we would certainly work to adhere to standards that are promulgated. We have already publicly announced that we will adhere to the international standards promulgated by the International Organization of Securities Commissions.

Senator SARBANES. Do you think the Commission can inspect your agency in terms of your practices and what you are doing to be assured and to assure the public that they are proper, objective, and meeting all standards?

Mr. McDANIEL. They do inspect us. They have periodically in the past, yes.

Mr. JOYNT. Again, whether they have the technical authority, I do not know, but we are fully responsive to them, and we would be happy to have them——

Senator SARBANES. I just want to make sure that if the SEC moves with something, you are not going to then rise up and say, "Oh, no. You do not have the power or authority to do that." That is what I am trying to ascertain here today.

Now, I take it, Mr. McDaniel, you would not say that. You would say, well, they do have it.

What would you say?

Mr. JOYNT. The only question that has come up regarding practices and outside influence for the rating agencies that I am aware of is managing or attempting to manage the content of the rating process itself, which we believe is a pretty important independent responsibility of ours. And so outside of that, other aspects of the process, and the number of employees, and the way they would conduct an inspection or they have so far, and all of the issues they have presented to us that we have been fully open to, I think I am comfortable with.

Senator SARBANES. Ms. Corbet.

Ms. CORBET. We cannot opine in terms of what their specific legal counsel may have advised them as to whether or not they have authority, but, again, we are subject to inspections currently by the SEC, and we believe that the current NRSRO designation process, with the amendments that we support, is sufficient, in terms of regulatory oversight.

Senator SARBANES. We will see how this develops. We will have the SEC in here at some point, and we will proceed down the path. But, obviously, there are a number of problems, which you all have recognized here at the table.

Senator SCHUMER. Mr. Chairman, I do have one more question.

Chairman SHELBY. Senator Schumer, go ahead.

Senator SCHUMER. It is not related to, but I wanted to get your opinion. Since you are rating agencies and you give unsolicited opinions, I wanted to get your opinion on another issue, which is the Federal budget.

The President released his fiscal year 2006 budget. It projects that the debt held by the public as a percentage of GDP will rise and then level off to about 39 percent in 2010. But this is a fundamentally misleading budget, in my judgment, because it leaves off major proposals that we know are going to be in there. Adding the President's Social Security proposal, permanent tax cuts, cost of the war in Iraq and Afghanistan will bring the debt held by the public to close to 50 percent of GDP by 2015, if not higher.

So here is my question. Deficits are rising, debt is rising, yet according to the CBO Director, Mr. Holtz-Eakin, these deficits are structural, meaning we will not be able to grow our way out of them.

If a private company were in the same situation as the Federal Government, with this greatly increasing debt, namely, exploding debt in the case of a private company as a share of sales, with no expected future revenue stream to pay back the debt, how would the leading credit agencies rate it?

Chairman SHELBY. I think that is a hypothetical question.

Senator SCHUMER. It is.

[Laughter.]

Mr. Chairman, it is becoming less hypothetical.

Chairman SHELBY. I do not think they answer hypothetical questions—I hope not.

Senator SCHUMER. Any rating agency want to make a comment on that?

Chairman SHELBY. I will answer it. It will be AAA graded.

[Laughter.]

Senator SCHUMER. Oh, yes. Well, then, Mr. Chairman, I would urge the SEC not to certify your firm to rate the agencies.

Chairman SHELBY. Well, I am going to be with the Government, like you.

[Laughter.]

Thank you, Senator.

We will continue to examine the issues here that were raised this morning. We will hear, as Senator Sarbanes just said, we will hear from Chairman Donaldson, among others. Credit rating agencies, such as yours, play a very prominent role in the markets. And it is important, I think, that we fully understand the range of issues that confront you and the SEC here.

A couple of things, observations brought up here today: Possible conflicts of interest—let us be honest with each other—lack of competition. I think those are two things that have to be explored further, but that will be another day, but we thank you for the hearing today.

[Whereupon, at 12:41 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

## PREPARED STATEMENT OF SENATOR JIM BUNNING

Thank you, Mr. Chairman. I would like to welcome all of our witnesses here today. I applaud Chairman Shelby for holding this important hearing on the role of the Credit Rating Agencies in the Capital Markets.

As you know, this is a issue I have been working on for some time. In the Sarbanes-Oxley legislation I inserted language to direct the SEC to study credit rating agencies. In light of the events that have happened over the course of the last few years, I think this is a very important and needs further examination.

Credit ratings have become an important investor tool in the financial markets. The average American investor relies heavily on ratings that the four Nationally Recognized Statistical Credit Organizations (NRSCO's) make. NRSCO's have special access to the companies they deal with and they can have private conversations with companies' management that analysts cannot have. They can see financial information about companies that is not public, and SEC exempted them from the Regulation Fair Disclosure (FD). In short, they have insight into the financial well-being of a company average investors do not have. The markets expect you to anticipate what happens and to also warn people if something is producing a red flag.

As we have seen, in the case of Enron and others, these extra advantages are not always enough for the NRSCO's to issue ratings that properly reflect a company's true investment value or credit worthiness. I know that NRSCO's rely heavily on the information that companies provide them. But, in light of the Enron fiasco, the NRSCO and the other credit rating agencies have a major obligation to look beyond what is given to them by any corporation. Also, the average investor has the right to know what procedures NRSCO's use to determine a credit rating. Right now, there is no transparency in the process. For all investors know, you could be pulling a rabbit out of a hat.

I look forward to hearing from all of our witnesses and getting their opinions and expertise on the questions facing us.

## PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Mr. Chairman, thank you for holding this important hearing. I look forward to working with you on many such issues during the 109th Congress.

The role of credit rating agencies in our Nation's economy can not be overstated. Like individuals, companies, cities, counties, and States rely on their credit worthiness to determine if they can borrow money and at what interest rate. If there are problems in the process used to determine creditworthiness, then we should address them. The matter is too important to be left to fester until a crisis occurs.

The matter that most concerns me today is the possibility that conflict of interests may exist at the rating agencies—for instance, a rating analyst trading on confidential information or a rating agency senior executive sitting on a corporate management board.

I am also concerned that rating agencies may be billing clients for work they do not perform. There are reports, for instance, that companies occasionally receive bills for ratings on upcoming equity and debt issues that they did not request. In the 1990's, there were cases in which Michigan school districts were billed for such unrequested ratings and while compared to corporate ratings these bills may be small, they represent a big problem to the school superintendent that is trying to find money in the budget to pay for text books. An unexpected bill of this sort trickles down to the taxpayer in the form of higher tax levies for repayment of school bonds. We clearly have an obligation to do what we can to make sure the system is working properly and that taxpayers and consumers are not taken advantage of.

I look forward to hearing from our witnesses today, determining what problems exist, and how we can best address them.

## PREPARED STATEMENT OF KATHLEEN A. CORBET

PRESIDENT, STANDARD & POOR'S

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 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 90 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 website: *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 1 percent of issuers initially rated in the "AAA" category have defaulted while approximately 60 percent 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 percent of our credit ratings in the United States) are disseminated via real-time posts on our website, 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 nonratings businesses, including any cross marketing of nonratings 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 website 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

* Held in Committee files.

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 cashflow.[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". 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 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.

[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 cashflow 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).

**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 NRSRO's. 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 NRSRO's. 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 NRSRO's 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 would be happy to answer any questions you may have.

## PREPARED STATEMENT OF SEAN J. EGAN

MANAGING DIRECTOR, EGAN-JONES RATINGS CO.

FEBRUARY 8, 2005

Chairman Shelby, Members of the Committee, good morning. I am Sean Egan, Managing Director of Egan-Jones Ratings Company, a credit ratings firm. By way of background, I am a Co-Founder of Egan-Jones Ratings Co., which was established to provide timely, accurate credit ratings to institutional investors. Our firm differs significantly from other ratings agencies in that we have distinguished ourselves by providing timely, accurate ratings and we are not paid by the issuers of debt, which we view as a conflict of interest. Instead, we are paid by approximately 400 firms consisting mainly of institutional investors and broker/dealers. We are based in the Philadelphia, Pennsylvania area, although we do have employees that operate from other offices.

The rating industry is in a crisis. At a time when the capital markets have become increasingly reliant on credit ratings, the ratings industry is suffering from a State that is hard to characterize as anything other than dysfunctional. The problems are:

*Severe consolidation*—Department of Justice personnel referred to the industry as a "partner monopoly" since S&P and Moody's control over 90 percent of the revenues and do not compete against each other as two ratings are normally needed for issues;

*Conflicts of interest*—issuers payment for ratings create conflicts of interest that are similar to those experienced by the equity research analysts;

*Freedom of speech defense*—there is no downside to bad rating calls by the two dominant firms.

Manifestations of the flawed structure are:

Failure to warn investors about problem credits such as Enron, the California utilities, WorldCom, Global Crossing, AT&T Canada, and Parmalat.

- Enron was rated investment grade by the NRSRO's 4 days before bankruptcy,
- The California utilities were rated "A-" 2 weeks before defaulting;
- Worldcom was rated investment grade 3 months before filing for bankruptcy;
- Global Crossing was rated investment grade in March 2002 and defaulted on loans in July 2002;
- AT&T Canada was rated investment grade in early February 2002 and defaulted in September 2002; and
- Parmalat was rated investment grade 45 days before filing for bankruptcy.
- Losses from the Enron and WorldCom failures alone were in excess of $100 billion, thousands of jobs, and the evaporation of pensions for thousands. It is likely that some of these failures could have been avoided had the problems been identified and addressed sooner. (Enron was left with only Dynergy as an acquirer by the time the alarm was sounded.)

*Under-rating credits*—such as Nextel, American Tower, and Thyssenkrupp were assigned credit ratings which were too low, thereby significantly increasing their cost of capital and restricting growth.

*Insider trading*—CitiGroup and probably other institutions were given advanced information about the Enron downgrade. Additionally, S&P and Moody's request advance information about transactions and other major events which creates opportunities for insider trading. S&P analyst Rick Marano and his associates traded on confidential information relating to the acquisition of ReliaStar and American General.

*Investor fraud*—the NRSRO rating firms pulled their ratings on an Allied Signal entity so Allied could repurchase debt more cheaply;

*Issuer coercion*—forcing issuers to pay rating fees (see *The Washington Post* article for a description of Hanover Re actions and Northern Trust comments to SEC) *http://www.washingtonpost.com/wp-dyn/articles/A8032–2004Nov23.html;*

*Punishment ratings*—see the municipality lawsuits; and

*Expansion of monopoly*—expansion into consulting and corporate governance ratings despite rating failures.

Despite the recent credit rating debacles, S&P and Moody's revenues and earnings have continued to grow because of their lock on the market (Moody's operating earnings have increased 230 percent over the past 4 years) and the lack of normal checks and balances. To put the industry structure in perspective, it is as though there were only two major broker-dealers for corporate securities and the approval of both were required before any transactions could be completed.

The arguments used to by the NRSRO's to defend their actions and inactions are the following:

*"Issuer Misdeeds" (they did not tell us)*—S&P, Moody's, and Fitch claim they did not assign the correct rating because WorldCom, Enron, et al. did not provide accurate information. We believe it is a pathetic state when major rating firms are unable to recognize when an issuer and its executives are desperate to keep their firms solvent; it was public knowledge that Bernie Ebbers owed WorldCom more than $400 million. Fraud is present in most failures, and the rating firms (at least those recognized by the SEC) should be able to detect the majority of egregious cases.

*"Little Incentive" (the Jack Grubman defense)*—another argument used by the current NRSRO's to defend their actions is that any single issuer represents only small portions of their overall revenue bases. However, revenues produced by equity analysts Jack Grubman and Henry Blodget were likewise only a small portion of CitiGroup's and Merrill's revenues. Furthermore, when large investment banks are pressing the rating firms to hold off on any rating action, it becomes difficult not to listen.

*"Our Reputation is Key" (the Arthur Andersen defense)*—Arthur Anderson argued that it would not do anything untoward because it would hurt the firm's reputation. Likewise, the current NRSRO's argue that they would not risk their reputation for any one issuer. However, since most issuers believe their ratings are too low and the lack of competition provides little downside for inaccurate ratings, there are few checks in the industry.

*"Committee Approach" (the Lemming defense)*—a final defense normally proffered for the flawed industry is that unlike the investment banks, the NRSRO's use a committee approach for assigning ratings, which is harder to manipulate. Unfortunately, one analyst typically covers a firm and during rating committees what superiors want is probably clear.

To reform the ratings industry, we recommend the following changes:

*(1) Recognize some rating firms which have succeeded in providing timely, accurate ratings*—The problems with the current system are: (a) improving firms have been penalized by paying too much for capital, and (b) investors have been hurt by not obtaining warning of deteriorating firms. The recognition of some firms that have succeeded in providing timely, accurate ratings would be of great benefit.

*(2) Wean rating firms of issuer compensation*—the crux of the equity research analysts' scandal is that analysts were paid by issuers via investment banking fees, thereby corrupting the investment analysis. The same conflicts exist in the credit rating industry. Studies from the Kansas City Federal Reserve Bank and Stanford University and the University of Michigan support the superiority of nonconflicted firms.

*(3) Adopt the Code of Standard Practices for Participants in the Credit Rating Process issued by the ACT, AFP, and AFTE*—the proposed guidelines will assist in increasing the transparency and credibility in the ratings industry.

*(4) Prohibit rating firms from obtaining inside information*—the rating firms should not be given preferential treatment over other financial analysts.

*(5) Sever ties between rating firm personnel and issuers and dealers*—the ex-chairman of Moody's should not have served as a director of WorldCom nor should ratings firm personnel be tied to broker/dealers or broker/dealer industry associations such as the NASD.

Broker/dealers were fined $1.4 billion for the issuance of conflicted equity research. In contrast, the SEC has been studying the rating industry since the early 1990's and has not yet made any substantive changes. The SEC has provided a false sense of security by giving its seal of approval to conflicted firms. If the SEC is unable to implement these changes rapidly, we recommend it withdraw from providing NRSRO designations and protecting the currently recognized firms from competition. Perhaps a board made up of users of credit ratings (excluding broker/dealer affiliated firms) is best able to assess the competency of rating firms.

Regarding Egan-Jones Ratings, we have provided warning for the Enron, Genuity, Global Crossing, and WorldCom failures (we did not rate Parmalat). Furthermore, we regularly identify improving credits; most of our ratings have been above S&P's and Moody's over the past 2 years (thereby providing issuers with more competitive capital). Our success has been recognized by the Federal Reserve Bank of Kansas City which compared all our ratings since inception in December 1995 to those of S&P and concluded:

> "Overall, it is robustly the case that S&P regrades from BBB- moved in the direction of EJR's earlier ratings. It appears more likely that this result reflects systematic differences between the two firms' rating policies than a small number of lucky guesses by EJR."

Source: Research Division, Federal Reserve Bank of Kansas City, Feb. 2003
Link: *http://www.kc.frb.org/publicat/reswkpap/RWP03–01.htm.*

Stanford University and the University of Michigan drew similar conclusions:

> "we believe our results make a strong case that the noncertified agency [Egan-Jones] is the leader and the certified agency [Moody's] is the laggard."

Link: *aaahq.org/AM2004/display.cfm?Filename =SubID—1213.pdf&MIMEType =application percent2Fpdf.*

In August 1998, we applied for recognition by the SEC as a ratings firm (that is, NRSRO status). We continue to provide information to the SEC and hope eventually to be recognized.

Timely, accurate credit ratings are critical for robust capital markets. Investors, issuers, workers, and pensioners will continue to be hurt by the flawed credit rating industry until someone addresses the basic industry problems. I would be happy to answer any questions.

## PREPARES STATEMENT OF MICAH S. GREEN

PRESIDENT, THE BOND MARKET ASSOCIATION

FEBRUARY 8, 2005

Thank you, Chairman Shelby, for the opportunity to testify today on credit rating agencies. My name is Micah S. Green and I am the President of The Bond Market Association. As you know, the Association represents securities firms and banks that underwrite, distribute, and trade debt securities in the United States and internationally—a global market estimated at $44 trillion today. The Association speaks for the bond industry worldwide, advocating its positions and representing its interests in New York, Washington, London, and elsewhere. The Association also works with bond issuers—companies, governments, and others who borrow in the capital markets—and investors in fixed-income products from across the globe.

Our members account for approximately 95 percent of U.S. municipal bond underwriting and trading activity. The membership also includes all primary dealers in U.S. Government securities, as recognized by the Federal Reserve Bank of New York, and all major dealers in U.S. agency securities, mortgage- and asset-backed securities and corporate bonds, as well as money market and funding instruments. In recent years, the Association has sponsored both the American and the European Securitization Forums. These are affiliated organizations that focus on the rapidly growing securitization markets in the United States and Europe. Another Association-sponsored organization, the Asset Managers Forum, brings together institutions that are active in the bond market as investors to address major operational, accounting, public policy, and market practice initiatives. The comments here reflect the collective views of the Association and our forums.

The Bond Market Association is deeply involved in investor education. Although most bond markets are dominated by large, sophisticated institutional investors, it is our strong belief that retail investors must have sufficient background and data to not only make informed investment decisions but also to realize that allocating their assets in a diversified manner is an important investment strategy. Last week, the Association launched an updated version of our award winning investor education website, *Investinginbonds.com.* The site provides investors with background, news, data, and commentary on the bond markets in addition to bond prices. Included in this information is the very important credit rating that is attached to most fixed-income investments.

We welcome the opportunity to testify here today on the role of credit rating agencies in the capital markets. The past 15 years have seen dramatic growth in the number of issuers and the range and complexity of fixed-income securities. The importance of credit ratings to investors and other securities market participants has increased proportionally. The role of rating agencies is critical to the efficient functioning of the fixed-income markets. It is both important and useful for this Committee to focus on an industry that plays such a vital role in the capital markets.

**Credit Rating Agencies and the Fixed-Income Markets**

All investments involve risk. One important type of risk associated with certain bonds and other fixed-income investments is credit risk—the chance that a bond will default, or the issuer will fail to make all interest and principal payments under the bond's terms. A credit rating is essentially an opinion offered by a rating agency on the credit risk of a bond. The credit rating process employs both quantitative tools and subjective judgment. In addition to analyzing a company's balance sheet, for example, credit ratings may also take into account subjective forecasts of the issuer's ability to generate revenue in the future. An investor can determine objective factors such as a security's coupon, maturity, call features, and covenants from the issuer's mandated disclosure. Analysis of an issuer's credit quality, however, involves individual judgments about a variety of complex financial and other information. A credit rating is a valuable complement to an investor's own credit analysis precisely because it is both expert and independent. Credit ratings also guide the market's pricing decisions. Bonds with lower ratings are viewed as riskier than higher-rated bonds by investors who demand a yield premium as compensation for this risk. Conversely, higher-rated bonds will offer a relatively lower yield as a reflection of their stronger credit standing. In addition, ratings play an important role in market regulation.

Rating agencies in general, and certainly the more established agencies, approach the rating process in similar ways. Rating analysts are grouped by market, such as corporate, asset-backed, or municipal bonds, and industry or sector, such as financial services or transportation and rating decisions are made by committee. As part of the process of gathering information, rating agency personnel maintain regular contact with issuers and also rely on regulatory filings, news, and industry reports, among other information. Nonpublic information, such as proprietary business forecasts, also may be available to rating agencies under promises of confidentiality and under an exemption from the Securities and Exchange Commission's (SEC) Regulation FD. The Association strongly supports maintaining this exemption.

Rating agencies generally inform issuers and investors of their rating methodologies for particular asset classes. These are detailed descriptions that provide useful information to issuers and investors, and also help the rating agencies ensure the consistency of their ratings even when different rating analysts are involved.

Once ratings are published, they are available to all market participants and the public. To receive a detailed analysis of the rationale for the rating decision, however, generally requires a fee-based subscription. These subscription fees and the fees paid by the issuer for the rating itself are the principal revenue sources for most rating agencies. The ratings assigned by the three major firms by category are shown in the chart below.

| | Moody's | Standard & Poor's | Fitch Ratings | Dominion Bond Rating |
|---|---|---|---|---|
| **Investment** | **Grade** | | | |
| Highest Quality | Aaa | AAA | AAA | AAA |
| High Quality (very Strong) | Aa | AA | AA | AA |
| Upper Medium Grade | A | A | A | A |
| Medium Grade | Baa | BBB | BBB | BBB |
| **Non Investment** | **Grade** | | | |
| Somewhat Speculative | Ba | BB | BB | BB |
| Speculative | B | B | B | B |
| Highly Speculative | Caa | CCC | CCC | CCC |
| Most Speculative | Ca | CC | CC | CC |
| Imminent Default | C | C | C | C |
| Default | C | D | D | D |

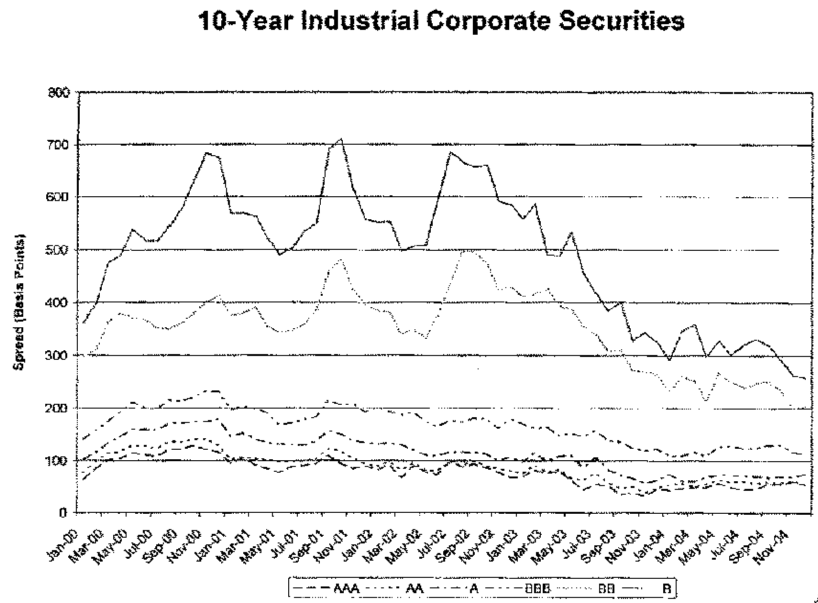
Capital market participants make use of rating information and interact with rating agencies differently depending on their role in the market. For issuers of fixed-income securities, credit ratings typically have a direct effect on the rate at which they can borrow in the capital markets. As noted above, investors will assign a risk premium on lower-rated securities to reflect the higher chance of default. The premium translates into a higher interest rate on the issuer's debt, or an increase in the cost of capital.

To better appreciate the relationship between ratings and yields it is important to consider how the market prices bonds. With few exceptions, prices for fixed-income products are quoted as a number of basis points [1] over a benchmark such as U.S. Treasury securities of a comparable maturity, the London Interbank Offered Rate (LIBOR), the rate on interest rate swaps of comparable duration or some other benchmark that represents an investment perceived to be free of credit risk. The amount that the return on a given investment exceeds the return on the benchmark—a bond's "credit spread"—represents the risk premium investors receive as a result of the degree of risk, principally credit risk, the investment carries. Higher rated bonds have a smaller spread than lower-rated bonds of the same maturity. As the chart below shows, the correlation between rating and spread is historically consistent. It is a trusted metric that promotes market efficiency as it allows a participant to commoditize partially what are disparate assets. A bond dealer asked for a quote on a corporate or municipal security, for example, will look not only at any recent trades for the same security but also at the current yield on similar bonds that have a similar credit rating.

Bond investors are overwhelmingly comprised of mutual funds, pension funds, endowments and asset management firms, and other institutions that employ sophisticated, professional money managers.[2] As of the end of 2003, less than 10 percent of all bonds outstanding in the United Stataes were held directly by individual investors, although in the tax-exempt municipal bond market that figure is about 35 percent. Institutional investors often conduct their own credit analysis of issuers but also rely on credit ratings as part of their overall risk analysis.

[1] One basis point equals 1/100th of a percentage point.

[2] A majority of outstanding municipal debt is beneficially owned by individuals through mutual funds and individual holdings, but investment decisions for a majority of outstanding municipal bonds are made by professional money managers.




Source. Bloomberg

It is common for some institutional investors to have in-house rules limiting investment in any fixed-income security that does not have at least an investment grade rating.[3] Similarly, most States have laws dictating the permitted investments of insurance companies on the basis of credit rating. Some States require two ratings. The National Association of Insurance Commissioners (NAIC) maintains a list of rating agencies whose ratings are acceptable for this purpose.

Broker-dealers also use credit ratings to supplement proprietary credit analysis. They also advise issuers of the effect of ratings on the cost of capital. Credit ratings, of course, are also important to investors with whom broker-dealers interact in the marketplace. In September 2004, the Corporate Debt Market Panel sponsored by the National Association of Securities Dealers (NASD) released a report recommending the disclosure of credit ratings immediately prior to an investor's decision to buy or sell a bond as well as upon confirmation of a trade.

Credit ratings are also used in the regulation of broker-dealers and different types of institutional investors. One notable example is the Securities and Exchange Commission's net capital rule, which requires broker-dealers to maintain specified minimum capital levels to support their assets or customer liabilities. Since 1975, the net capital rule has imposed different capital charges for assets depending upon whether (and at what level) the assets are rated by what the SEC defined as a "Nationally Recognized Statistical Rating Organization" or NRSRO. Higher-rated securities receive a lower capital charge than lower-rated securities. Similarly, SEC-registered money market funds are permitted to invest in short-term debt securities that receive one of the two highest NRSRO ratings. Investment grade ratings can also provide an issuer with the option of short-form SEC registration in some cases.

The Bank for International Settlement's Committee on Banking Regulation stipulates the use of credit ratings in assessing the capital charges for banks under the new Basel Capital Accord, Basel II. Basel II articulates a set of criteria a firm must satisfy in order to qualify as an External Credit Assessment Institution (ECAI) which allow its ratings to be used in this calculation.[4]

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[3] An investment grade rating is defined as at least a BBB rating offered by Fitch Ratings or Standard and Poor's or a Baa rating offered by Moody's. A sub-investment grade rating, also known as high-yield or speculative grade, is defined as any rating below investment grade. Some institutional investors purchase a mix of investment grade and sub-investment grade bonds and some specialize in sub-investment grade exclusively.

[4] International Convergence of Capital Measurement and Capital Standards, Basel Committee on Banking Supervision, June 2004. Page 35. The six criteria include objectivity, independence, transparency, disclosure, resources, and credibility.

**TBMA Response to United States and European Regulatory Proposals**

Recently, regulators in the United States and Europe have stepped up their focus on rating agencies and raised the prospect of changes in the current approach to regulatory oversight. The Association's view on the regulation of credit rating agencies is simple:

- We believe that the criteria adopted by regulators for approving NRSRO's or ECAI's should be flexible enough to allow increased competition between a larger number of entities, while ensuring that designated rating agencies have the expertise to produce accurate ratings. In the United States, this means eliminating the current requirement that a rating agency be widely recognized, rather than accepted in a defined sector of the market.
- We believe credit rating agencies should have policies and procedures to ensure the independence of the credit rating process.
- We believe credit rating agencies should publish their rating methodologies for various types of securities, so that both issuers and users will understand the agencies' requirements and standards, and so that different rating analysts in the same agency will produce consistent ratings.
- We do not believe that regulation of the credit rating process is necessary or desirable, since Government regulation would tend to result in less diversity of opinion and would be less responsive to new product developments.
- We believe issuers should be given an opportunity to correct factual misstatements in rating agency reports, but not to appeal rating designations outside the rating agency.
- We believe rating agencies should publish information on the historical accuracy of their rating assessments.

As the capital markets develop and mature globally, the need for a measured approach by regulators toward the conduct of rating agencies grows in importance. The Association does support those actions by regulators—such as modifying the criteria for NRSRO designation—that we believe will help enhance competition among rating agencies. We do not support steps that would limit the independence of rating agencies to determine their opinions of the creditworthiness of issuers.

For more than a decade, the SEC has contemplated a rulemaking to address the credit rating industry, the role it plays in the securities market and how it should be regulated. A 1994 concept release led to a proposed rule in 1997 that would have set new criteria for NRSRO status. The SEC did not act on the proposal but in 2003 issued a report[5] in accordance with the Sarbanes-Oxley Act followed by a concept release. The concept release addressed questions of NRSRO regulation, potential conflicts of interest between rating agencies and issuers and competition within the industry. (The Association's 2003 response to the concept release is attached in appendix 1.)*

In response to the concept release, the Association filed a comment letter endorsing the NRSRO designation with some clarification to address competition and other issues. Generally speaking, the Association acknowledges the important role rating agencies play in the capital markets. All market participants—investors, dealers, issuers (and their advisors), and regulators—count on rating agencies as reliable sources of analysis whose judgments are sound. A number of statistical studies show a correlation between strong ratings and a low probability of default. At the same time, rating agencies cannot be expected to evaluate risk perfectly. Their analysis relies on the integrity of an issuer's disclosure.

In 2004, the International Organization of Securities Commissions (IOSCO), of which the SEC is a member, proposed a code of conduct for rating agencies, which was followed by a request from the European Commission for public input on how the code of conduct should be implemented. In response, the Committee of European Securities Regulators (CESR) produced a consultative paper suggesting a range of regulatory approaches based on the IOSCO principles. In our comments to CESR, The Association's position on the regulatory proposals dealing with the credit rating process in the United States and Europe is centered on the fundamental issues of competition and market conduct. (The Association's response to both IOSCO and CESR can be found in appendix 2.)*

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[5] *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, U.S. Securities and Exchange Commission, January, 2003. Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws,* S.E.C. Concept Release June 2003.

* Held in Committee files.

**Competition**

Some observers have questioned whether the credit rating industry is as competitive as it should or could be and suggest that inappropriate barriers to entry exist. In the United States, the nature of the NRSRO designation is often brought up as a factor in this debate. The Association supports the retention of this designation. We have also called for greater clarity in the SEC's approval policy and the elimination of the requirement that a rating agency be "widely accepted" in order to gain the designation. The Association certainly welcomes additional entrants to the marketplace from any part of the globe. Increasing competition among qualified rating agencies could only benefit issuers, investors, and the market generally.

The Association responded to the 2003 concept release with suggestions for improving the transparency of the designation process. Increased transparency will aid public understanding of the process and improve the ability of other rating agencies to gain the NRSRO designation leading to enhanced competition in the industry. The SEC should adopt a formal and standardized application process. Applications should be public and the subject of public comment. Applicants likely to receive an adverse decision should have the option to withdraw their applications to prevent the release of proprietary information. The SEC's reasons for accepting or rejecting an application should be explicitly stated and existing NRSRO's should also complete the application process to ensure uniform treatment.

At present, the SEC primarily considers whether an agency is "widely accepted" when deciding whether to grant NRSRO status. Other factors such as an agency's financial resources, staff experience, independence, and rating procedures are also considered. The Association believes the "widely accepted" standard should be relaxed in the cases where a rating agency meets all other criteria but happens to specialize in only a single market or industry or geographic sector. The NRSRO status of such a rating agency could be limited to its area of expertise. This will reduce barriers to entry and enhance competition. An obvious way to increase the number of agencies whose ratings are widely accepted is to approve niche credit raters which can then—after gaining experience and market acceptance—expand to cover a broader range of industries and securities.

In Europe, CESR has listed barriers to entry that exist in the credit rating field and asked how regulators should address them. The credit rating industry is difficult to penetrate for new firms. Much of the value the market assigns to credit ratings is based on reputation and track record, something new entrants necessarily lack. This dynamic, however, is not unique to the rating industry and CESR itself has described barriers as "natural." It also has not created a market failure or a condition in which a segment of issuers goes without service. The flexibility of an IOSCO-type code-of-conduct approach, as opposed to detailed regulation of rating agency business practices, will facilitate the entrance and expansion of new credit rating agencies in the market.

The NRSRO designation serves a unique purpose in SEC regulations for which a substitute is either not available or not practical. Using credit spreads or internal credit ratings as alternatives to NRSRO ratings for computing net capital requirements is possible, for example, but would add significant costs. In addition, in the case of internal ratings it could result in the nonuniform treatment of the same assets by different firms.

**Rules of Conduct**

The day-to-day operations of rating agencies should never be controlled by regulation. With respect to both the United States and Europe, specific rating methodologies and standards of due diligence should not be mandated by regulators. The rating process is subjective in some respects and cannot be evaluated for appropriateness by a Government agency. The Association does believe it would be appropriate for rating agencies to disclose internal statistics on the accuracy of their ratings. Government mandates of rating methodology, however, could be construed as a Government approval of securities that receive high ratings from designated rating agencies. It would also effectively eliminate differences in the analysis of competing rating agencies and undermine the value of independent credit analysis.

Similarly, while conflicts of interest between rating agencies, issuers, and subscribers may exist, it would not be appropriate for regulators to prescribe specific methods for dealing with the issue. A more favorable approach—and one the IOSCO code now requires—would be for rating agencies to adopt policies and procedures to address and disclose potential conflicts of interest, such as issuer and subscriber influence and the potential misuse of public information. It is the view of some institutional investors—particularly with respect to structured finance products—that such policies and procedures should be designed to discourage participation in the practice known as "ratings shopping," a situation in which an issuer employs a rating agency based on real or perceived differences in methodology that could result in more favorable ratings.

**Conclusion**

The Association is pleased to offer the above comments on credit rating agencies. As we have noted, the credit rating industry plays an important and unique role in the capital markets. It is also an industry whose integrity is effectively ensured by market discipline. Rating agencies that appear biased or corrupt or supply dishonest analyses would find their services without value. Regulators can best ensure the credit rating industry remains robust and independent by endorsing a principles-based approach to industry oversight, like the IOSCO Code, that supports competition but does not dictate specific methodologies or other rules of conduct. Regulators need to address the barriers to entry by clarifying the criteria for designating NRSRO's and changing the "widely recognized" requirement so niche players can enter the market.

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## PREPARED STATEMENT OF YASUHIRO HARADA

EXECUTIVE VICE PRESIDENT, RATING AND INVESTMENT INFORMATION, INC.

FEBRUARY 8, 2005

Thank you, Chairman Shelby, Ranking Member Sarbanes, and Members of the Senate Banking Committee for your kind invitation to present testimony at today's hearing entitled "Examining the Role of Credit Rating Agencies in the Capital Markets."

We are very pleased to offer our thoughts on this topic as well as some more specific information about the challenges faced by our firm, Rating and Investment Information, Inc. (R&I), a credit rating agency headquartered in Tokyo, as we have sought to clear the hurdles necessary to become an effective new competitor in the United States market. Even though R&I is the most recognized credit rating agency in Japan and the broader Asian markets, obtaining designation in the U.S. as a "Nationally Recognized Statistical Rating Organization" (NRSRO) has been an exercise in delay and disappointment.

**Background Regarding Credit Rating Agencies as NRSRO's**

Investors and market professionals historically have used securities ratings issued by credit rating agencies to gauge the creditworthiness of a particular issue. The SEC significantly expanded the traditional use of ratings in 1975 when it adopted Rule 15c3–1 (the Net Capital Rule) under the Securities Exchange Act of 1934 (Exchange Act). The Net Capital Rule incorporated credit ratings by NRSRO's in certain of its provisions. Rather than use securities ratings as a measure of creditworthiness, the Net Capital Rule created the NRSRO concept to measure liquidity. Currently, there are four rating agencies designated by the SEC as NRSRO's for purposes of the Net Capital Rule.

Since 1975, however, the use of NRSRO ratings in the Federal securities laws and regulations has expanded considerably beyond a measure of a security's liquidity, as has reliance on those ratings by investors and the marketplace. The term "NRSRO" remains undefined in SEC regulations, and the informal process for determining who is an NRSRO remains unchanged—a credit rating agency seeking NRSRO status must "apply" to the SEC's Division of Market Regulation for a no-action letter. Meanwhile, both Congress and the SEC have on numerous occasions incorporated the NRSRO concept for other purposes, primarily as indicia of a security's creditworthiness—the historical and predominant use of securities ratings.

Congress, for example, employed the term NRSRO when it defined "mortgage related security." [1] However, Congressional reliance on the term used in SEC rules is significant because it reflects a recognition that the "term has acquired currency as a term of art." [2] The SEC also has incorporated the term "NRSRO" in various rulemakings under the Securities Act of 1933, the Exchange Act, the Investment

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[1] Section 3(a)(41) of the Exchange Act was added by the Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98–440, § 101, 98 Stat. 1689, 1689 (1984).

[2] H.R. Rep. No. 994, 98th Cong., 2d Sess. 46 (1984) (appending Statement of Charles C. Cox, Commissioner, Securities and Exchange Commission, to the Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce, Mar. 14, 1984).

Company Act of 1940, and the Investment Advisers Act of 1940 for purposes well beyond those originally intended under the Net Capital Rule.[3]

**Flaws in the NRSRO Process**

In order to compete effectively in the U.S. market, a designation by the SEC as an NRSRO is a critical factor in the industry. In addition to the NRSRO application process having little regulatory guidance and/or an established timetable for agency decisionmaking, the specific entry barrier for R&I and other companies is the SEC requirement that a new NRSRO be "nationally recognized." In essence, this means that the rating agency must be "widely accepted in the United States" as an issuer of credible ratings by predominant users of such ratings before it can gain such a designation to enter the U.S. market. As can be seen, this is a circular test. It was precisely this circular standard which the Antitrust Division of the U.S. Department of Justice singled out in 1998 as likely to preclude new competitors in this credit rating market.[4] Moreover, concern about the lack of new competitors in this market led the Justice Department to recommend to the SEC in 1998 that NRSRO designation be specifically awarded to some foreign rating agencies.

**R&I's NRSRO Application**

As noted, R&I is the largest and most recognized Asian rating agency. It is headquartered in Japan, the second largest economy in the world. R&I is a respected independent source of financial information for the overwhelming majority of United States broker-dealers and financial institutions that conduct operations in Japan, and provides a variety of ratings services to United States and foreign companies. Market participants particularly appreciate that R&I calculates and publishes a "broad-definition default ratio" based on a 27-year record which indicates the probability that an issuer that has been given a publicly released rating will fall into default within that given period of time. R&I's ratings are regularly announced and published by the leading financial electronic and print media in Japan, and in the United States as well.

In regard to your Committee's specific request for a discussion of our agencies' internal ratings process we present the following overview of the R&I rating team's procedures. The rating team is responsible for reviewing financial information regarding the issuer and the terms of the instrument to be issued. The team reviews both publicly available information and confidential information obtained from the issuer. Teams generally review the financials of the issuer from the prior 5 years, as well as forecasts for the next 3 years.

R&I staff, including at least one senior analyst, will visit the senior management of the issuer as part of a detailed due diligence exam of the issuer. This on-site due diligence examination typically lasts several days. During the visit, the team meets with the chief executive officer of the issuer, holds various meetings with senior executives in the areas of finance, planning and development, production, sales, and, where applicable, may schedule an inspection of plants and/or other facilities. The meetings include both issuer presentations and detailed, extensive interview sessions with senior management. Particular attention is focused on the issuer's cashflow and overall financial stability. Each rating team considers industry trends, sector volatility, and any relevant geopolitical or economic risk. The rating team also conducts intercompany comparisons, taking into consideration any relevant geopolitical, currency, or economic risk.

Once the initial analysis is complete, each team's written report is scrutinized in R&I's intensive committee review process. The team's report and recommendation initially is submitted to the Rating Committee. R&I has three classifications of Ratings Committees: The Plenary Committee, the Standing Committee, and the Subcommittee. The Plenary Committee is the most senior committee and serves as an "appellate" body for the other committees, addressing any controversial or novel rating that is under consideration by the other committees. The Standing Committee evaluates the majority of the proposed ratings, and the Subcommittee reviews ratings that are less likely to change than other ratings, such as ongoing ratings of previously rated issues or issuers. R&I management is generally prohibited from participating in the Rating Committee. In exceptional circumstances, and only with

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[3] The SEC currently employs the NRSRO concept in the following rules: 17 CFR 228.10(e), 229.10(c), 230.134(a)(14), 230.436(g), 239.12, 239.33, 240.3a1–1(b)(3), 2401.10b–10(a)(8), 240.15c3–1(c)(2)(vi)(E), (F), and (H), 240.15c3–1a(b)(1)(i)(C), 240.15c3–1f(d), 242.101(c)(2), 242.102(d), 242.300(k)(3) and (1)(3), 270.2a–7(a)(10), 270.3a–7(a)(10), 270.3a–7(a)(2), 270.5b–3(c), and 270.10f–3(a)(3).

[4] Letter from Antitrust Division of the U.S. Department of Justice in the matter of File No. S7–33–97 Proposed Amendments to Rule 15c3–1 under the Securities Exchange Act of 1934 (Mar. 6, 1998).

express authorization of R&I's Board of Directors, R&I senior executives may observe the Rating Committee meetings, but cannot vote on any matter discussed by the Rating Committee.

For over a decade, R&I and its predecessors have engaged the SEC in an effort to receive NRSRO designation. This began in October 1990, when the Japan Bond Research Institute (JBRI) submitted a letter to the SEC requesting designation as an NRSRO. In January 1991, Nippon Investors Services, Inc. (NIS) submitted its request for NRSRO designation. While there was some interaction with the SEC following these applications neither entity received a formal response from the SEC.

On April 1, 1998, NIS and JBRI merged to form R&I and in July 1998, R&I submitted a follow-up letter to the SEC requesting that R&I be designated as an NRSRO. This led to some discussion with the SEC staff after which R&I submitted an amended request for NRSRO designation in January 2002. The 2002 request was limited in scope in that R&I sought to be recognized as an NRSRO solely with respect to yen-denominated securities. R&I's expertise in yen-denominated securities is recognized throughout the world's financial markets and by the leading financial institutions in the United States. There is past precedent for the SEC to designate limited-purpose NRSRO's including the designation of two agencies, in particular, IBCA and Thompson BankWatch, Inc., as NRSRO's for limited purposes. Such recognition on a limited-basis was considered appropriate if a rating agency could demonstrate that it possesses unique expertise in rating particular securities, or securities of particular currency denomination. As a practical matter, investors and the marketplace will be significantly deprived of the full benefit of this expertise unless the rating agency is recognized as a NRSRO, at least with respect to those securities issues in which the rating agency has expertise.

**Recent Developments**

In early 2002, the Senate Committee on Government Affairs held a series of hearings into the collapse of Enron. In a follow-up staff report on Enron, hearings focused, among other things, on the fact that there were only three major NRSRO operating in the United States.[5]—a situation which continues to this day. As this Committee is aware, the Sarbanes-Oxley Act of 2002 required that the SEC then conduct a study of the role of credit rating agencies in the U.S. securities markets and submit a report regarding its study to the President and Congress.

In November 2002, as part of its study, the SEC held 2 full-days of hearings attended by a variety of academics, credit rating agencies, and consumers of ratings reports such as investment companies. R&I submitted written comments to the SEC prior to these hearings. Additionally, I participated in the SEC Roundtable forum on November 21, 2002. In January 2003, the SEC issued its report which included its plans to issue a concept release within 60 days of the report to seek comment on issues that would form the basis of proposed rules with respect to credit rating agencies. In February 2003, shortly after issuing its report, the SEC approved a fourth credit rating agency as a new NRSRO. In June 2003, the SEC issued a concept release on credit rating agencies and the administration of the NRSRO application process. R&I promptly submitted its comments on the concept release. Since publication of the SEC's concept release, there has been additional public action with respect to credit rating agencies including two additional hearings in the House Financial Services Committee,[6] a three-part series in *The Washington Post* that focused mainly on the lack of competition in the credit rating industry which appeared in November 2004, and most recently a white paper on the subject published by the American Enterprise Institute.[7]

**Action Sought with Respect to R&I's Application**

It is essential that additional qualified credit rating agencies be recognized as NRSRO's to increase the quality of the oversight function that such credit rating agencies play in the U.S. securities markets. Each additional NRSRO will benefit investors and the financial markets by improving the availability of important financial information and analysis. Considering the pace and uncertainty of any regulatory change, pending NRSRO applications, including R&I's application, should receive prompt attention.

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[5] Press Statement, "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs," Chairman Joe Lieberman, October 7, 2002.

[6] House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, "Rating the Rating Agencies: the State of Transparency and Competition," hearing on April 2, 2003, and "The Ratings Game: Improving Transparency and Competition Among the Credit Ratings Agencies," held on September 14, 2004.

[7] "End the Government-Sponsored Cartel in Credit Ratings" by Alex Pollock, AEI Financial Services Outlook, January 2005.

Despite the increased interest and attention directed at credit rating agencies since the submission of R&I's January 2002 NRSRO request, there has been no appreciable progress with respect to R&I's application. Eight leading Wall Street investment-banking firms and two major U.S. insurance companies have written to the SEC to support R&I's NRSRO designation. R&I understands that the future regulation of credit rating agencies and the use of the NRSRO designation is in transition, particularly in light of the concept release and continuing Congressional hearings; however, without such designation, we operate at a competitive disadvantage every day under the current regulatory scheme. R&I is well-qualified to contribute to the flow of information and expert analysis so valuable to U.S. investors and issuers. Therefore, the lack of progress on R&I's application harms both R&I and investors. If allowed to enter the market, U.S. investors, especially institutional investors such as insurance companies, would benefit from having an additional source of proven credit analyses and U.S. issuers benefit from having more providers of rating services in the Samurai bond market. Until such time as a new regulatory scheme is implemented with respect to credit rating agencies (which could be years away, if ever), we respectfully suggest the SEC should be focusing on approving qualified NRSRO's. We encourage the Committee to advise the SEC not to neglect pending NRSRO applications nor require such applicants to await further rulemaking prior to approval.

**Appropriate Type of Regulatory Oversight for Credit Rating Agencies**

It would be appropriate and fair to regularly check if rating agencies recognized as NRSRO's have been maintaining their original qualification criteria. This can be accomplished by requiring NRSRO's to submit reports to the SEC indicating past performance and continuing qualification. Such submissions should be disclosed to the public. If the SEC determines that a particular NRSRO fails to satisfy all of the necessary criteria, such rating agency should be required to immediately rectify the situation. If, after one year's probation period, such an NRSRO still fails to all of the criteria, the NRSRO recognition should be revoked.

The SEC should review an NRSRO's continuing compliance with the original qualification criteria. If there is any reason to believe that an NRSRO has failed to meet any of the original qualification criteria at any time, the SEC should be able to conduct a review of the particular NRSRO in question. The evaluation of the overall quality and performance of NRSRO's generally should be deferred to market participants.

If the Committee has any questions regarding R&I, its operations, or its application with the SEC for NRSRO status, we would be glad to respond to any requests for information. We earnestly seek a timely review and a speedy determination regarding R&I's NRSRO application. Thank you for the opportunity to present these views.

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## PREPARED STATEMENT OF STEPHEN W. JOYNT

PRESIDENT AND CHIEF EXECUTIVE OFFICER, FITCH RATINGS

FEBRUARY 8, 2005

**Introduction**

Fitch Ratings traces it roots to the Fitch Publishing Company established in 1913. In the 1920's, Fitch introduced the now familiar "AAA" to "D" rating scale. Fitch was one of the three rating agencies (together with Standard & Poor's (S&P) and Moody's Investors Service (Moody's)) first recognized as a Nationally Recognized Statistical Rating Organization (a so-called "NRSRO") by the Securities and Exchanges Commission (SEC) in 1975.

Since 1989 when a new management team recapitalized Fitch, Fitch has experienced dramatic growth. Throughout the 1990's, Fitch especially grew in the new area of structured finance by providing investors with original research, clear explanations of complex credits and more rigorous surveillance than the other rating agencies.

In 1997, Fitch merged with IBCA Limited, another NRSRO headquartered in London, significantly increasing Fitch's worldwide presence and coverage in banking, financial institutions, and sovereigns. Through the merger with IBCA, Fitch became owned by Fimalac, a holding company that acquired IBCA in 1992. The merger of Fitch and IBCA represented the first step in our plan to respond to investors' needs for an alternative global, full-service rating agency capable of successfully competing with Moody's and S&P across all products and market segments.

Our next step in building Fitch into a global competitor was our acquisition of Duff & Phelps Credit Rating Co., an NRSRO headquartered in Chicago, in April 2000 followed by the acquisition later that year of the rating business of Thomson BankWatch. These acquisitions strengthened our coverage in the corporate, financial institution, insurance, and structured finance sectors, as well as adding a significant number of international offices and affiliates.

As a result of this growth and acquisitions, Fitch today has approximately 1,600 employees, including over 750 analysts, in over 49 offices and affiliates worldwide. Fitch currently covers over 4,400 corporations, banks and financial institutions, 86 sovereigns, and 40,000 municipal offerings in the United States. In addition, we cover over 7,500 issues in structured finance, which remains our traditional strength.

Fitch is in the business of publishing research and independent ratings and credit analysis of securities issued around the world. A rating is our published opinion as to the creditworthiness of a security, distilled into a simple, easy to use grading system (AAA to DDD). Fitch typically provides explanatory information with each rating.

Rating agencies gather and analyze a variety of financial, industry, market, and economic information, synthesize that information, and publish independent, credible assessments of the creditworthiness of securities and issuers, thereby providing a convenient way for investors to judge the credit quality of various alternative investment options. Rating agencies also publish considerable independent research on credit markets, industry trends, and economic issues of general interest to the investing public.

By focusing on credit analysis and research, rating agencies provide independent, credible and professional analysis for investors more efficiently than investors could perform on their own.

We currently have hundreds of institutional investors, financial institutions, and Government agencies subscribing to our research and ratings, and thousands of investors and other interested parties that access our research and ratings through our free website and other published sources and wire services such as Bloomberg, Business Wire, Dow Jones, Reuters, and The Wall Street Journal.

A diverse mix of both short-term and long-term investors uses our ratings as a common benchmark to grade the credit risk of various securities.

In addition to their ease of use, efficiency and widespread availability, we believe that credit ratings are most useful to investors because they allow for reliable comparisons of credit risk across diverse investment opportunities.

Credit ratings can accurately assess credit risk in the overwhelming majority of cases and have proven to be a reliable indicator for assessing the likelihood that a security will default. Fitch's most recent corporate bond and structured finance default studies are summarized below.

**Fitch Average Annual Default Rates**

| | **Corporate Finance* 1990 - 2003** | **Structured Finance** 1991 - 2003** |
|---|---|---|
| AAA | 0.00% | 0.00% |
| AA | 0.00% | 0.01% |
| A | 0.05% | 0.02% |
| BBB | 0.38% | 0.11% |
| BB | 1.93% | 0.48% |
| B | 2.33% | 1.15% |
| CCC - C | 27.20% | 15.57% |
| Investment Grade | 0.12% | 0.03% |
| Non Investment Grade | 4.33% | 1.54% |

* Based on Fitch-rated global corporate debt issuers.

** Based on Fitch-rated U.S. structured finance bonds.

The performance of ratings by the three major rating agencies is quite similar. We believe this similarity results from the common reliance on fundamental credit analysis and the similar methodology and criteria supporting ratings.

Through the years, NRSRO ratings also have been increasingly used in safety and soundness and eligible investment regulations for banks, insurance companies, and other financial institutions. While the use of ratings in regulations has not been without controversy, we believe that regulators rely on ratings for the same reason that investors do: Ease of use, widespread availability, and proven performance over time.

Although one can use other methods to assess the creditworthiness of a security, such as the use of yield spreads and price volatility, we believe that such methods, while valuable, lack the simplicity, stability, and track record of performance to supplant ratings as the preferred method used by investors to assess creditworthiness.

However, we also believe that the market is the best judge of the value of ratings. We believe that if ratings begin to disappoint investors they will stop using them as a tool to assess credit risk and the ensuing market demand for a better way to access credit risk will rapidly facilitate the development of new tools to replace ratings and rating agencies.

**Regulatory Review of Rating Agencies**

Beginning in 2002, the SEC began a thorough study of rating agencies that included informal discussions with Fitch and the other rating agencies, a formal examination of our practices and procedures, and two full days of public hearings in November 2002 in which we participated. Following the passage of the Sarbanes-Oxley Act of 2002, the SEC issued its *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Market* in January 2003. In June 2003, the SEC issued a concept release, *Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws,* soliciting public comment on a variety of issues concerning credit rating agencies.

In the international arena, in the summer of 2003, a working group of the International Organization of Securities Commissions (IOSCO), under the leadership of SEC Commissioner Roel Campos, began its study of the credit rating agencies. Fitch was an active participant in the IOSCO process that ultimately led to the publication by IOSCO of the *Statement of Principles Regarding the Activities of the Credit Rating Agencies* in September 2003 and the *Code of Conduct Fundamentals for Credit Rating Agencies* at the end of last year.

Given the importance of credit ratings in the financial market, we agree that there is a strong need for credit rating agencies to maintain high standards. For that reason, throughout the past 3 years Fitch has participated actively in the dialogue at the SEC, IOSCO, and on a local level throughout the world about the role and function of the rating agencies in the worldwide capital markets.

Fitch supports the four high-level principles outlined by IOSCO as announced in it *Principles* in September 2003, which the IOSCO Code complements. These four principles include transparency and symmetry of information to all market participants, independence, and freedom from conflict of interest. We are supportive of the IOSCO Code and we believe that our present operating policies and practices exemplify the principles of the IOSCO Code and will continue to work with all capital markets participants to refine "best practices" for the ratings industry. We plan to publish our formal code of conduct, together with our existing policies that complement it, by the end of the first quarter of this year.

**Testimony**

Set forth below is a summary of our views on the issues we understand the Committee on Banking, Housing, and Urban Affairs intends to explore at its hearing "Examining the Role of Credit Rating Agencies in the Capital Markets."

*NRSRO Recognition Process And Criteria*

We believe that the SEC should formalize the process by which it recognizes rating organizations. The application process, specific recognition criteria, and time frames for action on all applications should be specified in appropriate regulations. We believe public comment should be solicited on applications and an appropriate appeal process should be put in place.

The criteria for recognition should include an evaluation of the organization's resources, its policies to avoid conflicts of interest and prevent insider trading and the extent to which market participants use the organization's ratings. Most importantly, however, recognition should be based upon the organization demonstrating the performance of their ratings over time by publication of actual default rates experienced in rating categories and transition studies showing the actual movement of ratings over time. When considering a rating organization for possible recognition, we believe the SEC should evaluate the default and transition experience of each organization's ratings against a benchmark reflecting the aggregate, historical default, and transition rates of all ratings issued by rating agencies in the market.

Ultimately, we believe that recognition should be reserved for those organizations that prove the performance of their ratings over time relative to the performance of other rating systems.

We also believe that the SEC should continue the practice of limited recognition that acknowledges the special expertise of smaller organizations in selected areas of specialty or geographic regions such as the prior recognition afforded to IBCA and BankWatch for their expertise in financial institution analysis.

Fitch does not believe that a criterion for recognition should be adherence to generally accepted industry standards. In fact, such industry standards do not exist in the case of credit rating agencies and we believe that it would be detrimental to introduce them. Ratings are opinions, and as such are based on differing criteria, qualitative and quantitative, in each agency. The market benefits from this diversity of opinion, and demands it. Requiring that a rating agency abide by strict standards would create a situation in which each agency would produce the same result on each credit and there would be no need for competing agencies or any benefit from competing agencies.

*Examination and Oversight of NRSROS*

Fitch acknowledges the Commission's right to revoke the recognition of any NRSRO that no longer meets the criteria for recognition. Given the importance of credit ratings in the financial markets, we believe this is an important need. As we discussed in connection with the criteria for recognition, we also believe that the examination and oversight of NRSRO's should be principally focused on the performance of a rating organization's ratings over time relative to the performance of other rating systems. Accordingly, we believe that the Commission's principal oversight function should be to evaluate regularly the default and transition experience of each organization's ratings against an aggregate benchmark. Additionally, we also acknowledge the importance of our adherence to policies designed to prevent the misuse of inside information and the need of the Commission to ensure compliance with these important policies.

In addition, we believe that any oversight should be narrowly tailored to recognize the constitutional rights of the rating agencies, which function as journalists and thus should be afforded the high level of protection guaranteed by the First Amendment. An excessive amount of interference with the business of rating agencies would both violate the First Amendment rights of the agencies and remove some of the flexibility in the ratings process that is critical to objective and timely ratings.

Within this framework, a narrowly tailored oversight scheme specific to rating agencies should be developed. While the rating agencies currently file voluntarily under the Investment Advisor's Act, this is not a "good fit," as our agencies function as journalists, providing analysis and opinion, and not as investment advisers. As the Supreme Court recognized in Lowe, Congress "did not seek to regulate the press through the licensing of nonpersonalized publishing activities" when it enacted the Investment Advisors Act, but rather was "primarily interested in regulating the business of rendering personalized investment advice." *Lowe* v. *SEC,* 472 U.S. 181, 204 (1985). Fitch does not provide any personalized investment advice; indeed, even Fitch's nonpersonalized ratings do not make any recommendations to buy or sell particular securities, but rather simply analyze the creditworthiness of a security, a point noted by the SEC staff in its June 4, 2003 response to questions from Congressman Richard H. Baker. Fitch is therefore not an "investment advisory business" within the meaning of the Investment Advisors Act and to try to make the Investment Advisors Act apply to Fitch and other rating agencies would not be productive.

In the same vein, it would be unsound to seek to impose a diligence requirement on rating agencies either for purposes of creating a private right of action or for oversight purposes. Even putting aside the significant and in our view insurmountable issues of statutory authority and constitutionality, rating agencies do not now audit or verify the information on which they rely, and to impose such a requirement would duplicate the work of the various professionals (auditors, lawyers, investment bankers, and fiduciaries) upon whom the law does place certain obligations of diligence and due care.

*Conflicts of Interest*

Over the years, there has been considerable discussion about the fact that the current NRSRO's derive a significant portion of their revenue from the ratings fees charged to issuers of rated securities. Fitch does not believe that the fact that issuers generally pay the rating agencies' fees creates an actual conflict of interest, that is, a conflict that impairs the objectivity of the rating agencies' judgment about creditworthiness reflected in ratings. Rather, it is more appropriately classified as a potential conflict of interest, that is, something that should be disclosed and managed to ensure that it does not become an actual conflict. We believe the measures that Fitch uses to manage the potential conflict adequately prevent an actual conflict of interest from arising.

Charging a fee to the issuer for the analysis done in connection with a rating, dates back to the late 1960's. Investors, who are the ultimate consumers of the rating agency product, are quite aware of this.

By way of context, Fitch's revenue comes from two principal sources: The sale of subscriptions for our research, and fees paid by issuers for the analysis we conduct with respect to ratings. In this we are similar to other members of the media who derive revenue from subscribers and advertisers that include companies that they cover. Like other journalists, we emphasize independence and objectivity because our independent, unbiased coverage of the companies and securities we rate is important to our research subscribers and the marketplace in general.

Fitch goes to great lengths to ensure that our receipt of fees from issuers does not affect our editorial independence. We have a separate sales and marketing team that works independently of the analysts that cover the issuers. In corporate finance ratings, analysts generally are not involved in fee discussions. Although structured finance analysts may be involved in fee discussions, they are only the most senior analysts who understand the need to manage any potential conflict of interest.

We also manage the potential conflict through our compensation philosophy. The revenue Fitch receives from issuers covered by an analyst is not a factor in that analyst's compensation. Instead, an analyst's performance, such as the quality and timeliness of research, and Fitch's overall financial performance determine an analyst's compensation. Similarly, an analyst's performance relative to his or her peers and the overall profitability of Fitch are what determine an analyst's bonus. The financial performance of an analyst's sector or group does not factor into their bonuses.

Fitch does not have an advisory relationship with the companies it rates. It always maintains full independence. Unlike an investment bank, our fees are not based on the success of a bond issue or tied to the level of the rating issued. The fee charged an issuer does not go up or down depending on the ratings assigned or the successful completion of a bond offering.

Our fee is determined in advance of the determination of the rating and we do not charge a fee for a rating unless the issuer agrees in advance to pay the fee. While we do assign ratings on an unsolicited basis, we do not send bills for unsolicited ratings. Any issuer may terminate its fee arrangement with Fitch without fear that its rating will be lowered, although we do reserve the right to withdraw a rating for which we are not paid or if there is insufficient investor interest in the rating to justify continuing effort to maintain it.

As noted above, Fitch believes that the disclosure of the arrangement by which an issuer pay fees to Fitch in connection with Fitch's ratings of the issuer is appropriate. Accordingly, Fitch currently discloses that it receives fees from issuers in connection with our ratings as well as the range of fees paid. This has been our practice for sometime.

Another concern discussed by the SEC in the Concept Release is that subscribers have preferential access to rating analysts and may obtain information about a rating action before it is available to the general public. This concern is completely unwarranted in the case of Fitch. Fitch takes great efforts to ensure that all members of the public have access to our ratings and may discuss those ratings with our analysts, whether or not those interested parties are subscribers.

All public ratings and rating actions are widely disseminated through our web sites and international wire services. Except for prior notification to the issuer of a rating or rating action, Fitch never selectively discloses ratings and rating actions to any subscriber or any other party. Fitch's ratings and related publications, including those detailing rating actions, are widely available through our public websites and wire services free-of-charge and there are no prior communications of rating actions to subscribers.

Fitch analysts do regularly conduct informal conversations with investors, other members of the financial media, and interested parties discussing our analysis and commentary, but as a matter of policy, those conversations can never go beyond the scope of our published analysis or communicate any nonpublic information. We believe that making our analysts available to anyone interested in discussing our analysis is a valuable service to investors and the capital markets at large. The contact information for the principal analysts and other key contact people at Fitch is included in every item we publish for the purpose of facilitating interested parties posing questions to our analysts. Anyone can call our analysts free-of-charge and discuss our analysis with them, whether or not the person is a subscriber to our subscription services.

From time to time, we also hold free telephone conferences that are available to anyone interested, at which our analysts will discuss our published analysis and criteria and take questions from the participants. These telephone conferences are publicly announced in the same manner our ratings and rating actions are disseminated.

We also sponsor conferences throughout the world, as well as participate in conferences sponsored by others (which may sometimes require payment of a registration fee) at which our analysts will discuss our published analysis and criteria. Fitch publicly advertises these conferences and all are welcome.

In addition, we firmly believe that existing antifraud remedies are sufficient to deter any inappropriate disclosures by rating agencies to subscribers or any other parties.

Concern has also been raised about the potential conflicts of interest that may arise when rating agencies develop ancillary fee-based businesses. Over the years, revenue derived by Fitch from nonrating sources, including consulting and advisory services has been minimal. Historically, the bulk of such services related to providing customized ratings, performance, or scoring measures and were usually provided to subscribers of our subscription products, which were not necessarily entities that we rate.

In the fourth quarter of 2001, Fitch Group, Fitch Ratings' parent company established Fitch Risk Management, Inc. (FRM), a newly formed company offering risk management services, databases, and credit models to help financial institutions and other companies manage both credit and operational risk. Fitch Ratings and FRM are subject to a "fire wall" policy and FRM has its own employees, offices, and marketing staff. Fitch Group recently acquired Algorithmics, a leading provider of enterprise risk management solutions. Algorithmics, part of FRM, is subject to the same "firewall" policies.

Based on the above-described procedures regarding issuer payment of fees, selective disclosure and ancillary services, Fitch believes that it adequately addresses any potential conflict of interest. In fact, we believe that the suggestions proposed in both the SEC Concept Release and the provisions of the IOSCO Code to protect against conflicts of interest have already been in large part adopted by Fitch. However, Fitch would not oppose narrowly tailored conditions to SEC recognition that ensure that these standards continue.

*Transparency*

We believe quite strongly that the process and procedure that rating agencies use should be transparent. Accordingly, at Fitch, there are hundreds of criteria reports published highlighting the methodology we use to rate various types of entities and securities, together with detailed sector analysis on a broad array of sectors, companies, and issues, all available free on our website (*www.fitchratings.com*). Fitch has also been a leader in publishing presale reports in the areas of structured finance, global power, project finance, and public finance, where our published analysis of various transactions of interest to the market is made available free of charge on our website prior to the pricing of the transaction. In addition, Fitch makes available free of charge on our website all of our outstanding ratings. We also distributes announcements of rating actions through a variety of wire services as mentioned above.

However, certain of our publications and data are only available to our paid subscribers. We commit extensive time and resources to producing our publications and data and we believe they are valuable to anyone interested in objective credit analysis. In this practice, we are no different from other members of the financial media, such as Bloomberg, Dow Jones, Thomson Financial, and others that charge subscribers for access to their publications and data services.

While we believe that for the most part credit rating agencies have adequate access to the information they need to form an independent and objective opinion about the creditworthiness of an issuer, Fitch would welcome improved disclosure by issuers. As we found in our various published studies of the use of credit derivatives in the global market, financial reporting and disclosure with respect to areas such as credit derivatives, off-balance sheet financing, and other forms of contingencies vary greatly by sector, and comparability is further obscured by differences in international reporting and accounting standards.

As the SEC noted in their report, issuers provide rating agencies with nonpublic information as part of the rating process. The nature and level of nonpublic information provided to Fitch varies widely by company, industry, and country. Nonpublic information frequently includes budgets and forecasts, as well as advance notification of major corporate events such as a merger. Nonpublic information may also include more detailed financial reporting.

While access to nonpublic information and senior levels of management at an issuer is beneficial, Fitch can form an objective opinion about the creditworthiness of an issuer based solely on public information in many jurisdictions. Typically, it is not the value of any particular piece of nonpublic information that is important to the rating process, but that access to such information and to senior management that assists us in forming a qualitative judgment about a company's management and prospects.

Another factor critical to the adequate flow of information to and from the rating agencies is the understanding that information can be provided to a rating agency without necessitating an intrusive and expensive verification process that would largely if not entirely duplicate the work of other professionals in the issuance of securities. Thus, as noted by the SEC Report, rating agencies do not perform due diligence or conduct audits, but do assume the accuracy of the information provided to them by issuers and their advisors. Since rating agencies are part of the financial media, we believe that our ability to operate on this assumption, and to exercise discretion in deciding how to perform our analysis and what to publish, is protected by the First Amendment.

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## PREPARED STATEMENT OF JAMES A. KAITZ

PRESIDENT AND CEO, THE ASSOCIATION FOR FINANCIAL PROFESSIONALS

FEBRUARY 8, 2005

Good morning, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. I am Jim Kaitz, President and CEO of the Association for Financial Professionals. AFP welcomes the opportunity to participate in today's hearing on the role of credit rating agencies in the capital markets.

The Association for Financial Professionals (AFP) represents more than 14,000 finance and treasury professionals representing more than 5,000 organizations. Organizations represented by our members are drawn generally from the *Fortune* 1,000 and the largest of the middle-market companies from a wide variety of industries. Many of our members are responsible for issuing short- and long-term debt and managing corporate cash and pension assets for their organizations. In these capacities, our members are significant users of the information provided by credit rating agencies. Acting as both issuers of debt and investors, our members have a balanced view of the credit rating process, and have a significant stake in the outcome of the examination of rating agency practices and their regulation.

AFP believes that the credit rating agencies and investor confidence in the ratings they issue are vital to the efficient operation of global capital markets. Before outlining the consequences of inaction, it is useful to provide some background on how we got to where we are today and summarize AFP's research on this important issue.

### Background

For nearly 100 years, rating agencies have been providing opinions on the creditworthiness of issuers of debt to assist investors. The Securities and Exchange Commission (SEC) and banking regulators also rely on ratings from rating agencies. In 1975, the SEC recognized Moody's, Standard & Poor's, and Fitch, the three major rating agencies in existence at that time, as the first Nationally Recognized Statistical Rating Organizations (NRSRO). The SEC and other regulators use the ratings from the NRSRO's to determine whether certain regulated investment portfolios, including those of mutual funds, insurance companies, and banks, meet established credit quality standards. As a result, companies that hope to have their debt purchased by these portfolios must have a rating from an NRSRO. From 1975 to 1992, the SEC recognized four other rating agencies, but each of these entrants consequently merged with Fitch. The SEC did not recognize any new agencies from 1992 until April 2003, when Dominion Bond Rating Service received recognition from the SEC, becoming the fourth NRSRO.

Some market participants have argued that the NRSRO's did not adequately warn investors of the impending failure of Enron, WorldCom, Parmalat, and other companies. For example, in 2001, the rating agencies continued to rate the debt of Enron as "investment grade" days before the company filed for bankruptcy. These failures occurred despite the fact that credit rating agencies (CRA's) have access to nonpublic information because of their exemption from Regulation Fair Disclosure (Reg FD). As a result of the corporate scandals of 2001, Congress, in the Sarbanes-

Oxley Act required the Securities and Exchange Commission (SEC) to conduct a study on credit rating agencies examining the role of rating agencies in evaluating debt issuers, the importance of that role to investors and any impediments to accurate appraisal by credit rating agencies. Sarbanes-Oxley also required the study to determine whether there are any barriers to entry into the credit rating market and whether there are conflicts of interest that hinder the performance of the rating agencies.

In January 2003, the SEC released the Sarbanes-Oxley required study, which identified five major issues that the SEC stated it would examine further: Information flow, potential conflicts of interest, alleged anticompetitive or unfair practices, reducing potential barriers to entry, and ongoing oversight. Following the study, the SEC issued, for public comment, a concept release exploring these issues on June 4, 2003. As of this hearing, the SEC has not issued any proposed rules.

In September 2002, AFP surveyed senior level corporate practitioners and financial industry service providers on their views regarding the quality of the NRSROs' ratings, the role the SEC should take in regulating the agencies, and the impact additional competition may have on the marketplace for ratings information. In that survey, many financial professionals indicated that the ratings generated by the NRSRO's were neither accurate nor timely.

In September 2004, AFP once again surveyed senior level financial professionals regarding the accuracy and timeliness of the NRSROs' analyses and on the potential role regulators may have in promoting competition among credit rating agencies.[1]

Key findings of the 2004 AFP Rating Agency Survey include:

- Eighty-seven percent of responding organizations with debt indicate that credit providers require them to obtain and maintain a rating from at least one of the four NRSRO's.
- Many financial professionals believe that the ratings of their organizations are either inaccurate or are not updated on a timely basis.
- A third of corporate practitioners believe the ratings on their organization's debt are inaccurate.
- Fifty-two percent of financial professionals indicate that the cost of credit ratings has increased by at least 11 percent over the past 3 years, including 19 percent that indicate that costs have increased at least 25 percent over that time period.
- While many responding organizations are confident in the accuracy of the ratings they use for investments, they are less confident in the timeliness of the same ratings.
- Financial professionals believe the Securities and Exchange Commission (SEC) should take a greater role in overseeing the credit rating agencies along with encouraging greater competition in the field.

Recently, other organizations have taken steps to address credit rating agency reform issues. The International Organization of Securities Commissions (IOSCO) in September 2003 issued a Statement of Principles regarding the manner in which rating agency activities are conducted. In December 2004, IOSCO released Code of Conduct Fundamentals for Credit Rating Agencies.

In July 2004, the Committee of European Securities Regulators (CESR), at the request of the European Commission, issued a call for evidence on possible measures concerning credit rating agencies. The Committee intends to approve and publish its final advice to the European Commission in March 2005.

**Consequences of Inaction**

Why is reforming the credit rating system so important? Along with the SEC and other regulators that have incorporated the NRSRO designation into their rules, institutional and individual investors have long relied on credit ratings when purchasing individual corporate and municipal bonds. Further, nearly every mutual fund manager that individuals and institutional investors have entrusted with over $8 trillion relies to some degree on the ratings of nationally recognized agencies. Rating actions on corporate debt also have an indirect but sizeable impact on the stock prices of rated companies.

Debt issuers rely on the credit rating agencies to understand the company's finances, strategic plans, competitive environment, and any other relevant information about the company in order to issue ratings that accurately reflect the company's creditworthiness. These ratings determine the conditions under which a company can raise capital to maintain and grow their business. Credit ratings also allow others that deal with the issuer to make an informed assessment of the issuer

[1] For complete copies of both survey results visit the AFP website at *www.AFPOnline.org*.

as a potential trading partner, and are a valuable part of the issuer's external communications with the market.

While credit rating agencies have long played a significant role in the operation of capital markets, the Administration's recent single-employer pension reform proposal would further increase the importance of the NRSRO's and their impact on Americans. The proposal would tie pension funding and Pension Benefit Guaranty Corporation (PBGC) premiums to a plan sponsor's financial condition as determined by existing credit ratings. In some cases, plan sponsors would be prohibited from increasing benefits or making lump sum payments based on their credit rating and funded status. Such a proposal would further codify the NRSRO designation and even further empower the rating agencies.

Despite the increasing reliance on credit ratings, even after more than 10 years of examining the role and regulation of credit rating agencies, the Securities and Exchange Commission has not has not taken any meaningful action to address the concerns of issuers and investors. These concerns include questions about the credibility and reliability of credit ratings and conflicts of interest and abusive practices in the rating process. Chairman Shelby and Members of the Committee, these issues are far too important for the SEC to remain silent while the world waits for it to take action.

As I noted earlier, the credit rating agencies and investor confidence in the ratings they issue are vital to the operation of global capital markets. As evidenced in AFP's research, confidence in rating agencies and their ratings has diminished over the past few years. Addressing issues such as the lack of a defined process by which an agency can become an NRSRO, eliminating potential conflicts of interest, and effective marketplace competition will begin to restore the much-needed confidence in the credit ratings system.

When the SEC recognized the first Nationally Recognized Statistical Rating Organization (NRSRO) in 1975 without enumerating the criteria by which others could be recognized, it created an artificial barrier to entry to the credit ratings market. This barrier has led to a concentration of market power with the recognized rating agencies and a lack of competition and innovation in the credit ratings market. Only the SEC can remove the artificial barrier to competition it has created. Therefore, AFP strongly recommends that the SEC maintain the NRSRO designation and clearly articulate the process by which qualified credit rating agencies can attain the NRSRO designation.

Not only has the SEC bestowed a significant competitive advantage, but it has also failed to exercise any meaningful oversight of the recognized agencies. In nearly 30 years since creating the NRSRO designation, there has been no review of the ongoing credibility and reliability of the ratings issued by the NRSRO's. The SEC must improve its ongoing oversight of the rating agencies to ensure that they continue to merit NRSRO status.

The SEC further empowered the rating agencies when it exempted them from Regulation Fair Disclosure (FD). Through this exemption, the rating agencies have access to nonpublic information about the companies they rate. Again, the Commission has done nothing to ensure that those who are granted this powerful exemption do not use the nonpublic information inappropriately. The SEC must require that NRSRO's have policies in place to protect this valuable and privileged information. Again, this should be part of the SEC's ongoing oversight of the rating agencies.

As highlighted in recent media reports, rating agencies continue to promulgate unsolicited ratings of debt issuers. Because unsolicited ratings are issued without the benefit of access to company management or nonpublic information about the issuer, the resulting ratings are often not an accurate reflection of an organization's financials condition. Credit ratings are critical to an organization's ability to issue debt and issuers often feel compelled to participate in the rating process and pay for the rating that was never solicited. The potential for abuse of these unsolicited ratings by the rating agencies must be addressed by the SEC.

Finally, an NRSRO is also in a position to compel companies to purchase ancillary services. These ancillary services include ratings evaluations and corporate governance reviews. Further, the revenue derived from these services has the potential to taint the objectivity of the ratings. You need look no further than the equity research and audit professions to understand why these potential abusive practices and conflicts of interest must be addressed by the SEC.

**Recommendations**

To address many of the questions raised by the SEC and market participants, the Association for Financial Professionals, along with treasury associations from the United Kingdom and France, released a Code of Standard Practices for Participants in the Credit Rating Process.

A copy of the Code is attached to my testimony.* Importantly, the Code contains recommendations for regulators, as well as rating agencies and issuers. To be clear, the Code is a private sector response intended to *complement* rather than replace regulation

Earlier in my testimony, I touched upon many of the regulatory recommendations contained in the Code. I would like to take this opportunity to provide more detailed regulatory recommendations. Specifically, we recommend establishing transparent recognition criteria based on whether a credit rating agency can consistently produce credible and reliable ratings over the long-term. Establishing clearly defined recognition criteria is a crucial step to removing barriers to entry and enhancing competition in the credit ratings market.

In the Code, we also urge regulators to require that rating agencies document internal controls that protect against conflicts of interest and anticompetitive and abusive practices, and ensure against the inappropriate use of nonpublic information to which the rating agencies are privy because of their exemption from Regulation FD. Regulatory recommendations also include improving ongoing oversight of approved rating agencies to ensure that NRSRO's continue to meet the recognition criteria.

For rating agencies, the Code includes suggestions to improve the transparency of the rating process, protect nonpublic information provided by issuers, protect against conflicts of interest, address the issue of unsolicited ratings, and improve communication with issuers and other market participants.

Finally, recognizing that the credibility and reliability of credit ratings is heavily dependent on issuers providing accurate and adequate information to the rating agencies, the Code of Standard Practices outlines issuer obligations in the credit rating process. These obligations are intended to improve the quality of the information available to the rating agencies during the initial rating process and on an ongoing basis, and to ensure that issuers respond appropriately to communications received from rating agencies.

A reasonable regulatory framework that minimizes barriers to entry and is flexible enough to allow innovation and creativity will foster competition among existing NRSRO's and those that may later be recognized and restore investor confidence in the rating agencies and global capital markets. Rather than excessively prescriptive regulatory regimes, innovation and private sector solutions, such as AFP's Code of Standard Practices, are the appropriate responses to many of the questions that have been raised about credit ratings.

Restoring issuer and investor confidence in the credit ratings process is critical to global capital markets. Chairman Shelby and Members of the Committee, we strongly recommend that you hold the SEC accountable by demanding immediate action on the issues that have been raised here today. If the SEC does not act immediately to aggressively address each of the concerns we have outlined, we urge you act to restore investor confidence in the credit ratings process through action by this Committee. We commend you, Mr. Chairman, and the Committee for recognizing the importance of this issue to investors and global capital markets and hope that this hearing will compel the SEC to act.

## PREPARED STATEMENT OF RAYMOND W. MCDANIEL, JR.

PRESIDENT AND CHIEF OPERATING OFFICER, MOODY'S INVESTORS SERVICES, INC.

FEBRUARY 8, 2005

Good morning. I am Ray McDaniel, President of Moody's Investors Service. Let me begin by thanking Chairman Shelby, Senator Sarbanes, and the Members of the Committee on Banking, Housing, and Urban Affairs (the Committee) for inviting Moody's to participate in this hearing.

Today, I will briefly discuss Moody's background, the role and the use of our ratings in the market, our rating process and enhancements we have made to that process, the competitive landscape in which we operate, some global developments in our industry, and finally the regulatory environment in the United States.

### Background about Moody's

Rating agencies occupy a niche in the investment information industry. Our role in that market is to disseminate information about the relative creditworthiness of, among other things, corporations, governmental entities, and pools of assets collected in securitized or "structured finance" transactions. Moody's is the oldest bond

* Held in Committee files.

rating agency in the world. We have been rating bonds since 1909. Today, we have more than 1,000 analysts in 18 countries around the world. Our products include our familiar credit rating opinions, which are publicly disseminated via press release and made freely available on our website, as well as research and special reports about debt issuers and their industries that reach more than 3,000 institutions and 22,000 subscribers around the globe.

Moody's integrity and performance track record have earned it the trust of capital market participants worldwide. Our ratings and analysis track more than $30 trillion of debt issued in domestic and international markets, covering approximately 10,000 corporations and financial institutions, more than 20,000 municipal debt issuers, over 12,000 structured finance transactions, and 100 sovereign issuers.

**What Moody's Ratings Measure**

Moody's ratings are expressed according to a simple system of letters and numbers. Ratings forecast the relative likelihood that debt obligations or issuers of debt will meet future payment obligations in a timely manner. Company ratings are formulated utilizing the traditional techniques of fundamental credit analysis and are thus based primarily on an independent assessment of a company's published financial statements.

Moody's bond rating system, which we have used for 96 years, has 21 categories, ranging from Aaa to C. Investment-grade ratings include ratings of Aaa, Aa, A, and Baa. Ratings below Baa are considered speculative-grade. Moody's ratings are opinions regarding relative expected loss, which reflects an assessment of both the probability that a debt instrument will default and the severity of loss in the event of default. The lowest expected credit loss is at the Aaa level, with a higher expected loss rate at the Aa level, a yet higher expected loss rate at the A level, and so on down through the rating scale. In other words, the rating system is not a "pass-fail" system; rather, it is a probabilistic system in which the forecasted probability of future loss rises as the rating level declines.

Moody's rating system has over the years extended to other aspects of an issuer's creditworthiness, thereby disaggregating the various elements of our analysis and providing the market with our opinions on those specific characteristics. Two such examples are:

- short-term ratings—which measure the likelihood that an issuer will be able to meet its short-term liabilities; and,
- financial strength ratings—which measure the stand alone financial strength of an entity, excluding any implied or guaranteed third party support

**Role and Usage of Ratings**

Moody's believes that the most important function of credit ratings is to contribute to fair and efficient capital markets. Our ratings are one means of communicating relevant information about a bond to potential investors in that bond. At the same time, the broad, public distribution of ratings by Moody's helps assure that our credit opinions are freely and simultaneously available to all investors, regardless of whether they purchase products or services from Moody's.

Our ratings have 3 intrinsic qualities that have made them useful for a variety of purposes. First, as I have mentioned, our ratings are publicly and simultaneously available to all market participants; second, our rating opinions are independently formed; and third, and possibly most important, Moody's rating performance:

- can be tested,
- is regularly tested, and
- has been consistently shown to have predictive content.

As a result, ratings have been employed by a diverse collection of investors, issuers, financial institutions, and regulatory bodies, which have a variety of objectives in their use of ratings. For example:

- Investors use ratings when making investment decisions to help assess a bond's relative creditworthiness;
- Debt issuers use ratings to broaden the marketability of their securities and thereby to improve their access to the capital markets;
- Portfolio managers employ ratings for performance benchmarking and portfolio composition rules (commitments to specific portfolio investment strategies); and
- Regulators of banks, securities firms, and insurers use ratings to determine investment suitability, measure capital adequacy, and promote market stability.

MOODY'S MANAGEMENT OF THE RATING SYSTEM

The market utility of a credit rating system is highest when ratings effectively distinguish riskier credits from those that are less risky, when they do so on a comparable basis across a wide range of issuers, and when the ratings are widely disseminated. Stability of ratings is also valued in the market, and Moody's manages its ratings so that they are changed only in response to changes in relative credit risk that we believe will endure, rather than in response to transitory events or shifts in market sentiment.

Having said that, our ratings should not be any more stable than our perception of fundamental creditworthiness warrants. Moreover, in an effort to provide greater transparency around possible future changes in ratings, we have developed a series of additional public signals, called "watchlists" and "outlooks," through which we communicate our opinion on possible trends in future creditworthiness and the likely direction of ratings that are under review. A rating outlook, expressed as positive, stable, negative, or developing, provides an opinion as to the likely direction of any medium-term rating actions, typically based on a 12–18 month horizon. Most investment grade companies have a rating outlook assigned to them.

If changing circumstances contradict the assumptions or data supporting a current rating, we may place the rating on our watchlist. The watchlist highlights issuers (or debt obligations) whose rating is formally on review for possible change. At the conclusion of a review, typically within 90 days of placement on the watchlist, we will assess whether the issuer's credit risk is still consistent with the assigned rating. Although the watchlist is not a guarantee or commitment to change ratings over a certain time horizon, or even to change them at all, historically about 66 percent of all ratings have been changed in the same direction (and rarely in the opposite direction) as indicated by their watchlist status.

Through our overall management of the rating system, we believe we have achieved the balance demanded by the marketplace for a relatively stable product that also is capable of providing timely public information about possible future movements in creditworthiness.

**Moody's Rating Process**

Let me now describe how we go about rating debt securities issued by corporations. Our ratings and research are produced by our credit professionals generally located in the region of the issuing entity. Our rating process begins when an issuer or its representative requests a rating. A managing director responsible for the issuer's industry sector will assign the analysis of the corporation to a lead analyst and back-up analyst. The lead analyst is responsible for compiling relevant information on the issuer. Moody's analysts rely heavily on publicly available information, including regulatory filings and audited financial statements. The remainder of the information comes from macroeconomic analysis, industry-specific knowledge, and the issuer's responses to any requests for additional information from the credit analyst. Although issuers may choose to volunteer nonpublic information to inform our deliberations, they are not required to do so as part of the rating process. In instances where, in Moody's' view, there is insufficient information to form a rating opinion, we will either not rate the entity or withdraw an already published rating.

Once information has been gathered, the lead analyst will analyze the company, which incorporates an evaluation of, among other things: Franchise value, financial statement analysis, liquidity analysis, management quality, and the regulatory environment of the industry in which the company operates. Depending on the complexity of the transaction, the analyst may include the expertise of some of our specialist teams, which I will discuss in more detail later. Based on this assessment, the lead analyst will draft a rating memorandum. That memorandum is then distributed and discussed in a rating committee, which ultimately is responsible for taking a rating decision on a majority-vote basis.

The rating committee is typically comprised of the rating committee chair; the lead analyst, who has researched the company; the back-up analyst; junior support analysts; and possibly additional analysts or managing directors who have expertise relevant to the rating decision. During the committee meeting, the lead analyst presents his or her views and discusses the underlying reasoning and assumptions. The committee then challenges and debates the various points, and after vetting the various issues, it votes.[1]

When the committee concludes, the issuer is contacted and informed of Moody's rating decision. If the issuer has new information which is important and relevant, the issuer may appeal the rating. Otherwise, Moody's provides the issuer with a copy of the draft press release announcing the rating decision. The draft press release will include the rating action and our reasoning. The issuer then has an oppor-

[1] Junior support analysts typically do not vote. They are however encouraged to fully participate in the discussion as the process is an effective means of training.

tunity to review the draft press release prior to its dissemination,[2] for the purpose of verifying that it does not contain any inaccurate or nonpublic information. Once final, the rating is released to the news-wires and made available on our website. The entire rating process generally takes from 4 to 6 weeks, and sometimes longer if the credit is particularly complex.

Once a rating has been published, Moody's monitors the credit quality of that outstanding debt issuance and will alter the rating—through the same rating committee process—should our perception of the issuance's creditworthiness change.

*Issuer Pays Model*

Most of Moody's revenues are generated from issuer fees. Issuers request and pay for ratings from us because of the broad marketability of bonds that ratings facilitate. Ratings facilitate this marketability in part because many U.S. institutional investors have prudential investment guidelines that rely in part upon ratings as a measure of desired portfolio quality. While both issuers and investors rely on our ratings, issuers are more motivated to pay for ratings than investors because of two attributes of ratings:

First, there is a substantial difference between issuers and investors in their need for a rating on any single debt instrument. While ratings promote broad marketability of bonds, investors can select from a wide range of investment alternatives and are, therefore, more interested in the general existence and application of ratings than in any individual rating. If, for example, a rating is not assigned to a particular bond, in most cases an investor's motivation to request and pay for a rating on that bond is low. There are many other rated bonds or investment opportunities that the investor can choose among.

This relative indifference to individual ratings means that investors would only be motivated to pay fees for ratings that are delivered on an aggregate, comparative basis. Such a service, which would have to operate as a subscription service to generate fees, is impractical because of the second principle: The expectation that ratings of public debt will be made simultaneously available to all investors through public dissemination.

Because ratings are publicly disseminated, investors do not need to purchase ratings, as they are freely available. Public availability, when combined with the relative indifference of investors versus issuers toward any single rating, allows investors to benefit from ratings as a "free good" by consuming them without a compelling need to support the cost base that produces them. An issuer does not have the same tolerance as an investor for a missing rating on its bond. It does not have the same range of choices in accessing capital that an investor has in deploying capital. In order for an issuer to facilitate broad marketability of its bond, it will likely choose to have a rating on that specific bond.

*Conflicts of Interest*

The issuer-pays business model has conflicts of interest, as does the investor-subscription business model, and so we have taken important steps to effectively manage and disclose those risks. Issuer fees were introduced over three decades ago. Since that time, we believe we have successfully managed the conflicts of interest and have provided the market with objective, independent, and unbiased credit opinions. To foster and demonstrate objectivity, Moody's has adopted and disclosed publicly certain Fundamental Principles of Moody's ratings management. Among them are:

- Policies and procedures which require that analysts participating in a committee be fully independent from the company they rate—for example, analysts are prohibited from owning securities in institutions which they rate (except through holdings in diversified mutual funds);
- Analyst compensation is unconnected with either the ratings of the issuers the analyst covers or fees received from those issuers;
- Rating decisions are taken by a rating committee and not by an individual rating analyst;
- Rating actions reflect judicious consideration of all circumstances believed to influence an issuer's creditworthiness;
- Moody's will not refrain from taking a rating action regardless of the potential effect of the action on Moody's or an issuer; and

[2] If an issuer has no rated debt outstanding in the market, it may request that the timing of the press release coincide with its contemplated debt issuance.

• Moody's does not create investment products, or buy, sell, or recommend securities to users of our ratings and research.[3]

The integrity and objectivity of our rating process is of utmost importance to us. Our continued reputation for objective ratings, as a recent Federal Reserve[4] study indicated, is essential to our role in the marketplace.

*Track Record of Predictive Content*

Perhaps the most important litmus test, however, for whether conflicts of interest are being properly managed is the performance of our ratings. As I said earlier, ratings performance can be and is regularly tested according to measures that are subject to third party verification. This testing has repeatedly demonstrated the predictive content of our ratings over time. Moody's and independent academics have published studies on the relationship between our ratings and credit risk.[5] Our annual "default study" consistently shows that higher-rated bonds default at a lower rate than lower-rated bonds, and that the proportion of defaults varies with the credit cycle. Moreover, since 2003, Moody's has been publishing a quarterly "report card" of our rating quality performance utilizing a range of accuracy and stability metrics.

**Enhancements to the Rating Process**

The ultimate value of a rating agency's contribution to market fairness and efficiency depends on its ability to offer predictive opinions about the relative credit risk of rated entities. However, I caution that our ratings should not be construed as investment advice, as performance guarantees, or as a means of auditing for fraud. Further, the quality of the opinions we provide to the market is in large part a function of the quality of information to which we have access when formulating our opinions. As a result, the role rating agencies play in any market is either augmented or hindered by the quality and completeness of the financial information published by debt issuers.

As high profile corporate frauds in recent years have demonstrated, if issuers abandon the principles of transparency, truthfulness, and completeness in disclosure, neither rating agencies nor any other market participants—including regulatory authorities—can properly fulfill their roles. As one of the largest consumers of issuers' financial disclosure, Moody's has supported the efforts of this Committee and the Congress to require truthful financial disclosure.

Nevertheless, while our processes are not intended to systematically detect fraud nor reaudit financial statements, we recognize that in order to fulfill our role in the market, our methodologies must evolve with the market and our analysts must stay abreast of market developments. For almost 100 years, we have been committed to providing the highest quality credit assessments available in the global markets, which means that we must continue to learn both from our successes and our mistakes. In this spirit, we have undertaken substantial internal initiatives to enhance the quality of our analysis and the reliability of our credit ratings. These initiatives include:

• *Analytical specialist teams:* We have added over 40 professionals specializing in accounting and financial disclosure, off-balance sheet risk, corporate governance, and risk management assessment. These professionals work alongside our analytical teams and do not have direct rating responsibilities. As such, they are able to devote full attention to their areas of concentration and bring their expertise to credits that are more complex and which need greater scrutiny.

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[3] Moody's parent company, Moody's Corporation, invests excess cash in highly rated short-term debt securities. All investment decisions are made at the parent company level.

[4] Daniel M. Covits, Paul Harrison, "Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate," Federal Reserve Board, December 2003.

[5] See generally, Rober W. Holthausen and Richard W. Leftwich, "The Effect of Bond Rating Changes on Common Stock Prices," *Journal of Financial Economics* 17 (1986) 57–89; Edward I. Altman, Herbert A. Rijken, "How Rating Agencies Achieve Rating Stability", *Journal of Banking & Finance* 28 (2004) 2679–2714; William Perraudin, Alex P. Taylor, "On the Consistency of Ratings and Bond Market Yields," *Journal of Banking & Finance* 28 (2004) 2769–2788; Gunter Loffler, "Ratings Versus Market-Based Measures of Default Risk in Portfolio Governance," *Journal of Banking & Finance,* February 28 (2004), 2715–2746; Credit Ratings and Complementary Sources of Credit Quality Information, by a working group led by Arturo Estrella, Basel Committee on Banking Supervision Working Papers, No. 3, August 2000; Default & Loss Rates of Structured Finance Securities: 1003–2003, Moody's Special comment, September 2004; Default and Recovery Rates of Corporate Bond Issuers, 1920–2004, Moody's Special Comment, January 2005; The Performance of Moody's Corporate Bond Ratings: December 2004 Quarterly Update, Moody's Special Comment, January 2005; Measuring the Performance of Corporate Bond Ratings, Moody's Special Comment, April 2003.

- *Analyst professional development program:* Moody's company analysts must annually complete 40 hours of course work that covers a range of substantive disciplines, including accounting, securitization and risk transfer, liquidity analysis, and ethics.
- *Greater use of market information:* Moody's has developed market-based monitoring tools to help analysts maintain close scrutiny over their portfolios.
- *Global realignment:* Moody's has restructured organizationally along lines of business, rather than regions, to allow analysts covering the same industry to share information and expertise more easily across borders.
- *Reinforced centralized credit policy function:* The credit policy function at Moody's has been augmented to help ensure that credit policies and procedures are efficiently communicated throughout Moody's and the market, and are uniformly implemented.
- *Chief credit officers:* We have appointed chief credit officers, charged with helping to ensure rating quality, in our United States and European corporate finance groups and in structured finance.
- *Performance metrics:* As part of our commitment to predictive ratings, we publish a quarterly report card on the accuracy and stability of our corporate bond ratings. We publish numerous studies and measurement statistics, which have shown that overall our ratings, as forward looking opinions, effectively distinguish bonds with higher credit risk from bonds with lower credit risk.

**Level of Competition in the Industry**

There are numerous types of credit assessment providers, which compete vigorously for the trust of the market. They include, for example, traditional credit ratings, subscription-based rating providers, statistically derived ratings that rely solely on market-based or other financial data, bond research provided by brokerage firms, credit research performed by banks and other financial firms, and trade credit reporting agencies.

The combination of the public nature of credit ratings and natural barriers to entry[6] may imply that only a limited number of traditional rating agencies will be able to operate and thrive under an issuer-pays model. It is possible that only a limited number of agencies (though potentially a shifting group) will attain an issuer's business, regardless of the aggregate number of competitors. Therefore, while there are numerous types of credit assessment providers, the number of large traditional rating agencies has always been few.

OVERSIGHT OF CREDIT RATING AGENCIES—DEVELOPMENTS IN THE INTERNATIONAL COMMUNITY

As the Committee is aware, over the past 3 years much regulatory and legislative attention has been focused on the global financial services industry. Credit rating agencies have been included in this examination process.

A global cooperative effort over the past 2 years led by the International Organization of Securities Commissions (IOSCO)—a committee comprised of approximately 100 of the world's securities regulatory authorities, importantly including the U.S. Securities and Exchange Commission (SEC)—produced and published a code of conduct (the Code) for the credit rating agency industry. The Code addresses:

- The quality and integrity of the rating process;
- Credit rating agency independence and the avoidance of conflicts of interest; and,
- Credit rating agency responsibilities to the investing public and issuers.

Under each broad section, the Code enumerates specific provisions. While spearheaded by the SEC, the Code was drafted jointly by global regulators, who consulted with issuers, investors, intermediaries, and rating agencies in their respective juris-

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[6] Natural barriers to entry in the traditional credit rating agency industry where ratings are publicly and freely provided are:

- *The Costly Nature of Executive Time*—Debt issuers have a limited use for more than a few ratings because fundamental credit analysis, and therefore each agency relationship, requires the issuer's time and executive resource commitments. This includes preparing and presenting information, and maintaining that flow of information and communication on a periodic basis.
- *Network Externalities*—Investors desire consistency and comparability in credit opinions. The more widely an agency's ratings are used/accepted by market participants the greater the utility of its ratings to investors, and therefore to issuers.
- *Broad Coverage*—Investors place greater value on an agency's ratings the broader its rating coverage and the more widely its ratings are used.
- *Track Record*—Investors have more confidence in ratings that are assigned by agencies with publicly established track records of predictive ratings over a period of time. Due to the relatively small number of defaults in the public capital markets, it is difficult to establish quickly a performance track record.

dictions. The Code is to be implemented through a "comply or explain" mechanism. Specifically, rating agencies are to voluntarily adopt the Code, and then publish their compliance with it or explain why they are unable to satisfy specific provisions. Moody's has announced that we intend to adopt the IOSCO Code and periodically disclose our compliance with it. Our disclosure would naturally address our ratings activity in the United States, as well as all other jurisdictions in which we operate.

In Moody's view, the Code provides a comprehensive framework for rating agency disclosure that will better equip the market to assess rating agency reliability. Moody's is committed to supporting the IOSCO process and to implementing the Code. We believe that it fosters greater market transparency and delivers accountability, while simultaneously encouraging a competitive marketplace and information flow. Such an outcome should serve market integrity and investor confidence without unduly increasing the financial or administrative cost of business for rating agencies or users of ratings.

**Regulatory Landscape in the United States**

The Nationally Recognized Statistical Rating Organization (NRSRO) designation in the United States—which allows regulated entities to use ratings provided by credit rating agencies that have been so designated—is administered and overseen by the SEC. To the extent that the NRSRO designation is seen to limit competition, Moody's is on record as not opposing its discontinuance.[7] We do not believe that our business depends upon the continuance of the NRSRO system.

By way of background, the use of ratings in U.S. regulation and legislation has been an evolutionary process. In the 1930's, bank regulators began using credit ratings in bank investment guidelines. State laws and regulations soon adopted similar standards for State banks, pension funds, and insurance companies, and additional Federal regulation followed. In 1975, the SEC introduced credit ratings into its net capital rule for broker-dealers.

Informally called the "haircut" rule, the net capital rule requires broker-dealers to take a larger discount on speculative-grade corporate bonds—a "haircut"—when calculating their assets for the purposes of the net capital requirements than for investment-grade bonds. This rule specified the ratings must come from NRSRO's. While the term was not defined, rating agencies which had established a presence at the time were so designated; among them was Moody's. Over time, the use of NRSRO ratings has spread into various legislative and regulatory frameworks, including those for the banking, insurance, educational, and housing industries.

It is our view that the use of ratings in regulation and the subsequent necessity of recognizing or regulating rating agencies should neither alter the rating product nor increase barriers to competition. Moody's supports allowing natural economic forces to guide competition in the rating agency industry. We believe that a healthy industry structure is one in which the role of natural economic forces is conspicuous, and where competition is based on performance quality to promote the objectives of market efficiency and investor protection.

In responding to regulatory authorities globally, Moody's has consistently supported eliminating barriers to entry caused by, for example, vague or difficult to achieve recognition standards. More generally, we have supported competition in the rating agency industry. Increased competition may augment the number and diversity of opinions available to the financial markets; and encourage rating agencies to improve their methodological approach and better respond to market demands.

On behalf of my colleagues at Moody's, I greatly appreciate the Committee's invitation to participate in this important hearing. The obligation to assure that the U.S. financial market remains among the fairest and most transparent in the world is one that all market participants should share. I look forward to answering any questions the Committee has in pursuit of this important goal.

[7] Moody's Response to the U.S. SEC Concept Release, July 28, 2003.

**RESPONSE TO A WRITTEN QUESTION OF SENATOR SHELBY FROM SEAN J. EGAN**

**Q.1.** Financial Executives International submitted a comment letter on the SEC's Concept Release about credit rating agencies in which it recommended: Every 3 to 5 years, the NRSRO should be subject to an intensive audit to determine whether it remains qualified for such recognition, and to ensure that it is abiding by its certifications and documented procedures. The Commission should have the authority to penalize an NRSRO for "failing" an audit and those penalties should range from fines to "disbarment."

What is your view on the benefits and costs of the recommendation?

**A.1.** We are in favor of such a review and have been and continue to be supportive of the efforts of the Association for Financial Professionals and its international affiliates as reflected in their Code of Standard Practices for Participants in the Credit Rating Process. Such a review should assist in evaluating potential conflicts in interest, abusive practices, and protection of nonpublic information.

**RESPONSE TO A WRITTEN QUESTION FROM SENATOR SHELBY FROM MICAH S. GREEN**

**Q.1.** Financial Executives International submitted a comment letter on the SEC's Concept Release about credit rating agencies in which it recommended: Every 3 to 5 years, the NRSRO should be subject to an intensive audit to determine whether it remains qualified for such recognition, and to ensure that it is abiding by its certifications and documented procedures. The Commission should have the authority to penalize an NRSRO for "failing" and audit, and those penalties should range from fines to "disbarment."

What is your view on the benefits and costs of the recommendation?

**A.1.** We are in substantial agreement with this recommendation. As noted in our comment letter, dated July 28, 2003, on the SEC's Concept Release on credit rating agencies, we believe an NRSRO should make an annual certification that it continues to meet the standards that have been set for recognition as an NRSRO.

We also support the December 2004 IOSCO "Code of Conduct Fundamentals for Credit Rating Agencies," which requires each NRSRO to publish and comply with a Code of Conduct covering such areas as the quality and integrity of the rating process, the independence of each NRSRO and the avoidance of conflicts of interest, the transparency and timeliness of ratings disclosure, and the treatment of confidential issuer information. We believe an NRSRO's annual certification should include a certification that it complied during the previous year in all material respects with its Code of Conduct (or an explanation of the reasons for any variation from such Code).

Our July 28, 2003, comment letter also states that we do not believe that NRSRO's need to be subject to significant additional ongoing examination or oversight, as it is unclear what the purpose of such examinations would be. In the event periodic examinations of each NRSRO are undertaken, we do not believe such examinations should involve reviewing individual rating determinations, but instead should involve a review of (1) the process by which rating methodologies are developed, (2) adherence to, or amendment of, rating methodologies, (3) the results of the NRSRO's back-testing of the accuracy of ratings, (4) the NRSRO's training program, and (5) the NRSRO's procedures for ensuring compliance with its Code of Conduct, including its procedures for identifying and managing conflicts of interest. We believe it is important for ratings to be objectively determined, but equally important to ensure that the SEC does not mandate any particular rating methodology.

The principal question about the costs and benefits of this system is whether the costs to the SEC of conducting periodic examinations of NRSRO are warranted by the scope of the problem, or whether the same benefits (in terms of compliance with the NRSRO designation criteria and the NRSRO's Code of Conduct) could be obtained by relying on a certification by the NRSRO's Chief Executive and Chief Compliance Officer, with review by its Board of Directors. We do not believe it would be necessary or cost-justified for the SEC to engage in an intensive audit of all aspects of the NRSRO's business.

**RESPONSE TO A WRITTEN QUESTION OF SENATOR SHELBY FROM YASUHIRO HARADA**

**Q.1.** Financial Executives International submitted a comment letter on the SEC's Concept Release about credit rating agencies in which it recommended: Every 3 to 5 years, the NRSRO should be subject to an intensive audit to determine whether it remains qualified for such recognition, and to ensure that it is abiding by its certifications and documented procedures. The Commission should have the authority to penalize an NRSRO for "failing" an audit and those penalties should range from fines to "disbarment."

What is your view on the benefit and costs of the recommendation?

**A.1.** As a preliminary matter, R&I believes in order to maintain credibility and public trust in NRSRO's, a certain degree of oversight and review of NRSRO's is necessary. However, it would have negative consequences on the activities of rating agencies if the Commission were to adopt strict and detailed standards on the way rating agencies should provide their services. Strict and inflexible regulatory standards would discourage creative development of new rating and risk analysis methods and technology. Setting rigid regulatory standards for purposes of oversight and inspection would be detrimental to the healthy development of the capital market and should be avoided. The question as to who should bear the burden of the cost associated with strict and detailed oversight must be carefully examined.

In this regard, an intensive audit to determine the qualifications for a NRSRO and to ensure compliance with certifications and documented procedure is inappropriate and unnecessary. An onsight examination of the soundness of a bank's assets is different from auditing the qualifications and compliance of rating agencies as the latter would be difficult to conduct in a unified and unique manner.

Therefore, regularly checking the qualification criteria can be accomplished by requiring NRSRO's to submit reports to the Commission indicating past performance and continuing qualification.

Such submissions should be disclosed to the public. If the Commission determines that a particular NRSRO fails to satisfy all of the necessary criteria, then such rating agency should be required to immediately rectify the situation. If, after one year's probation period, such an NRSRO still fails to satisfy all of the criteria, then NRSRO recognition should be revoked.

**RESPONSE TO A WRITTEN QUESTION OF SENATOR SHELBY FROM JAMES A. KAITZ**

**Q.1.** Financial Executives International submitted a comment letter on the SEC's Concept Release about credit rating agencies in which it recommended: Every 3 to 5 years, the NRSRO should be subject to an intensive audit to determine whether it remains qualified for such recognition, and to ensure that it is abiding by its certifications and documented procedures. The Commission should have the authority to penalize an NRSRO for "failing" an audit, and those penalties should range from fines to "disbarment."

What is your view on the benefits and costs of the recommendation?

**A.1.** Prudent SEC oversight, including the ability to take enforcement action against recognized credit rating agencies, must be a component of any reform effort. To that end, conducting a periodic review of whether a recognized rating agency continues to meet the established recognition criteria must be an integral part of SEC oversight. As we stated in our comment letter on the SEC's 2003 concept release, "[t]he SEC should revoke NRSRO status for those rating agencies that fail continually to meet the same criteria used to determine whether to grant an agency initial NRSRO status." Additionally, we recommended that the SEC review each NRSRO no less frequently than every 5 years.

In our comment letter, we also stated that the recognition criteria should be based on whether an agency can consistently produce credible and reliable ratings, not on methodology. Also, the SEC should require that a credit rating agency seeking the NRSRO designation document its internal controls designed to protect against conflicts of interest and anticompetitive and abusive practices and to ensure against the inappropriate use of all nonpublic information to which rating agencies are privy.

Conducting a periodic review of whether a NRSRO continues to produce credible, reliable ratings and meet the recognition criteria will help restore confidence in the credit rating agencies and the ratings they provide. As with the recognition process, the SEC must clearly define the revocation or nonrenewal process. Withdrawal of NRSRO status would have a material impact on a rating agency and the value of all securities it rates. The markets are best-served if it is clearly known why the SEC took such an action.

On behalf of AFP's members, I thank you for your commitment to our Nation's capital markets. For your information, I am enclosing a copy of AFP's entire comment letter on the SEC's Concept Release.* Please do not hesitate to contact me if I can be of further assistance.

* Held in Committee files.

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March 28, 2005

The Honorable Richard Shelby
U. S. Senate
110 Hart Senate Office Building
Washington DC 20510

Re: Response to Questions posed at February 8th Senate Hearing

Dear Senator Shelby:

On behalf of Standard & Poor's, a division of The McGraw-Hill Companies, Inc., ("Standard & Poor's"), I wanted to respond to the questions posed to me at the Senate Banking, Housing, and Urban Affairs Committee hearing on February 8, 2005 and in a subsequent letter from you dated February 25, 2005. We would like this letter added to the record of the hearing.

The following subject matters are included within this letter:



**SEC OVERSIGHT OF NRSROs**

As a follow-up to the February 8th hearing, Senator Sarbanes asked the following question as it appears in your letter to me dated February 25th:

> Financial Executives International submitted a comment letter on the SEC's Concept Release about credit rating agencies in which it recommended: Every three to five years, the NRSRO should be subject to an intensive audit to determine whether it remains qualified for such recognition, and to ensure that it is abiding by its certifications and documented procedures. The Commission should have the authority to penalize an NRSRO for 'failing' an audit, and those penalties should range from fines to 'disbarment'.
>
> What is your view on the benefits and costs of the recommendation?

As one of the original NRSROs designated by the SEC in 1976, Standard & Poor's Ratings Services ("S&P Ratings Services") is well aware of the role its ratings opinions play in the capital markets and the need for those ratings to be objective, independent and the result of rigorous analytical process. S&P Ratings Services similarly recognizes the public's interest in having a level of comfort that the integrity of the processes employed by NRSROs has not been compromised by conflicts of interest or other threats. To that end, S&P Ratings Services has among other things been engaged in an on-going dialogue with the SEC and, at the SEC's request, other NRSROs with respect to establishing a voluntary framework for SEC oversight of NRSROs. We have been diligently exploring such a framework with the SEC over the past few months and look forward to continuing that process with the hope of reaching a mutually agreeable resolution.

That being said, however, it is important that any SEC oversight of NRSROs, including the framework, recognize that NRSRO independence, including independence from intrusive governmental regulation, has been the hallmark of the contribution that ratings opinions such as those published by S&P Ratings Services have made to the public assessment of credit quality. As I stated in my February 8, 2005 testimony: "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."

Put more concretely, any oversight by the SEC should look to whether an NRSRO has in place and is following appropriate *procedures* to safeguard the integrity of the ratings process, not to whether, in retrospect with respect to a particular rating, the NRSRO "got it right". There are a number of reasons why this distinction is important:

- Ratings are, at their core, opinions about the creditworthiness of a particular issuer or issue at a given point in time. Ratings are not precise designations resulting from a scientific process, but rather the results of quantitative and qualitative analysis performed on a case-by-case basis. Accordingly, there is no one model or methodology for producing sound ratings opinions and any attempt to review the substance of such decisions in hindsight would be misguided in principle;

- Given the numerous factors that go into any ratings decision, it is doubtful that a later reviewer of such a decision, such as a member of the SEC staff, no matter how skilled and dedicated, would possess the experience, industry knowledge, and time necessary to determine whether application of particular criteria and/or methodologies to specific ratings decisions was appropriate; and

- Most fundamentally, any oversight framework that provided for later review of the content of particular ratings decisions would threaten the independence of the decision making process and could compromise the value that ratings provide to the market. An analyst or rating committee confronted with the prospect of "second-guessing" will have a natural incentive to be more cautious and conservative. This "chilling" effect reflects the same concerns that courts have acknowledged in holding that entities, such as S&P Ratings Services, that broadly publish information in the market must be afforded "breathing space" under the First Amendment to formulate and disseminate their publications without undue fear of second-guessing.

Taken together, these considerations lead to the view that while the proper degree of SEC oversight could result in benefits to the market, such oversight must not be of an intrusive nature such that it threatens the independence of NRSROs in their determinations of their ratings opinions. At S&P Ratings Services, we have consistently taken this position in our discussions with the SEC about a possible voluntary framework for SEC oversight of NRSROs and have stated it publicly on numerous occasions.

**BOARD OF DIRECTORS**

Senator Bunning asked during the February 8th hearing: "Do any of your company's officers [and directors] or employees sit on any corporate boards or Government boards or agencies like the NASD, like the New York Stock Exchange, like NASDAQ, like the SEC?" The Senator requested this information for the past 20 years.

All employees of The McGraw-Hill Companies, Inc. ("McGraw-Hill") are bound by McGraw-Hill's Code of Business Ethics, discussed below. This includes employees of Standard & Poor's and S&P Ratings Services which is a business unit that operates separately from McGraw-Hill and the other Standard & Poor's businesses within the division. The organization of S&P Ratings Services within the McGraw-Hill Corporation is unique compared with the other global rating agencies. As a separate business but not a separate legal entity, S&P Ratings Services does not have its own board of directors. In performing credit analysis and determining credit ratings, S&P Ratings Services operates within strict firewall restrictions, independently of McGraw-Hill's other operating segments and Standard & Poor's other business units.

McGraw-Hill's longstanding Code of Business Ethics does not allow employees to serve as a director or officer of any firm whose business competes with McGraw-Hill or that has business dealings with McGraw-Hill unless senior management approves the position. Standard & Poor's, including S&P Ratings Services, has various codes and policies and procedures that supplement McGraw-Hill's Code to avoid conflicts of interest. Standard & Poor's recently adopted its own policy to prohibit employees from serving on boards of U.S. public companies. For the period 2000 until now, out of approximately 3,600 U.S. Standard & Poor's employees, I am aware of only one Standard & Poor's employee who now sits or, since 2000, has sat on any U.S. corporate board or on the boards of the government entities which Senator Bunning identified at the hearing. The Standard & Poor's employee who currently sits on 2 corporate boards plans to resign both positions by June 30th. The employee is not affiliated with S&P Ratings Services and is not involved in the credit rating analytic or decision-making process. Our response to this question dates back to 2000 only as this is the year we started to electronically monitor and maintain this information.

McGraw-Hill is a public company (MHP: NYSE). Certain members of McGraw-Hill's board of directors are officers and directors of companies S&P Ratings Services rates. However, consistent with Standard & Poor's firewall policies, neither McGraw-Hill's officers, directors and employees outside S&P Ratings Services nor McGraw-Hill's board members have any day-to-day involvement in the credit rating process or in making rating decisions.

**NEW JERSEY'S PREDATORY LENDING LAW**

At the February 8th hearing, Senator Corzine asked our opinion of the New Jersey Predatory Lending Act.

On May 2, 2003, S&P Ratings Services first addressed New Jersey's anti-predatory lending law that was to become effective on November 27, 2003. Based on a review of the law, S&P Ratings Services determined that certain New Jersey loans (New Jersey high-cost loans, covered loans, manufactured housing loans, home improvement loans, and loans that are refinancings) would have to be excluded from S&P Ratings Services' rated transactions. The primary reason that S&P Ratings Services decided to exclude these loans was that liability for violation of the law in connection with these loans was unlimited. Thus, the funds available to pay investors in rated securities backed by these loans might have been reduced.

On November 25, 2003, two days before the law became effective, S&P Ratings Services revised its position regarding some of the types of loans listed above. The revisions were based on clarifications of the law that were made in Bulletins issued by the New Jersey Department of Banking and Insurance and an opinion of the New Jersey Attorney General. Both the Bulletins and the Attorney General's opinion interpreted the law and addressed most of the concerns that S&P Ratings Services raised in its May 2, 2003 publication. Essentially, the November 25 revisions permitted all New Jersey loans into S&P Ratings Services rated transactions, except for high-cost loans.

On May 13, 2004, S&P Ratings Services published new criteria for evaluating anti-predatory lending laws. This publication expanded on S&P Ratings Services' initial general criteria publication issued in April, 2003. We have attached this publication to this letter. The primary change to S&P Ratings Services' criteria was the requirement for "additional credit enhancement" for certain loans governed by certain anti-predatory lending laws. In other words, this requirement made it more costly for issuers to include these loans in deals rated by S&P Ratings Services. In New Jersey, this requirement resulted in the imposition of additional credit enhancement for the covered loan category.

On July 7, 2004, S&P Ratings Services issued a press release in which it announced it was eliminating all requirements for the covered loan category. This followed an amendment to the New Jersey law that became effective on July 6, 2004 and eliminated the whole category of covered loans from the law. This change had a significant impact on the market because a large group of securitized loans fell into this category.

Currently, New Jersey high-cost loans continue to be excluded. (However, it is S&P Ratings Services' understanding that high-cost loans are a small percentage of loans being securitized; thus, this exclusion does not significantly impact the securitization market. In addition, S&P Ratings Services excludes from its rated deals high-cost loans from other jurisdictions.) All other New Jersey loans are permitted without any additional credit enhancement.

In conclusion, it is S&P Ratings Services' belief that the New Jersey law (as amended, and as interpreted by the Bulletins and the AG's opinion) is similar in impact to other jurisdictions' anti-predatory lending laws, notwithstanding the exclusion of New Jersey high-cost loans. As noted above, S&P Ratings Services believes high-cost loans constitute a very small percentage of loans being securitized in today's market.

Frank Raiter, a Senior Director in S&P Ratings Services' Structured Finance Division, testified before the House Financial Services Committee on June 23, 2004. We have also enclosed his testimony with this letter.

For more information, we have also included a number of press releases and commentaries that we've published regarding this issue.

**RESPONSE TO WASHINGTON POST SERIES**

As the Washington Post November 22-24, 2004 series on credit rating agencies will be included in the record of the hearing, we would like to submit a copy of our November 30, 2004 Letter to the Editor of the Washington Post. Although this letter was not published by the Washington Post, we would like the Committee to have the benefit of our views on the series.

**SECURITIES AND EXCHANGE COMMISSION INSPECTIONS**

Senator Corzine asked during the February 8th hearing whether Standard & Poor's has been inspected by the SEC and, if so, when the inspection had occurred. I stated during the hearing that the SEC last inspected S&P Ratings Services in 2002. In response to Senator Corzine's question, prior to the 2002 inspection, the SEC, through its Northeast Regional Office, examined Standard & Poor's, including S&P Ratings Services, in August 2001.

If you would like any more information on these issues, we'd be happy to make ourselves available to discuss them with you.

Sincerely,

Kathleen G. Corbet

Kathleen Corbet
President
Standard & Poor's

Enclosures
cc: The Honorable Paul Sarbanes
The Honorable Jim Bunning
The Honorable Jon Corzine
The Honorable Charles Schumer
Ms. Elizabeth Hacketter, Banking Committee's Deputy Chief Clerk

# Research:

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## Standard & Poor's Permits Additional New Jersey Mortgage Loans Into Rated SF Transactions

**Publication date:** 25-Nov-2003
**Credit Analyst:** Natalie Abrams, Esq. , New York (1) 212-438-6607; Maureen Coleman, Esq. , New York (1) 212-438-6626

NEW YORK (Standard & Poor's) Nov. 25, 2003--Standard & Poor's Ratings Services announced today that it is revising its position regarding the New Jersey Home Ownership Security Act of 2002 (the Act) that is to become law effective Nov. 27, 2003. Based on clarifications of the Act set forth in interpretive bulletins number 03-15 and number 03-30 (the Bulletins) issued by the New Jersey Department of Banking and Insurance, an opinion of the Attorney General of the State of New Jersey received by Standard & Poor's relating to the Bulletins, and further analysis of relevant New Jersey statutory and case law, Standard & Poor's has concluded that it will now rate structured finance transactions that include additional New Jersey loans governed by the Act, in accordance with its criteria set forth below.

The Act categorizes loans as: "Home Loans," "Covered Home Loans," and "High-Cost Home Loans" and sets forth certain practices and prohibitions in connection with these categories. In addition, the Act sets forth certain prohibitions for Home Loans that are made in connection with home improvements (i.e., "Home Improvement Loans") and manufactured homes (i.e., "Manufactured Housing Loans"). Violations of the Act can result in monetary liability for the originator of the loans and, for some loan categories, for purchasers and assignees.

Standard & Poor's will now admit into its rated structured transactions, in accordance with the criteria set forth below, the following loan categories: Home Loans, Covered Home Loans, Home Improvement Loans, and Manufactured Housing Loans, provided, however, that these loans are not High-Cost Home Loans.

First, for Standard & Poor's to rate transactions that include these loans, Standard & Poor's will continue to rely on the representation and warranty that the loans included in the pool were originated in compliance with all applicable laws, including but not limited to, all applicable anti-predatory and abusive lending laws (compliance representation).

Second, with regard to loans included in a securitized pool, Standard & Poor's will require issuers to demonstrate that existing compliance procedures are effective to: (1) identify which loans constitute Home Loans, Covered Home Loans, Home Improvement Loans, and Manufactured Housing Loans under the Act, and (2) determine that these loans do not violate the Act.

Standard & Poor's will continue to exclude High-Cost Home Loans because of the potential for uncapped statutory and punitive damages. In this regard, Standard & Poor's will require that the seller of loans into the securitization structure provide a representation and warranty that the loans in the rated pools are not High-Cost Home Loans (Exclusion Representation). The Exclusion Representation must be provided by an entity that can demonstrate that existing procedures are effective to identify and exclude High-Cost Home Loans under the Act (including compliance with the Act's safe harbor provisions).

Standard & Poor's will require both the Compliance Representation and the Exclusion Representation to be provided by a creditworthy entity with sufficient financial strength to repurchase loans that are in breach of these representations at a purchase price that would make the securitization issuer whole, including any costs and damages incurred by the issuer in connection with such loan.

Standard & Poor's notes that in revising its criteria as described above, it has relied on the Bulletins only to the extent that the Bulletins clarify, as opposed to change or contradict, the Act.

Standard & Poor's regularly reviews its criteria to keep current with changes in the law in the area of predatory lending. These criteria are not stagnant, but evolve over time. Standard & Poor's will continue to publish its criteria
to keep market participants informed of any new approaches in this area.

Members of the media may contact Adam Tempkin, Media Relations Manager, at 212-438-7530 or adam_tempkin@standardandpoors.com.

Standard & Poor's, a division of The McGraw-Hill Companies, provides widely recognized financial data, analytical research and investment, and credit opinions to the global capital markets. With more than 5,000 employees located in 20 countries, Standard & Poor's is an integral part of the global financial infrastructure. Additional information is available at www.standardandpoors.com.

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## Standard & Poor's Addresses New Jersey Predatory Lending Law

**Publication date:** 02-May-2003
**Credit Analyst:** Natalie Abrams, Esq. , New York (1) 212-438-6607; Maureen Coleman, New York (1) 212-438-6626

(Editor's Note: When this commentary was published earlier today, much of the text was missing due to technical difficulties. The complete article follows.)

Standard & Poor's Ratings Services announced today that it has reviewed the New Jersey Home Ownership Security Act of 2002 that will become effective on or after Nov. 27, 2003 (the Act). Based on its review, Standard & Poor's has concluded that it will permit certain New Jersey loans governed by the Act and originated on or after the effective date to be included in its rated structured finance transactions.

## Loans That Will Be Accepted into Standard & Poor's Rated Transactions

### Loans Not Governed by the Act

Mortgage loans on properties in New Jersey not governed by the Act may be included in Standard & Poor's structured finance transactions. Among others, these loans include reverse mortgage loans and loans on homes that are not the borrower's principal dwelling, such as loans to finance second homes and investor properties. For these loans, Standard & Poor's will continue to rely on its standard representation and warranty that the loans included in the pool were originated in compliance with all applicable laws.

### Loans Governed by the Act

For loans governed by a predatory lending statute, Standard & Poor's evaluates the impact the statute may have on the availability of funds to pay investors of its rated securities. In its review of the Act, Standard & Poor's followed its general approach set forth in its recently published article on evaluating predatory lending statutes. (For a discussion of Standard & Poor's general approach to evaluating predatory lending statutes, see "Evaluating Predatory Lending Laws: Standard & Poor's Explains its Approach," published on RatingsDirect on April 15, 2003).

The Act categorizes loans as "Home Loans," "Covered Home Loans," and "High-Cost Home Loans" and sets forth certain practices and prohibitions in connection with these categories. In addition, the Act sets forth certain prohibitions for Home Loans that are made in connection with home improvements ("Home Improvement Loans") and manufactured homes ("Manufactured Housing Loans"). Violations of the Act could result in monetary liability for the originator of the loans and, for some loan categories, for purchasers and assignees.

For Home Loans that are not Covered Home Loans, High-Cost Home Loans, Home Improvement Loans or Manufactured Housing Loans, the Act does not provide for assignee liability. Based on Standard & Poor's stated criteria, these Home Loans will be admitted into Standard & Poor's rated structured finance transactions, provided (i) the Home Loan is either for the purpose of purchasing a home or a rate-term refinancing; and (ii) the seller into the securitization structure provides a representation and warranty that the loans in the rated pools are not Excluded Loans (see below). Standard & Poor's will require this representation from a creditworthy entity that can demonstrate that existing compliance procedures are effective to identify and exclude Excluded Loans under the Act (including compliance with the Act's safe harbor provisions for the exclusion of High-Cost Loans). Standard & Poor's will then look for repurchase of any loan that is in breach of this representation at a purchase price that will include any costs and damages incurred by the trust in connection with such loan. Standard & Poor's believes these measures are necessary to protect against liability that would arise with the inadvertent inclusion of Excluded Loans. In addition, Standard & Poor's will continue to rely on the representation and warranty that the loans included in the pool were originated in compliance with all applicable laws.

## Loans That Will Not Be Accepted in Standard & Poor's Rated Transactions

For all other loan categories (Covered Home Loans, High-Cost Home Loans, all Home Improvement Loans, all Manufactured Housing Loans, and Home Loans that are cash-out refinancings or junior lien mortgage loans (open or closed-end) (collectively, Excluded Loans), the Act provides the potential for assignee liability (loans exposed to assignee liability are referred to as Exposed Loans). Although damages for some of these loan categories are capped under the Act, for the reasons set forth below, Standard & Poor's will not permit these loans to be included in its rated structured finance transactions.

First, in addition to the damages available to a borrower under the Act, the Act permits a borrower to elect to recover damages under either the Act or New Jersey's Consumer Fraud Act (CFA), which provides for recovery of treble the damages sustained by a borrower, plus costs. Because Standard & Poor's believes the Act is unclear as to whether a borrower may recover under the CFA in a suit against assignees for a violation under the Act, Standard & Poor's believes it must adopt the more conservative approach and factor into its credit analysis the possibility that treble actual damages might be recoverable against an assignee. Moreover, because the language of the CFA does not define actual damages, for the purposes of its credit analysis, Standard & Poor's must assume that such damages are not limited to a determinable dollar amount (i.e., the damages are not capped). Thus, notwithstanding any caps on damages that may be provided for under the Act, Standard & Poor's believes it is unable to quantify the assignee damages that might be obtainable under the CFA for violations of the Act. Therefore, the right provided for in the Act to elect damages under either the Act or the CFA was critical in Standard & Poor's determination to exclude all Exposed Loans from its structured finance transactions.

However, even if it were clear that a borrower could not recover damages against assignees under the CFA, for the reasons stated in the following paragraph, for certain loan categories, Standard & Poor's believes the damages may still be unquantifiable under the Act. Therefore, in accordance with its stated criteria, Standard & Poor's would still exclude such loans from its structured finance transactions.

Specifically, although damages against assignees of Home Improvement Loans and Manufactured Housing Loans that are in violation of the Act are capped, because the Act does not preclude class action suits for these categories, the cumulative damages might not be capped if the class size is not determinable. In addition, for these loan categories, Standard & Poor's believes that a borrower may recover under more than one section of the Act, each of which separately provides for damages that may equal or exceed the principal balance of the loan, thereby posing the potential problem of cumulative damages. With respect to Home Loans that are cash-out refinancings or junior lien mortgage loans (open or closed-end), Standard & Poor's believes it is necessary to exclude these loans because the funds from these loans could be used for the purpose of home improvement (which loans carry the potential for assignee liability) and this fact may not be disclosed upon origination. Finally, for High-Cost Loans held by assignees who fail to meet the Act's safe harbor provisions for excluding High-Cost loans, the Act clearly provides for uncapped statutory and punitive damages and, thus, would be excluded from Standard & Poor's rated structured finance transactions.

On the other hand, if it were clear that a borrower could not recover damages against assignees under the CFA, because the damages for Covered Home Loans are capped under the Act, Standard & Poor's would consider permitting Covered Home Loans into its rated pools, provided that the loans are not Home Improvement Loans, Manufactured Housing Loans, or High-Cost Home Loans.

## Summary of Standard & Poor's Criteria set forth above for New Jersey Loans Governed by the Act

Loans allowed into Standard & Poor's rated structured transactions:

*--Home Loans (except for Home Loans that are cash-out refinanced transactions and junior lien mortgage loans)

Loans not allowed into Standard & Poor's rated structured transactions:

*–High-Cost Home Loans

*--Covered Home Loans

*--Home Improvement Loans

*--Manufactured Housing Loans

**Standard & Poor's Criteria Evolve Over Time**

Market participants should note that until the Act becomes effective Standard & Poor's will continue to apply its current criteria for inclusion of New Jersey loans in rated transactions.

Standard & Poor's regularly reviews its criteria to keep current with changes in the law in the area of predatory lending. These criteria are not stagnant, but evolve over time. Standard & Poor's will continue to publish its criteria to keep market participants informed of any new approaches in this area.

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## New Criteria Implemented for Including Anti-Predatory Lending Law Lns in U.S. Rtd SF Trans

**Publication date:** 13-May-2004
**Credit Analyst:** Natalie Abrams, Esq. , New York (1) 212-438-6607; Maureen Coleman, Esq. , New York (1) 212-438-6626; Frank Raiter, New York (1) 212-438-2579; Scott Mason, New York (1) 212-438-2539; Susan E Barnes, New York (1) 212-438-2394

NEW YORK (Standard & Poor's) May 13, 2004-- Standard & Poor's is announcing that, effective today, it will require additional credit support for certain loans governed by anti-predatory lending laws that are included in its rated transactions.

Over the past year, Standard & Poor's has reviewed anti-predatory lending laws and has published criteria updates on laws that impose liability on purchasers of these loans (assignee liability). Standard & Poor's believes that when the risk associated with violating an anti-predatory lending law is quantifiable, Standard & Poor's will rate transactions that include loans governed by that law. To date, Standard & Poor's has relied on seller representations and warranties to cover the exposure of rated pools to the penalties associated with violating the various anti-predatory lending laws.

Because of the proliferation of these laws, Standard & Poor's anticipates that an increased number of loans governed by these laws are likely to be included in transactions it is asked to rate. For some of these loans, the potential assignee liability may exceed the original principal balance of the loan. This assignee liability has to be appropriately factored into the rated transactions. The risk increases for laws that have subjective standards, such as net tangible benefit or vague repayment ability tests, to determine whether a loan is "predatory."

Consequently, Standard & Poor's has determined that it is necessary to take additional measures to address the effect of the potential damages associated with these loans. In so doing, Standard & Poor's is implementing the credit enhancement concepts discussed in its general criteria publication on predatory lending, in which Standard & Poor's first suggested that it may require credit enhancement. (see "Evaluating Predatory Lending Laws: Standard & Poor's Explains Its Approach," published April 15, 2003 on RatingsDirect, Standard & Poor's Web-based credit analysis system at www.ratingsdirect.com).

Credit Enhancement Criteria

Standard & Poor's will continue to rely on representations and warranties that a loan complies with an applicable anti-predatory lending law, if Standard & Poor's concludes that the law has clear and objective standards to determine compliance. If, on the other hand, in Standard & Poor's opinion, an anti-predatory lending law does not contain clear and objective standards, there is an increased risk that originators or sellers may inadvertently breach a compliance representation or warranty made in good faith. For the loans covered by these subjective laws, Standard & Poor's will require additional credit enhancement as described below.

Based on a study of over 40 federal, state and municipal anti-predatory lending laws, Standard & Poor's will be requiring credit enhancement for loans governed by the following laws:

-- Arkansas (High-Cost Home Loans);
-- Cleveland Heights, Ohio (Covered Loans);
-- Colorado (Covered Loans);
-- District of Columbia (Section 7(A) Covered Loans);

-- District of Columbia (Section 7(B) Covered Loans);
-- Florida (High-Cost Home Loans);
-- Georgia (amended law) (High-Cost Home Loans);
-- Home Ownership Equity Protection Act (Section 32 Loans);
-- Illinois (High-Risk Home Loans);
-- Maine (High-Rate, High-Fee Loans);
-- Massachusetts (High Cost Home Loans);
-- New Jersey (Covered Home Loans- Refinancings only);
-- New Mexico (High-Cost Home Loans);
-- New York State (High-Cost Home Loans);
-- Ohio (Covered Loans);
-- Oklahoma (Subsection 10 Mortgage Loans); and
-- Toledo, Ohio (Home Loans).

Standard & Poor's will base its credit enhancement on an assessment of potential losses to the securitization transaction. This calculation involves an evaluation of several factors, including the number of successful lawsuits likely to be asserted against the issuer based on the jurisdictions involved, statutory borrower rights, the maximum potential damages that could be awarded, and an assessment of the likely amount of damages to be awarded. Standard & Poor's will separately identify the credit enhancement amount for affected loans as a percentage of a rated pool.

The loss severity on each affected loan will be calculated based on the jurisdiction, taking into account the principal balance of each loan, the interest rate and the term of the loan. After calculating this loss severity, Standard & Poor's will determine the number of defensive claims (claims raised by the borrower in a foreclosure action) by using the appropriate foreclosure frequency. It will then determine the frequency of affirmative claims (claims made against the lender prior to default of the loans) by assuming that a percentage of the non-defaulted loans are likely to be subject to affirmative claims. The total credit enhancement for affected loans is then calculated based on the percentage of losses on affirmative and defensive claims. Therefore, the total credit enhancement will depend on the number of loans in each pool, foreclosure frequencies, and the jurisdictional distribution of the loans.

A seller that has an outstanding long-term debt rating from Standard & Poor's as high as the highest rating of the transaction may provide credit support by agreeing to buy back the affected loans. Market participants may also want to consider other established means of providing credit support, such as LOCs, guarantees or surety bonds issued by appropriately rated entities that meet Standard & Poor's criteria.

In the interest of market transparency, Standard & Poor's is publishing its findings regarding the maximum damages that may be imposed on assignees for violations of the anti-predatory lending laws. Standard & Poor's is publishing its findings to increase investor awareness of potential damages for a given loan, as well as market awareness of the issue of assignee liability overall. For a complete discussion of Standard & Poor's criteria regarding anti-predatory lending law loans (including the required representations and warranties as well as the assumptions made for calculating the jurisdictional loss severities), see "Standard & Poor's Implements Credit Enhancement Criteria and Revises Representation and Warranty Criteria for Including Loans Governed by Anti-Predatory Lending Laws in U.S. Rated Structured Finance Transactions," published today on RatingsDirect, Standard and Poor's web based credit analysis system at www.ratingsdirect.com.

Standard & Poor's recognizes that its credit enhancement requirements may affect the economics of securitizing loans subject to this additional credit enhancement. However, market participants should note that the additional credit enhancement will be applied primarily to high cost loans that have historically not been a large component of Standard & Poor's rated transactions. As performance and loss information for the loans subject to additional credit enhancement develops, Standard & Poor's will adjust its criteria as appropriate.

Standard & Poor's regularly reviews its criteria to keep current with changes in the law in the area of predatory lending. These criteria are not stagnant, but evolve over time. Standard & Poor's will continue to publish its criteria to keep market participants informed of any new approaches in this area.

Standard & Poor's, a division of The McGraw-Hill Companies, provides widely recognized financial data, analytical research and investment and credit opinions to the global capital markets. With more than 5,000 employees located in 20 countries, Standard & Poor's is an integral part of the global financial infrastructure. Additional information is available at www.standardandpoors.com.

STANDARD & POOR'S

Print

# Anti-Predatory Lending Alert: Standard & Poor's Revises Criteria Related to Anti-Predatory Lending Laws

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**Quick Links**

Standard & Poor's Criteria

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Notes

Standard & Poor's Ratings Services is announcing that effective today for all first version loan pools received on or after today for analysis, it will require an addition to credit enhancement for certain loans included in its rated transactions that are governed by anti-predatory lending laws. As discussed in this release, this addition to credit enhancement may be waived if a seller of the loans into a securitization (Seller) meets certain financial capacity requirements.

Since publishing its initial criteria relating to anti-predatory lending laws on Jan. 16, 2003, Standard & Poor's has continued to review such lending laws as they have been enacted. If, in Standard & Poor's opinion, an anti-predatory lending law imposes liability on purchasers or assignees (assignee liability), Standard & Poor's has generally published criteria prior to the law's effective date. Standard & Poor's has recently completed a review of predatory and abusive lending laws enacted to date. These criteria are the end result of in-depth reviews and analyses of over 40 federal, state, and municipal anti-predatory lending laws and ordinances.

Standard & Poor's believes that when the risk associated with violating an anti-predatory lending law is quantifiable, then Standard & Poor's will allow loans governed by that law in its rated transactions if the risk is supported by the appropriate credit enhancement. To date, Standard & Poor's has relied on seller representations and warranties to cover the exposure of rated pools to the penalties associated with violating the various anti-predatory lending laws.

Because of the proliferation of these laws, Standard & Poor's anticipates that an increased number of loans governed by these laws are likely to be included in rated transactions. For some of these loans, the potential assignee liability may exceed the original principal balance of the loan. This prompted Standard & Poor's to conduct a study of the maximum damages that may be imposed on assignees under the anti-predatory lending laws presently in effect. As a result of this study, Standard & Poor's has determined that it is necessary to take additional measures to protect against the cumulative effect of the potential damages associated with these loans. This risk increases for laws that have subjective standards, such as net tangible benefit or vague repayment ability tests, to determine whether a loan is "predatory." Consequently, Standard & Poor's is implementing the credit enhancement concepts discussed in its general criteria publication on predatory lending (see "Evaluating Predatory Lending Laws: Standard & Poor's Explains Its Approach," published April 15, 2003, on RatingsDirect, Standard & Poor's Web-based credit analysis system at www.ratingsdirect.com, and also on Standard & Poor's Web site at www.standardandpoors.com).

## Standard & Poor's Criteria

Standard & Poor's is issuing this Alert to describe its expanded credit enhancement criteria, as well as its revised representation and warranty requirements, with respect to all of the anti-predatory lending laws that Standard & Poor's has reviewed and has concluded impose assignee liability (Assignee Liability Laws).

Standard & Poor's will apply the following criteria for including in or excluding from its rated structured finance transactions loans governed by the Assignee Liability Laws.

First, Standard & Poor's will continue to require a representation and warranty from the Seller of the loans into the transaction (the Seller) as of the cutoff date stating, "All loans were originated in compliance with all applicable laws, including, but not limited to, all applicable anti-predatory lending laws" (Compliance Representation).

Second, Standard & Poor's will now require a representation and warranty from the Seller, as of the cutoff date stating, "No loan is a High Cost Loan or Covered Loan, as applicable (as such terms are defined in the then-current version of Standard & Poor's LEVELS® Glossary, which is now Version 5.6 Revised, Appendix E) and no mortgage loan originated on or after Oct. 1, 2002 through March 6, 2003 is governed by the Georgia Fair Lending Act" (Exclusion Representation). The Glossary is available on the Standard & Poor's Web site and on RatingsDirect. If an issuer chooses to include any loans governed by an Assignee Liability Law in a rated transaction, exceptions to the Exclusion Representation should be identified.

In addition, it should be noted that Standard & Poor's is continuing to exclude the following loans from its rated pools: (i) High-Cost Home Loans, as defined in the New Jersey predatory and abusive lending law (NJ High-Cost Home Loans) and (ii) loans governed by the Georgia Fair Lending Act prior to its amendment on March 7, 2003 (GA Pre-Amendment Loans). (If and when the Los Angeles, CA and Oakland, CA predatory and abusive lending laws become effective, Standard & Poor's will also require the exclusion from its rated transactions of loans governed by either of these ordinances).

If any loan included in a rated pool is in breach of the Compliance Representation or the Exclusion Representation, Standard & Poor's will continue to require the Seller to repurchase any such loan(s) at a purchase price that would make the securitization trust whole, including any costs and damages incurred by the issuer in connection with such loan.

Third, Standard & Poor's will continue to require sellers into a securitization structure to demonstrate that their existing compliance procedures are effective to identify which loans fall into the various loan categories set forth in the applicable Assignee Liability Law and, if a Seller chooses to include in any rated pool loans governed by any of the Assignee Liability Laws, to determine that all such loans do not violate the applicable law.

Fourth, effective July 1, 2004, Standard & Poor's will require Sellers to identify on the loan level file submitted to Standard & Poor's for review in connection with a securitization transaction whether each loan to be included in a rated pool is a Home Loan, in addition to the already required disclosure of any Covered Loan and High Cost Loan, as applicable (as such terms are defined in the Glossary). This timeframe has been adopted considering the system changes required for issuers and originators to be capable of capturing and reporting the required information to Standard & Poor's.

Fifth, Standard & Poor's requires that a Seller into a securitization structure of loans governed by any Assignee Liability Law satisfy Standard & Poor's credit enhancement criteria, as more fully described below. This requirement may be waived if a Seller has an outstanding long-term debt rating from Standard & Poor's equal to or higher than the highest rated security to be issued in the applicable transaction or the payment of principal of and interest on the rated securities is guaranteed (pursuant to a guaranty agreement, LOC, or similar agreement) by an entity with such a rating.

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## Credit Enhancement Criteria and Methodology

Standard & Poor's will continue to rely on representations and warranties that a loan complies with an applicable anti-predatory lending law, if Standard & Poor's concludes that the law has clear and objective standards. If, on the other hand, in Standard & Poor's opinion, an anti-predatory lending law does not contain clear and objective standards(1), there is an increased risk that originators or sellers may inadvertently breach a compliance representation or warranty made in good faith. For the loans covered by these subjective laws, Standard & Poor's will require additional credit enhancement as described below.

Credit enhancement requirements (CER) will be calculated on both the loans governed by anti-predatory lending (APL) governed loans and on those that are not (non-APL loans). For the APL governed loans, CER will be calculated for each jurisdiction that is included in the pool. CER will be provided for each transaction with the inclusion and exclusion of the APL governed loans.

### Credit Enhancement Methodology

The calculation of CER for non-APL loans will be accomplished through Standard & Poor's existing loan level analysis, ratings methodologies, and criteria for determining a foreclosure frequency (FF) and loss severity (LS) for each loan.

Calculation of APL loan CER will encompass:

## Defensive Claims Calculation

- Standard & Poor's will use the FF as calculated utilizing the LEVELS® model to determine the frequency or probability of a defensive claim. Standard & Poor's assumes all defaulted loans will be subject to defensive APL loan claims;
- The LS for the APL loans will be calculated outside of the model based upon the specific jurisdiction's damages as described further in the Standard & Poor's Assumptions Appendix to the Anti-Predatory Lending Law Update table;
- The greater of the APL LS and Standard & Poor's LEVELS® model LS will be used; and
- Multiplying the FF by the greater of the APL loss severity or the LEVELS® model LS will yield the CER for the defensive claims.

The loan level CER formula for the defensive claims is: FF x (the greater of APL LS or LEVELS LS).

## Affirmative Claims Calculation

- To determine the affirmative APL claims Standard & Poor's assumes 25% of the nondefaulted loans (Litigation Frequency, or LF) will be subject to affirmative APL claims. The formula for determining this is (100- ('AAA' FF)*25%;
- The LS for the APL loans will be calculated outside of the model based upon the specific jurisdiction's damages as described further in the Standard & Poor's Assumptions Appendix to the Anti-Predatory Lending Law Update table; and
- Multiplying the LF times the APL loss severity will yield the CER for the affirmative claims.

The loan level CER formula for the affirmative claims is: LF x APL LS.

## Aggregate CER Calculation

To determine the aggregate loan level CER for APL loans: FF x (the greater of APL LS or LEVELS LS) + LF x (APL LS).

The CER will be reported separately for APL governed and non-APL loans. The two (or more) sets of CER will be weighted together to produce the pool level CER.

## Credit Enhancement Criteria

Standard & Poor's will base its credit enhancement requirements for a loan governed by a given anti-predatory lending law on its assessment of potential loss calculated for each such loan included in a rated pool (see table), as adjusted for the incidence of estimated affirmative and defensive claims.

| Anti-Predatory Lending Law Loss Severities by Jurisdiction (%) | |
|---|---|
| Arkansas (High-Cost Home Loans) | 119 |
| | |

Standard & Poor's will look to see how clearly a law sets forth what constitutes prohibited actions and/or omissions for a given loan category. Standard & Poor's looks for clear language that would enable an originator or seller to comply with the law. Notwithstanding a law's lack of clarity, however, Standard & Poor's will consider mitigating factors in deciding whether to require additional credit enhancement. These mitigating factors include the following: (i) whether damages are imposed under the law only if there is a "pattern or practice" of violating the law; (ii) if the law requires the borrower to prove that a violation was committed "knowingly and intentionally"; (iii) if a law provides objective standards for satisfying a repayment ability test or a net tangible benefits test; (iv) the litigation history of the law; (v) procedural factors contained in a law, such as statutes of limitation, cure periods, rebuttable presumptions, restrictions on affirmative and defensive claims against assignees; and (v) and other factor that Standard & Poor's deems relevant.

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**TESTIMONY OF FRANK RAITER**
**MANAGING DIRECTOR**
**STANDARD & POOR'S CREDIT MARKET SERVICES**

**SUBMITTED TO THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY**
**And**
**THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT**

**U.S. HOUSE OF REPRESENTATIVES**

**HEARING ON: PROMOTING HOMEOWNERSHIP BY ENSURING LIQUIDITY IN THE SUBPRIME MORTGAGE MARKET**

**JUNE 23, 2004**

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Standard & Poor's Ratings Services ("Standard & Poor's"), part of Standard & Poor's, a division of The McGraw-Hill Companies, Inc. ("McGraw-Hill"), appreciates the opportunity to share its views on its approach to rating securities backed by loans governed by anti-predatory lending statutes. As an independent and objective commentator on credit risk, Standard & Poor's generally does not take a position on questions of public policy. Thus, while Standard & Poor's strongly supports efforts to combat predatory lending and other abusive practices by lenders, it does not take a position on what legislative and regulatory actions would best accomplish that goal. Nevertheless, Standard & Poor's has been closely following legislative and regulatory initiatives designed to combat predatory lending in order to determine how those laws might affect its ability to rate securities backed by residential mortgage loans. Accordingly, Standard & Poor's is pleased to discuss the factors that it considers when evaluating the impact of anti-predatory lending laws on its rated transactions, and, in particular, the issue of assignee liability.

**INTRODUCTION**

Since beginning its credit rating activities in 1916, Standard & Poor's has rated hundreds of thousands of securities issues, corporate and governmental issuers and structured financings. Standard & Poor's began its ratings activities with the issuance of credit ratings on corporate and governmental debt issues. Responding to market developments and needs, Standard & Poor's also assesses the credit quality of, and assigns credit ratings to, financial guarantees, bank loans, private placements, mortgage- and asset-backed securities, mutual funds and the ability of insurance companies to pay claims, and assigns market risk ratings to managed funds.

Today, Standard & Poor's has credit ratings outstanding on approximately 150,000 securities issues of obligors in more than 50 countries. Standard & Poor's rates and monitors developments pertaining to these securities and obligors from operations in 20 countries around the world. With a U.S. staff of approximately 1,250 Standard & Poor's rates more than 99.2% of the debt obligations and preferred stock issues publicly traded in the United States.

Standard & Poor's believes that over the last century credit ratings have served the U.S. securities markets extremely well, providing an effective and objective tool in the market's evaluation and assessment of credit risk. Standard & Poor's recognizes the valuable role that credit rating agencies play in the U.S. securities markets and is committed to protecting and enhancing the reputation and future of its credit ratings business. In this regard, Standard & Poor's takes great care to assure that its credit ratings are viewed by the market as highly credible and relevant and will continue to review its practices, policies and procedures on an ongoing basis and modify or enhance them, as necessary, to ensure that integrity, independence, objectivity, transparency, credibility, and quality continue as fundamental premises of its operations.

When Standard & Poor's issues a rating, it is offering its opinion about a company's medium to long-term credit risk. Similarly, ratings on particular instruments, such as the securities related to structured finance transactions, reflect Standard & Poor's opinion about the likelihood of default on those securities. In determining all of its ratings, Standard & Poor's tries to take into account whatever relevant future events may be anticipated.

Standard & Poor's does not perform an audit of the issuer, does not guaranty an issuer's payment on its debt, or provide insurance in case the issuer does not pay the debt. A Standard & Poor's rating does not constitute a recommendation to purchase, sell, or hold a particular security. Nor does a Standard & Poor's rating speak to the suitability of an investment for particular investors. Rather, a rating reflects Standard & Poor's opinion as of a specific date of the creditworthiness of a particular company or security based on Standard & Poor's objective and independent analysis.

## EVALUATING ANTI-PREDATORY LENDING LAWS

### *General*

Increased access to mortgage loans has led to increased home ownership across the U.S. While this growth in home ownership is positive, it has become evident that some of this increase has unfortunately occurred simultaneously with a rise in predatory lending practices. Among others, these predatory practices include the following: charging excessive interest or fees; making a loan to a borrower that is beyond the borrower's financial ability to repay; charging excessive prepayment penalties; encouraging a borrower to refinance a loan notwithstanding the lack of benefit to the borrower; and increasing interest rates upon default.

To protect borrowers from unfair, abusive, and deceptive lending practices, numerous state and local governmental bodies have enacted anti-predatory lending laws. Typical laws include provisions that:

- Limit the interest rates and fees that a lender may charge;
- Preclude lending to borrowers without regard to their ability to repay;
- Require refinance loans to provide a net tangible financial benefit to the borrower;
- Prohibit excessive prepayment penalties and balloon payments;
- Require disclosure to the borrower of various loan provisions; and
- Require counseling for borrowers who are planning to take out certain loans that are governed by these laws.

Anti-predatory lending laws are designed to protect borrowers from such practices, and Standard & Poor's strongly supports efforts to combat predatory lending. For several reasons, however, these laws may also have the negative effect of reducing the availability of funds to such borrowers. First, a lender might reduce its lending in a given jurisdiction to protect itself from being found in violation of the jurisdiction's anti-predatory lending law. Second, a lender might reduce its business because the cost of lending in accordance with a law's provisions might be uneconomical. Third, a lender might reduce its activities within a given jurisdiction if the market for the sale of loans originated in that jurisdiction is effectively eliminated. This would occur, for example, if an anti-predatory lending law imposes liability on purchasers or assignees of loans causing potential purchasers and assignees to reduce, or even cease, their purchasing to avoid liability under the law.

Moreover, and most importantly from Standard & Poor's perspective, an anti-predatory lending law's imposition of liability on purchasers or assignees of mortgage loans ("assignee liability") might reduce the availability of funds to pay investors in securities backed by mortgage loans governed by the law. This would occur if the purchaser or assignee were found to hold a loan that violated the law ("predatory loan"), even if the purchaser or assignee did not itself engage in predatory lending practices. Therefore, in performing a credit analysis of structured transactions backed by residential mortgage loans, Standard & Poor's evaluates the impact an anti-predatory lending law might have on the availability of funds to pay investors in the rated securities. To the extent that Standard & Poor's determines that investors in securities backed by loans governed by an anti-predatory lending law might be negatively impacted, Standard & Poor's may require additional credit support to protect investors or, in certain circumstances, preclude such loans from being included in Standard & Poor's rated transactions.

***Evaluation of Laws***

In performing its evaluation of anti-predatory lending laws, Standard & Poor's considers, among other factors, whether the law provides for the following: (i) assignee liability; (ii) clearly delineated loan categories; (iii) penalties, including monetary damages, as well as restrictions or prohibitions on doing business with the governmental entity whose legislation is at issue; and (iv) clarity of statutory violations and safe harbors.

1. *Assignee Liability*. As the first part of its analysis, Standard & Poor's will review an anti-predatory lending law to see if it imposes assignee liability in connection with any type of loan covered by the law (a loan with associated assignee liability is referred to in this discussion as an "exposed loan"). Standard & Poor's defines assignee liability as liability that attaches to a purchaser or assignee of a loan (including a securitization trust) simply by virtue of holding a predatory loan. An anti-predatory lending law may impose assignee liability in a direct action by the borrower or only defensively, i.e., in an action by the purchaser/assignee to enforce a loan. Typically, laws that impose assignee liability permit a borrower to assert the same defenses against the purchaser or assignee as it could assert against the original lender.

If Standard & Poor's determines that no assignee liability is provided for under the law, Standard & Poor's will, generally, permit loans covered by the law to be included in Standard & Poor's rated transactions. If, on the other hand, Standard & Poor's determines that a given jurisdiction's anti-predatory lending law does permit assignee liability, Standard & Poor's will continue with the second part of its analysis.

2. *Statutory Loan Categories*. As the second part of its analysis, Standard & Poor's examines the categories of loans that are identified in the law. Standard & Poor's considers whether the language of the law clearly distinguishes between those loans that are covered by the law and those that are not, as well as among the various loan categories (for example, covered, high cost) covered by the law. Standard & Poor's looks to see if a loan originator, a seller of loans into a securitization transaction, or a purchaser or assignee of loans would be able to determine what category of loan (according to the law the entity is originating, selling, or purchasing.

If Standard & Poor's concludes that the distinctions discussed above are not clearly set forth in the law, then Standard & Poor's may not be able to rate transactions that include any loans originated in the relevant jurisdiction.

If, however, Standard & Poor's determines that the distinctions discussed above are clearly set forth in the law, Standard & Poor's will determine for which loan categories the law provides assignee liability. In general, and consistent with its approach discussed above in section 1, Standard & Poor's will permit loans with no associated assignee liability to be included in its rated transactions. In connection with exposed loans, Standard & Poor's will continue with the third part of its analysis.

3. *Penalties*. For exposed loans, Standard & Poor's will consider whether the law exposes the assignee or purchaser to monetary damages and, if so, whether such monetary damages are limited to a determinable dollar amount (i.e., the damages are capped). Standard & Poor's will perform this analysis for all types of monetary damages that may be assessed under the law, including statutory, actual, and punitive damages, as well as any other type of monetary damages provided for in the law.

If the damages for violation of a law in connection with a given loan category are not capped, Standard & Poor's will not be able to size the potential liability into its credit analysis and thus will not, as a general matter, permit these loans to be included in Standard & Poor's rated transactions.

If, on the other hand, Standard & Poor's determines that, for any given loan category, the monetary damages are capped, as a general matter, Standard & Poor's will be able to size in its credit analysis the potential monetary impact of violating the law and will continue with the fourth part of its analysis. In this regard, it should be noted that the ability of Standard & Poor's to size capped damages in its credit analysis is distinct from the question as to whether it would make economic sense to securitize loans, especially if the credit enhancement required equals or exceeds the monetary value of the loan. For example, some laws provide for rescission or voidance of a predatory loan and require that all amounts paid, including principal and interest, be returned to the borrower. Other laws permit a borrower to continue to hold a predatory loan, but forgive all interest that otherwise would be due. In addition, if a law provides for punitive damages (even if these damages are capped), the amount of the damages may well exceed the loan value. In some of these instances, securitization of these loans may prove to be too costly.

If an anti-predatory lending law imposes nonmonetary penalties on purchasers or assignees, e.g., restrictions or prohibitions on doing business with the governmental entity whose legislation is at issue, Standard & Poor's will review these penalties to determine the effect, if any, that these penalties will have on securitization transactions.

4. *Clarity of Statutory Violations; Safe Harbors*. As the fourth part of its analysis, Standard & Poor's will look to see how clearly an anti-predatory lending law sets forth what constitutes prohibited actions and/or omissions for each exposed loan category. Standard & Poor's looks for clear language that would enable an originator, seller, or assignee of an exposed loan to comply with the law. In addition, Standard & Poor's will look to see if the lawsets forth certain methods (for example, due diligence procedures and policies against the purchase of certain loans covered by the law) that a purchaser or assignee can implement to avoid liability ("safe harbors").

***Evaluation of Seller's Compliance Procedures and Creditworthiness***

In addition to reviewing an anti-predatory lending law for the factors discussed above, Standard & Poor's will also review the compliance procedures of any entity that proposes to sell mortgage loans into a securitization ("seller"). In this regard, Standard & Poor's will review a seller's compliance procedures, to determine if they are effective to identify (a) exposed loans, i.e., those subject to assignee liability, and (b) predatory loans, i.e., those that are in violation of the law. These factors assume increased significance in transactions where the seller proposes to include exposed loans. As mentioned above, in some instances, Standard & Poor's will require additional credit enhancement for inclusion of certain exposed loans.

Based upon its evaluation of all of the factors discussed above, as well as any other factors Standard & Poor's deems pertinent, Standard & Poor's will determine if any of the loans covered by an anti-predatory lending law may be included in its rated transactions, and what, if any, additional credit enhancement may be required.

**CONCLUSION**

In summary, in its evaluation of the credit risk to investors of rated securities backed by mortgage loans governed by anti-predatory lending laws, Standard & Poor's looks for statutory language that clearly sets forth what constitutes a violation under such a law, which parties may be liable under the law, the extent of such liability (monetary and otherwise), and whether any monetary liability is limited to a determinable dollar amount. Absent clarity on these issues, in order to best protect investors in rated securities, Standard & Poor's adopts a conservative interpretation of an anti-predatory lending law, and may, in instances in which liability is unlimited, exclude mortgage loans governed by a given anti-predatory lending law from transactions that it rates.

In offering these written comments, Standard & Poor's reiterates to the Honorable Members of the Subcommittee on Housing and Community Opportunity that, as a public policy matter, it is in favor of legislation that attempts to curb predatory and abusive lending practices. Standard & Poor's also acknowledges, however, that its role is to evaluate the credit risk to investors associated with anti-predatory lending legislation and not to recommend public policy, the making of which is the responsibility of elected officials.

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November 30, 2004

Letters to the Editor
The Washington Post
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To the Editor:

Your November 22-24 series on credit raters did not provide a complete and balanced assessment of the industry and the role credit ratings play in the broader capital markets.

By focusing on a handful of cases, you overlooked the enormous contributions S&P has made to the global capital markets. With more than 700,000 ratings outstanding, Standard & Poor's has helped to create a level playing field by providing transparency and a common language for assessing credit risk.

It stands to reason that some will differ with our opinions. This should not be confused with the contribution we make every day by increasing understanding of credit quality. Indeed, we issue 500 – 1000 rating actions each day, which are subject market scrutiny, and we focus on furnishing opinions that over time prove credible and reliable. Our long-term track record certainly demonstrates this. Moreover, S&P is continually enhancing the rating process in order to respond to evolving marketplace needs. It would not have been possible to build the practice we have if issuers and investors did not experience a fair, balanced and independent evaluation of creditworthiness. In fact, most market participants have said just that in public comments to government and regulatory organizations worldwide.

Standard & Poor's is working with US and global regulators to help build a greater understanding of the credit rating process and to address an oversight system that would not diminish the independence and credibility of ratings. Many recognize that the capital markets have greatly benefited from independent, objective and reliable ratings and any regulatory approach that could undermine this would not serve the markets well. It has long been S&P's position that the market benefits from a variety of credit opinions, therefore, we would welcome additional sources of credible ratings. We support a more transparent process for designating Nationally Recognized Statistical Rating Organizations and recognition of agencies that cover specific regions or sectors.

We work extremely hard each day to maintain and demonstrate our credibility and objectivity in the markets we serve and we are most disappointed that you chose to ignore the overwhelming evidence of our positive and constructive role, which, for decades has helped facilitate the flow of capital for vital public and private projects in every corner of the globe.

Sincerely,

Kathleen A. Corbet

cc: Jill Dutt
Larry Roberts
Alec Klein

# Research:

Return to Regular Format

## Standard & Poor's Eliminates New Jersey Covered Home Loan Criteria

**Publication date:** 07-Jul-2004
**Credit Analyst:** Natalie Abrams, Esq., New York (1) 212-438-6607; Maureen Coleman, Esq., New York (1) 212-438-6626

NEW YORK (Standard & Poor's) July 7, 2004--Standard & Poor's Ratings Services announced today that it has reviewed the amendment to the New Jersey Home Ownership Security Act of 2002 that was signed into law July 6, 2004 (the Amended Act). Among other changes, the Amended Act eliminates the "covered home loan category." Accordingly, Standard & Poor's is eliminating its previously published criteria for New Jersey "covered home loans" originated on or after July 6, 2004.

Because the Amended Act is not retroactive, Standard & Poor's will continue to apply its previously published criteria for New Jersey covered home loans to those loans that were originated on or after Nov. 27, 2003, and before July 6, 2004 (New Jersey Interim Loans). (For Standard & Poor's' previously published criteria regarding New Jersey covered home loans, see "Standard & Poor's Implements Credit Enhancement Criteria and Revises Representation and Warranty Criteria for Including Anti-Predatory Lending Law Loans in U.S. Rated Structured Finance Transactions," published May 13, 2004. This article is available on RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. The article is also available on Standard & Poor's Web site at www.standardandpoors.com. Under Credit Ratings, locate the article under Credit Ratings Criteria.)

Other than as set forth in the above paragraph, Standard & Poor's' criteria as stated in its May 13, 2004 criteria publication will continue to apply.

Standard & Poor's regularly reviews its criteria to keep current with changes in the law in the area of predatory lending. These criteria are not stagnant, but evolve over time. Standard & Poor's will continue to publish its criteria to keep market participants informed of any new approaches in this area.

Standard & Poor's, a division of The McGraw-Hill Companies, provides widely recognized financial data, analytical research and investment, and credit opinions to the global capital markets. With more than 5,000 employees located in 20 countries, Standard & Poor's is an integral part of the global financial infrastructure. Additional information is available at www.standardandpoors.com.

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March 1, 2005

The Honorable Richard Shelby
United States Senate
Chairman, Senate Committee on Banking, Housing and Urban Affairs

Dear Senator Shelby,

In response to your request in the Hearing of the Committee examining the Role of Credit Rating Agencies on February 8, I hereby submit information about current status and past records of R&I directors' concurrent board-membership with other institutions as follows;

1) Up to the present since the year 2000, any of the directors, officers or employees of Rating and Investment Information, Inc.("R&I") do not sit on any other corporate boards, government boards or agencies boards, except for one non-resident corporate auditor, who is a board member of Nihon Keizai Shimbun, Inc.("Nikkei"), publisher of business and financial daily, which is the largest shareholder of R&I by having 38.6% of R&I's stake. Nikkei is not rated by R&I as a matter of course. The code of conduct of R&I prohibits employees from working in other corporations or agencies.

2) Up to the 2000 since 1998, the President of R&I had been the Chairman of the board of Nikkei Business Publication, Inc., one of the equity holders of R&I, and in 1999, a non-resident board member of R&I had been a board member of Nikkei. Both Nikkei Business Publication and Nikkei were not rated by R&I.

3) Since the establishment in 1985 of Nippon Investors Service, Inc.("NIS"), which was one of R&I's predecessors up to the date of merger with Japan Bond Research Institute , Inc. ("JBRI") in 1998, three non-resident directors out of eight directors of the board and two non-resident corporate auditors out of three NIS's auditors had been sitting on the other corporate boards, which were rated by NIS.

株式会社 格付投資情報センター

R&I

Rating and Investment Information, Inc.

〒103-0027 東京都中央区日本橋1丁目4番1号 日本橋一丁目ビルディング19階
TEL. 03-3276-3400 FAX. 03-3276-3410 http://www.r-i.co.jp

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The Honorable Richard Shelby
March 1, 2005
Page 2

4) From 1978 to 1998, JBRI, the other predecessor of R&I, had not any directors of the board who had been sitting on other corporate boards.

On behalf of Rating and Investment Information, Inc., I hereby certify that all the facts I mentioned above are truth.

If you have any queries or require further information, please feel free to let me know.

Thank you very much for your interest in our operations.

Sincerely yours,

Y. Harada

Yasuhiro Harada
Executive Vice President

YH/ek

Moody's Investors Service

99 Church Street
New York, New York 10007

Raymond W. McDaniel
President
Tel: 212.553.4765
Fax: 212.553.3740
Email: raymond.mcdaniel@moodys.com

February 22, 2005

Hon. Richard Shelby, Chairman
U.S. Senate Committee on Banking, Housing and Urban Affairs
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman,

First, let me extend Moody's Investors Service's (**"Moody's"**) appreciation for the opportunity to participate in the hearing held by your Committee on Banking, Housing and Urban Affairs February 8, 2005 on the role and conduct of rating agencies (the "**Hearing**"). During that Hearing, questions regarding Moody's conduct vis-à-vis Hannover Reinsurance ("**Hannover**"), a German insurance company, were raised and discussed. Pursuant to your request at the Hearing, please find attached a summary of our investigation and findings with respect to the interaction between Hannover and Moody's referred to in the November 22, 2004 *Washington Post* article, "Gatekeepers: The Unchecked Power of Credit Raters" (the "**Post Article**").

During the week of November 22nd, the *Washington Post* published a series of articles regarding the credit rating agencies which raised a number of questions of varying gravity. The events reported in the Post Article involving Hannover caused concern to Moody's management. If reported correctly, some of the incidents and behaviors would have been a violation of Moody's ethical and procedural standards. Immediately following publication of the allegations, I directed our Legal and Ratings Compliance Departments to conduct an investigation including a review of the relevant documents and interviews with those individuals with knowledge of Moody's relationship with Hannover during the period in question.

Based on the facts that we were able to gather through our internal investigation, which included an interview with the former Hannover executive responsible for the rating relationship with Moody's at the time in question, we concluded that the observations in the Post Article that would have constituted conduct violations were incorrect, and that our procedural measures and ethical standards did not appear to have been violated. In fairness, because Moody's interactions with issuers are confidential, Moody's did not discuss its relationship with Hannover, or other individual companies, with the *Washington Post* reporter. This may have contributed to the inaccuracies in the Post Article.

Regardless, I appreciate the opportunity to provide you with the information to help correct the misperceptions that the Post Article may have created. Should you have any further questions, or concerns, please do not hesitate to contact me.

Sincerely,

Cc: Senator Sarbanes

## Discussion of Internal Investigation

### I. Questions Raised by the Post Article

The Post Article states that Moody's failed to separate appropriately its rating analysis of Hannover from its commercial relationship with the company, and manipulated Hannover's rating in order to pressure it to pay Moody's for its unsolicited rating.

The key issues raised by the Post Article were:

1. A statement that a letter concerning the unsolicited rating stated that "Moody's looked forward to the day when Hannover would be willing to pay".
2. The statement that a Moody's official told Hannover's Chief Financial Officer that if Hannover paid for a rating, "it could have a positive impact".
3. The implication that Moody's may have solicited payment from Hannover when it was under review for downgrade.
4. The implication that Hannover was repeatedly and unwarrantedly downgraded due to its unwillingness to pay for its insurance financial strength rating.

### III. Findings on Key Questions

Based on our interviews and a review of relevant documents, Moody's found:

- **In its initial letter to Hannover, Moody's did not say that it looked forward to the day when Hannover would be willing to pay.**

  The letter, which was sent by the Head of Moody's Germany on July 8, 1998, stated that, due to requests by market participants, Moody's was initiating rating coverage based on publicly available information. The letter invited the company's participation in the rating process and explained that *Moody's did not expect, nor would it accept, any compensation for this rating* (emphasis added). This clearly stated protocol regarding payment for the rating contradicts the notion that Moody's informed Hannover that the company would only be permitted to participate in the rating assignment if it paid for the rating. The letter sent to Hannover also stated that Moody's hoped to get back to the company and the market with its financial strength rating in the next six to eight weeks and expressed Moody's hope for a positive relationship with Hannover in the future.

- **Our investigation concluded that a Moody's employee did not tell Hannover that, if it paid Moody's, it would have a positive impact on Hannover's rating, nor that Moody's required payment before allowing Hannover participation in the rating process.**

  Not only would a statement amounting to a promise of a positive rating in exchange for a fee be in direct contravention of Moody's well-established practices, such a scenario also does not comport with the events outlined in the Post Article. According to the Post Article, the letter sent to Hannover indicated that Moody's rating would be assigned without charge and invited Hannover's participation. Thus, Moody's believes that it is more likely that a Moody's employee told Hannover that its *participation* in the initial rating process (rather than payment) could have a positive impact on the rating outcome because it could help provide information in areas where conservative assumptions might otherwise be appropriate. As noted above, the initial letter to Hannover specifically prohibited payment for the rating, contradicting the assertion that Moody's informed Hannover that the company would only be permitted to participate in the rating assignment if it paid for the rating. In the conversations with the company, Moody's communicated that should it participate in the rating process, Moody's might achieve a more informed analysis, which could have either a positive or a negative impact on the final rating.

- **Moody's did not solicit payment from Hannover when that company was under review for a downgrade.**

  The Post Article correctly reported that while Hannover was on review for possible downgrade, Hannover's chairman "bumped into a Moody's official" at a conference and arranged a meeting for the next day. According to Moody's Insurance Managing Director for Europe ("**Insurance MD**"), at this meeting, which was attended by the Insurance MD and the analyst assigned to Hannover at the time, Hannover's chairman made a comment that he supposed Hannover "should sign up for a rating now." Moody's Insurance MD responded that it was not an appropriate time to discuss the issue for two reasons. First, the Insurance MD explained that analysts should not be involved in payment issues. Second, the Insurance MD explained that Moody's could not accept payment from Hannover while Hannover was under a ratings review.

- **Moody's did not downgrade Hannover because they would not pay.**

  Please find attached the complete history, including all press releases and research analyses, of Hannover's financial strength and subordinated debt ratings from Moody's. As is evident from the attached rating history, both ratings were downgraded over the period in question.

  Moody's rationale for lowering the rating during the period in question was mainly that, in the view of Moody's rating committee, Hannover's financial and operating profile became over-leveraged relative to similarly-rated peer companies in a business whose intrinsic volatility magnifies the risk of such leverage. As the company's leverage profile subsequently improved, so too has Moody's rating outlook (from negative, to stable, to positive, to review for possible upgrade over the past year-and-a-half). The complete rationale for our views is provided in more detail in our various research analyses and press releases on the company which we have provided along with this summary of events.

  Furthermore, in March 1999, Hannover issued $400 million of subordinated debt through a financing vehicle, Hannover Finance, Inc., and requested a rating from Moody's. Hannover had a paying relationship with Moody's through 2004. Hannover still does not pay for its financial strength rating but it has been paying for its subordinated debt rating since 1999 and participated in the rating process until August 2004.

## CONCLUSION

We do not believe that Moody's policies or ethical standards were violated.

We look forward to continuing to work with your Committee in the coming year.

**Moody's Investors Service**

*99 Church Street*
*New York, New York 10007*

*Raymond W. McDaniel*
*President*
*Tel: 212.553.4765*
*Fax: 212.553.3740*
*Email: raymond.mcdaniel@moodys.com*

February 17, 2005

The Honorable Jim Bunning
U.S. Senate
316 Hart Senate Office Building
Washington, DC 20510

Dear Senator Bunning:

As you requested at the recent hearing about the credit ratings industry conducted by the Committee on Banking, Housing and Urban Affairs, attached please find information that Moody's has compiled regarding affiliations of members of Moody's board of directors and employees with other corporate or governmental entities. We have researched the available historical information and, to the best of our ability, believe that we are presenting a comprehensive response to your inquiry.

Prior to October 2000, Moody's Investors Service was a wholly-owned subsidiary of the Dun and Bradstreet Corporation ("**D&B**") and did not have a separate, functioning board. In 2000, Moody's separated from D&B and became a subsidiary of the newly formed public company, Moody's Corporation. In order to comply with your request, we therefore compiled information prior to October 2000 for the D&B board, and subsequently for the Moody's Corporation board. As Moody's Corporation is a public company, the affiliations of our board members are made publicly available and disclosed through our website, our annual report and our filings with the Securities and Exchange Commission.

In addition to the transparency surrounding the affiliations of our directors, Moody's has measures in place designed to assure that our board members do not interact with our professional staff regarding ratings and do not involve themselves in any way in the rating process. For example, we do not permit:

- any member of the Moody's Corporation board, including John Rutherfurd, Moody's Chairman and Chief Executive Officer, or myself, to participate in any rating committee;

- any action by a board member that might be perceived as attempting to influence a rating decision; or
- any communication of information on a pending rating action to non-employee board members prior to the rating's publication via press release. In other words, external board members learn about ratings and rating changes at the same time as the general public.

In addition to the information you requested, I also enclose Moody's Code of Business Conduct. This document codifies and describes the various rules and procedures with which all Moody's Corporation employees must comply. You will note that on page 16, it specifically states:

> *"An employee or director serving as an officer or director of an outside company may be regarded as a representative of Moody's and might find his or her duties with that company to be in conflict with Moody's interests. Employees should accept such position only upon approval by their Department Head after consultation with Moody's Legal Department."*

Over the course of Moody's Corporation's history (i.e. since October 2000), it has been our policy to disallow employees, including officers, of Moody's Investors Service or Moody's Corporation from sitting on the boards of any entities rated by Moody's.

Let me conclude by apologizing if I misunderstood or was otherwise unresponsive to your original question on this matter. I would be pleased to discuss further any matters concerning the rating agencies with you at any time.

Sincerely,

Ray McDaniel

cc: The Honorable Richard C. Shelby
The Honorable Paul S. Sarbanes

# Schedule of Directors

# of

# THE DUN & BRADSTREET CORPORATION

**Years 1984 through 1999**

**NOTE:**
**Unless otherwise specified, titles refer to positions at The Dun & Bradstreet Corporation.**
**The list of directors for each year is based on the disclosure in that year's proxy statement and so may not include new mid-year directors in the year that they joined.**

**1984**

| | | | | |
|---|---|---|---|---|
| • | **John W. Brooks** | | • | **James R. Lesch** |
| | *Former Chairman of the Board & Chief Executive Officer*<br>*Celanese Corporation*<br>*(Petrochemicals, Fibers and Plastics)*<br>*Other Directorships: Celanese Corp.; ACF Industries, Inc.; Bankers Trust New York Corp.* | | | *Chairman & Chief Executive Officer*<br>*Hughes Tool Company*<br>*(Equipment & Services for the Oil & Gas Industry)*<br>*Other Directorships: Borg-Warner Corp.; Houston Industries Incorporated; Texas Commerce Bancshares, Inc.; Raymond International, Inc.* |
| | | | | |
| • | **Robert J. Lanigan** | | • | **Vernon R. Loucks, Jr.** |
| | *Chairman & Chief Executive Officer*<br>*Owen-Illinois, Inc.*<br>*(Glass Paper, Plastics and Office Packaging Products)*<br>*Other Directorships: Hershey Foods Corp.; Sonat, Inc.* | | | *President & Chief Executive Officer*<br>*Baxter Travenol Laboratories, Inc.*<br>*(Medical Care Products and Services)*<br>*Other Directorships: Baxter Travenol Laboratories, Inc.; Continental Illinois Corp.; Emerson Electric Co.; The Quaker Oats Company* |
| | | | | |
| • | **Henry B. Cross, Jr.** | | • | **John R. Meyer** |
| | *Senior Vice President*<br>*Janney Montgomery Scott Inc. (Securities)* | | | *Professor*<br>*Harvard University*<br>*Other Directorships: Union Pacific Corp.; Trustee: Mutual Life Insurance Company of New York; AMCA International, Ltd.* |
| | | | | |
| • | **William E. C. Dearden** | | • | **Robert E. Weissman** |
| | *Former Chairman of the Board Hershey Foods Corporation*<br>*(Chocolate Confectionery and Pasta Products and Food Services)*<br>*Other Directorships: Hershey Foods Corp.; Carpenter Technology Corp.; Sterling Drug, Inc.; AMP Incorporated* | | | *President & Chief Operating Officer* |
| | | | | |
| • | **Kingman Douglass** | | • | **James R. Peterson** |

| | | | | |
|---|---|---|---|---|
| | *President*<br>*Kingman Douglas, Inc.*<br>*(Corporate Counselor)*<br>*Other Directorships: W. W. Grainger, Inc.* | | | *Former President & Chief Executive Officer*<br>*The Parker Pen Company*<br>*(Writing Instruments and Temporary Help Services)*<br>*Other Directorships: The Parker Pen Company; Avon Products, Inc.; Waste Management, Inc.* |
| • | **Harrington Drake** | | • | **Hamilton B. Mitchell** |
| | *Chairman of the Finance Committee*<br>*Former Chairman & Chief Executive Officer of the Corporation*<br>*Other Directorships: Irving Bank Corp.* | | | *Chairman of the Nominating Committee*<br>*Former Chairman & Chief Executive Officer of the Corporation*<br>*Other Directorships: Union Pacific Corp.; North American Philips Corp.* |
| • | **Robert A. Hanson** | | • | **Charles W. Moritz** |
| | *Chairman & Chief Executive Officer*<br>*Deere & Company*<br>*(Farm and Industrial Equipment)*<br>*Other Directorships: Continental Illinois Corp.; Proctor & Gamble Company* | | | *Chairman & Chief Executive Officer* |

## 1985

| | | | |
|---|---|---|---|
| • | **John W. Brooks**<br>*Former Chairman of the Board & Chief Executive Officer*<br>*Celanese Corporation*<br>*(Petrochemicals, Fibers and Plastics)*<br>*Other Directorships: Celanese Corp.; Bankers Trust New York Corp.* | • | **James R. Lesch**<br>*Chairman of the Board*<br>*Hughes Tool Company*<br>*(Equipment and Services for the Oil and Gas Industries)*<br>*Other Directorships: Borg-Warner Corp.; Houston Industries Incorporated; Texas Commerce Bancshares, Inc.* |
| • | **Henry Burk**<br>*Vice Chairman of the Corporation*<br>*Chairman*<br>*AC Nielsen Company* | • | **Vernon R. Loucks, Jr.**<br>*President & Chief Executive Officer*<br>*Baxter Travenol Laboratories, Inc.*<br>*(Medical Care Products and Services)*<br>*Other Directorships: Baxter Travenol Laboratories, Inc.; Emerson Electric Co.; The Quaker Oats Company* |
| • | **William E. C. Dearden**<br>*Former Chairman of the Board*<br>*Hershey Foods Corporation*<br>*(Chocolate Confectionery and Pasta Products and Food Services)*<br>*Other Directorships: Hershey Foods Corp.; Carpenter Technology Corp.; Sterling Drug, Inc.; AMP Incorporated* | • | **John R. Meyer**<br>*Professor*<br>*Harvard University*<br>*Other Directorships: Union Pacific Corp.; Trustee: Mutual Life Insurance Company of New York; AMCA International, Ltd.; Ryan Homes, Inc.* |
| • | **Kingman Douglass**<br>*President*<br>*Kingman Douglass, Inc.*<br>*(Corporate Counselor)*<br>*Other Directorships: W. W. Grainger, Inc.* | • | **Richard F. Schmidt**<br>*Executive Vice President-Finance & Planning* |
| • | **Harrington Drake**<br>*Chairman of the Finance Committee*<br>*Former Chairman & Chief Executive Officer of the Corporation*<br>*Other Directorships: Irving Bank Corp.; Rockwell International Corp.* | • | **James R. Peterson**<br>*Former President & Chief Executive Officer*<br>*The Parker Pen Company*<br>*(Writing Instruments and Temporary Help Services)*<br>*Other Directorships: Avon Products, Inc.; Waste Management, Inc.; Owens-Illinois, Inc.* |

**1985 (cont.)**

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|---|---|---|---|---|
| • | **Robert A. Hanson** | | • | **Hamilton B. Mitchell** |
| | *Chairman & Chief Executive Officer*<br>*Deere & Company*<br>*(Farm and Industrial Equipment)*<br>*Other Directorships: Proctor & Gamble Company; Merrill Lynch & Co., Inc.* | | | *Chairman of the Nominating Committee*<br>*Former Chairman & Chief Executive Officer of the Corporation*<br>*Other Directorships: Union Pacific Corp.; North American Philips Corp.* |
| • | **Volney Taylor** | | • | **Charles W. Moritz** |
| | *Executive Vice President* | | | *Chairman & Chief Executive Officer* |
| • | **Robert J. Lanigan** | | • | **Arthur C. Nielsen, Jr.** |
| | *Chairman & Chief Executive Officer*<br>*Owens-Illinois, Inc.*<br>*(Glass, Paper, Plastics and Other Packaging Products)*<br>*Other Directorships: Sonat, Inc.; Chrysler Corporation; Toledo Trustcorp., Inc.* | | | *Former Chairman & Chief Executive Officer*<br>*AC Nielsen Company*<br>*Other Directorships: General Binding Corp.; Hercules Incorporated; Marsh & McLennan Companies, Inc.; Motorola, Inc.; Walgreen Company; Wallace Computer Services, Inc.* |
| • | **Robert E. Weissman** | | | |
| | *President & Chief Operating Officer* | | | |

**1986**

| | | | |
|---|---|---|---|
| • | **John W. Brooks**<br>*Former Chairman of the Board & Chief Executive Officer*<br>*Celanese Corporation*<br>*(Petrochemicals, Fibers and Plastics)*<br>*Other Directorships: Celanese Corp.; Bankers Trust New York Corp.* | • | **James R. Lesch**<br>*Former Chairman of the Board & Chief Executive Officer*<br>*Hughes Tool Company*<br>*(Equipment and Services for the Oil and Gas Industries)*<br>*Other Directorships: Hughes Tool Co.; Borg-Warner Corp.; Houston Industries Incorporated; Houston Lighting & Power Co.; Texas Commerce Bancshares, Inc.; Texas Commerce Bank National Association* |
| • | **Henry Burk**<br>*Vice Chairman of the Corporation*<br>*Chairman*<br>*AC Nielsen Company* | • | **Vernon R. Loucks, Jr.**<br>*President & Chief Executive Officer*<br>*Baxter Travenol Laboratories, Inc.*<br>*(Medical Care Products and Services)*<br>*Other Directorships: Baxter Travenol Laboratories, Inc.; Emerson Electric Co.; The Quaker Oats Company* |
| • | **William E. C. Dearden**<br>*Former Chairman of the Board & Chief Executive Officer*<br>*Hershey Foods Corporation*<br>*(Chocolate Confectionery and Pasta Products and Food Services)*<br>*Other Directorships: Hershey Foods Corp.; Carpenter Technology Corp.; Sterling Drug, Inc.; AMP Incorporated; Super Valu Stores, Inc.* | • | **John R. Meyer**<br>*Professor*<br>*Harvard University*<br>*Other Directorships: Union Pacific Corp.; Union Pacific Railroad Company; Missouri Pacific Railroad Company; Trustee: Mutual Life Insurance Company of New York; AMCA International, Ltd.; Ryan Homes, Inc.* |
| • | **Kingman Douglass**<br>*Corporate Counselor*<br>*Other Directorships: W. W. Grainger, Inc.; Kingman Douglass, Inc.* | • | **Richard F. Schmidt**<br>*Executive Vice President-Finance & Planning* |

**1986 (cont.)**

| | | | | |
|---|---|---|---|---|
| • | **Harrington Drake**<br>*Chairman of the Finance Committee*<br>*Former Chairman & Chief Executive Officer of the Corporation*<br>*Other Directorships: Rockwell International Corp.; Baxter Travenol Laboratories, Inc.; Advisory Director-Irving Bank Corporation* | | • | **James R. Peterson**<br>*Former President & Chief Executive Officer*<br>*The Parker Pen Company*<br>*(Writing Instruments and Temporary Help Services)*<br>*Other Directorships: Waste Management, Inc.; Owens-Illinois, Inc.* |
| • | **Robert A. Hanson**<br>*Chairman & Chief Executive Officer*<br>*Deere & Company*<br>*(Farm and Industrial Equipment)*<br>*Other Directorships: Proctor & Gamble Company; Merrill Lynch & Co., Inc.* | | • | **Hamilton B. Mitchell**<br>*Chairman of the Nominating Committee*<br>*Former Chairman & Chief Executive Officer of the Corporation*<br>*Other Directorships: Union Pacific Corp.; North American Philips Corp.; Union Pacific Railroad Company; Missouri Pacific Railroad Company* |
| • | **John C. Holt**<br>*Executive Vice President*<br>*Other Directorships: Primark Corp.* | | • | **Charles W. Moritz**<br>*Chairman & Chief Executive Officer* |
| • | **Robert J. Lanigan**<br>*Chairman & Chief Executive Officer*<br>*Owens-Illinois, Inc.*<br>*(Glass, Paper, Plastics and Other Packaging Products)*<br>*Other Directorships: Sonat, Inc.; Chrysler Corporation; Toledo Trustcorp., Inc.* | | • | **Arthur C. Nielsen, Jr.**<br>*Former Chairman & Chief Executive Officer*<br>*AC Nielsen Company*<br>*Other Directorships: General Binding Corp.; Hercules Incorporated; Marsh & McLennan Companies, Inc.; Motorola, Inc.; Walgreen Company; Wallace Computer Services, Inc.* |
| • | **Robert E. Weissman**<br>*President & Chief Operating Officer* | | • | **Volney Taylor**<br>*Executive Vice President* |

**1987**

| | | | |
|---|---|---|---|
| • | **William E. C. Dearden**<br>*Former Chairman of the Board & Chief Executive Officer*<br>*Hershey Foods Corporation*<br>*(Chocolate Confectionery and Pasta Products and Food Services)*<br>*Other Directorships: Carpenter Technology Corp.; Sterling Drug, Inc.; AMP Incorporated; Super Valu Stores, Inc.* | • | **James R. Lesch**<br>*Former Chairman of the Board & Chief Executive Officer*<br>*Hughes Tool Company*<br>*(Equipment and Services for the Oil and Gas Industries)*<br>*Other Directorships: Hughes Tool Co.; Borg-Warner Corp.; Houston Industries Incorporated; Houston Lighting & Power Co.; Texas Commerce Bancshares, Inc.; Texas Commerce Bank National Association; Rowan Companies, Inc.* |
| • | **Kingman Douglass**<br>*Corporate Counselor*<br>*Other Directorships: W. W. Grainger, Inc.; Kewaunee Scientific Corp.* | • | **Vernon R. Loucks, Jr.**<br>*Chairman & Chief Executive Officer*<br>*Baxter Travenol Laboratories, Inc.*<br>*(Medical Care Products and Services)*<br>*Other Directorships: Emerson Electric Co.; The Quaker Oats Company* |
| • | **Harrington Drake**<br>*Chairman of the Finance Committee*<br>*Former Chairman & Chief Executive Officer of the Corporation*<br>*Other Directorships: Rockwell International Corp.; Baxter Travenol Laboratories, Inc.; Advisory Director-Irving Bank Corporation* | • | **John R. Meyer**<br>*Professor*<br>*Harvard University*<br>*Other Directorships: Union Pacific Corp.; Union Pacific Railroad Company; Missouri Pacific Railroad Company; AMCA International, Ltd.* |
| • | **Robert A. Hanson**<br>*Chairman & Chief Executive Officer*<br>*Deere & Company*<br>*(Farm and Industrial Equipment)*<br>*Other Directorships: Proctor & Gamble Company; Merrill Lynch & Co., Inc.* | • | **Richard F. Schmidt**<br>*Executive Vice President-Finance & Planning* |

**1987 (cont.)**

| | | | | |
|---|---|---|---|---|
| • | **John C. Holt**<br>*Executive Vice President*<br>*Other Directorships: Primark Corp.* | | • | **James R. Peterson**<br>*Former President & Chief Executive Officer*<br>*The Parker Pen Company*<br>*(Writing Instruments and Temporary Help Services)*<br>*Other Directorships: Waste Management, Inc.; Owens-Illinois, Inc.* |
| • | **Robert J. Lanigan**<br>*Chairman & Chief Executive Officer*<br>*Owens-Illinois, Inc.*<br>*(Glass, Paper, Plastics and Other Packaging Products)*<br>*Other Directorships: Sonat, Inc.; Chrysler Corporation; Trustcorp., Inc.* | | • | **Charles W. Moritz**<br>*Chairman & Chief Executive Officer* |
| • | **Robert E. Weissman**<br>*President & Chief Operating Officer* | | • | **Volney Taylor**<br>*Executive Vice President* |
| • | **Arthur C. Nielsen, Jr.**<br>*Former Chairman & Chief Executive Officer*<br>*AC Nielsen Company*<br>*Other Directorships: General Binding Corp.; Hercules Incorporated; Marsh & McLennan Companies, Inc.; Motorola, Inc.; Walgreen Company; Wallace Computer Services, Inc.* | | • | **John W. Brooks**<br>*Former Chairman of the Board & Chief Executive Officer*<br>*Celanese Corporation*<br>*(Petrochemicals, Fibers and Plastics)*<br>*Other Directorships: Celanese Corp.; Bankers Trust New York Corp.* |

**1988**

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|---|---|---|---|---|
| • | **William E. C. Dearden** | | • | **James R. Lesch** |
| | *Former Chairman of the Board & Chief Executive Officer*<br>*Hershey Foods Corporation*<br>*(Chocolate Confectionery and Pasta Products and Food Services)*<br>*Other Directorships: Carpenter Technology Corp.; AMP Incorporated; Super Valu Stores, Inc.* | | | *Former Chairman of the Board & Chief Executive Officer*<br>*Hughes Tool Company*<br>*(Equipment and Services for the Oil and Gas Industries)*<br>*Other Directorships: Houston Industries Incorporated; Houston Lighting & Power Co.; Advisory Director - Texas Commerce Bank National Association; Rowan Companies, Inc.* |
| | | | | |
| • | **Kingman Douglass** | | • | **Vernon R. Loucks, Jr.** |
| | *Corporate Counselor*<br>*Other Directorships: W. W. Grainger, Inc.; Kingman Douglass, Inc.* | | | *President & Chief Executive Officer*<br>*Baxter Travenol Laboratories, Inc.*<br>*(Medical Care Products and Services)*<br>*Other Directorships: Baxter Travenol Laboratories, Inc.; Emerson Electric Co.; The Quaker Oats Company* |
| | | | | |
| • | **Harrington Drake** | | • | **John R. Meyer** |
| | *Chairman of the Finance Committee*<br>*Former Chairman & Chief Executive Officer of the Corporation*<br>*Other Directorships: Rockwell International Corp.; Baxter Travenol Laboratories, Inc.* | | | *Professor*<br>*Harvard University*<br>*Other Directorships: Union Pacific Corp.; Union Pacific Railroad Company; Missouri Pacific Railroad Company* |
| | | | | |
| • | **John C. Holt** | | • | **Richard F. Schmidt** |
| | *Executive Vice President*<br>*Other Directorships: Primark Corp.* | | | *Executive Vice President-Finance & Planning* |
| | | | | |
| • | **Robert J. Lanigan** | | • | **James R. Peterson** |
| | *Chairman and Chief Executive Officer*<br>*Owens-Illinois, Inc.*<br>*(Glass, Paper, Plastics and Other Packaging Products)*<br>*Other Directorships: Sonat, Inc.; Chrysler Corporation; Trustcorp., Inc.* | | | *Former President & Chief Executive Officer*<br>*The Parker Pen Company*<br>*(Writing Instruments and Temporary Help Services)*<br>*Other Directorships: Waste Management, Inc.* |
| | | | | |
| • | **Robert E. Weissman** | | • | **Charles W. Moritz** |
| | *President & Chief Operating Officer* | | | *Chairman & Chief Executive Officer* |

**1988 (cont.)**

| | | | | |
|---|---|---|---|---|
| • | **Arthur C. Nielsen, Jr.**<br>*Former Chairman & Chief Executive Officer*<br>*AC Nielsen Company*<br>*Other Directorships: General Binding Corp.; Hercules Incorporated; Marsh & McLennan Companies, Inc.; Motorola, Inc.; Walgreen Company; Wallace Computer Services, Inc.* | | • | **Volney Taylor**<br>*Executive Vice President* |
| | | | | |
| • | **Robert A. Hanson**<br>*Chairman & Chief Executive Officer*<br>*Deere & Company*<br>*(Farm and Industrial Equipment)*<br>*Other Directorships: Proctor & Gamble Company; Merrill Lynch & Co., Inc.* | | | |

## 1989

| | | | |
|---|---|---|---|
| • | **William E. C. Dearden**<br>*Former Chairman of the Board & Chief Executive Officer*<br>*Hershey Foods Corporation*<br>*(Chocolate Confectionery and Pasta Products and Food Services)*<br>*Other Directorships: Carpenter Technology Corp.; AMP Incorporated; Super Valu Stores, Inc.* | • | **James R. Lesch**<br>*Former Chairman of the Board & Chief Executive Officer*<br>*Hughes Tool Company*<br>*(Equipment and Services for the Oil and Gas Industries)*<br>*Other Directorships: Houston Industries Incorporated; Houston Lighting & Power Co.; Advisory Director - Texas Commerce Bank National Association; Rowan Companies, Inc.* |
| • | **Kingman Douglass**<br>*Corporate Counselor*<br>*Other Directorships: W. W. Grainger, Inc.; Kewaunee Scientific Corp.* | • | **Volney Taylor**<br>*Executive Vice President* |
| • | **Harrington Drake**<br>*Chairman of the Finance Committee*<br>*Former Chairman & Chief Executive Officer of the Corporation*<br>*Other Directorships: Rockwell International Corp.; Baxter Travenol Laboratories, Inc.* | • | **John R. Meyer**<br>*Professor*<br>*Harvard University*<br>*Other Directorships: Union Pacific Corp.; Missouri Pacific Railroad Company; The Mutual Life Insurance Company* |
| • | **John C. Holt**<br>*Executive Vice President*<br>*Other Directorships: Primark Corp.* | • | **Richard F. Schmidt**<br>*Executive Vice President-Finance & Planning* |
| • | **Robert J. Lanigan**<br>*Chairman and Chief Executive Officer*<br>*Owens-Illinois, Inc.*<br>*(Glass, Paper, Plastics and Other Packaging Products)*<br>*Other Directorships: Sonat, Inc.; Chrysler Corporation; Trustcorp., Inc.* | • | **James R. Peterson**<br>*Former President & Chief Executive Officer*<br>*The Parker Pen Company*<br>*(Writing Instruments and Temporary Help Services)*<br>*Other Directorships: Waste Management, Inc.* |
| • | **Robert E. Weissman**<br>*President & Chief Operating Officer* | • | **Charles W. Moritz**<br>*Chairman & Chief Executive Officer*<br>*Other Directorships: Seamen's Corp.* |

**1989 (cont.)**

| | | | | |
|---|---|---|---|---|
| • | **Vernon R. Loucks, Jr.** | | | |
| | *President & Chief Executive Officer*<br>*Baxter Travenol Laboratories, Inc.*<br>*(Medical Care Products and Services)*<br>*Other Directorships: Baxter Travenol Laboratories, Inc.; Emerson Electric Co.; The Quaker Oats Company; Anheuser-Busch Companies, Inc.* | | | |

**1990**

| | | | |
|---|---|---|---|
| • | **William E. C. Dearden**<br>*Former Chairman of the Board & Chief Executive Officer*<br>*Hershey Foods Corporation*<br>*(Chocolate, Confectionery and Pasta Products and Food Services)*<br>*Other Directorships: Carpenter Technology Corp.; AMP Incorporated; Super Valu Stores, Inc.* | • | **Vernon R. Loucks, Jr.**<br>*Chairman & Chief Executive Officer*<br>*Baxter International Inc.*<br>*(Medical Care Products and Services)*<br>*Other Directorships: Emerson Electric Co.; The Quaker Oats Company* |
| • | **Kingman Douglass**<br>*Corporate Counselor*<br>*Other Directorships: W. W. Grainger, Inc.; Kewaunee Scientific Corp.* | • | **John R. Meyer**<br>*Professor*<br>*Harvard University*<br>*Other Directorships: Union Pacific Corp.; The Mutual Life Insurance Company* |
| • | **Robert E. Weissman**<br>*President & Chief Operating Officer*<br>*Other Directorships: State Street Boston Corp.* | • | **Charles W. Moritz**<br>*Chairman & Chief Executive Officer* |
| • | **James R. Lesch**<br>*Former Chairman of the Board & Chief Executive Officer*<br>*Hughes Tool Company*<br>*(Equipment and Services for the Oil and Gas Industry)*<br>*Other Directorships: Houston Industries Incorporated; Houston Lighting & Power Co.; Rowan Companies, Inc.* | • | **James R. Peterson**<br>*Former Chairman & Chief Executive Officer*<br>*The Parker Pen Company*<br>*(Writing Instruments and Temporary Help Services)*<br>*Other Directorships: Waste Management, Inc.* |
| • | **John C. Holt**<br>*Executive Vice President*<br>*Other Directorships: Primark Corp.* | • | **Michael R. Quinlan**<br>*Chairman & Chief Executive Officer*<br>*McDonald's Corporation*<br>*(Development, Operation, Franchising and Servicing of Quick Service Restaurants)* |
| • | **Robert J. Lanigan**<br>*Chairman of the Board*<br>*Owens-Illinois, Inc.*<br>*(Glass, Paper, Plastics and Other Packaging Products)*<br>*Other Directorships: Sonat, Inc.; Chrysler Corporation; Society Bank & Trust* | • | **Volney Taylor**<br>*Executive Vice President* |

**1991**

| | | | | |
|---|---|---|---|---|
| • | **William E. C. Dearden** | | • | **Vernon R. Loucks, Jr.** |
| | *Former Chairman of the Board & Chief Executive Officer*<br>*Hershey Foods Corporation*<br>*(Chocolate, Confectionery and Pasta Products and Food Services)*<br>*Other Directorships: Carpenter Technology Corp.; AMP Incorporated; Super Valu Stores, Inc.* | | | *Chairman & Chief Executive Officer*<br>*Baxter International Inc.*<br>*(Medical Care Products and Services)*<br>*Other Directorships: Emerson Electric Co.; The Quaker Oats Company; Anheuer-Busch Companies, Inc.* |
| • | **Kingman Douglass** | | • | **John R. Meyer** |
| | *Corporate Counselor*<br>*Other Directorships: W. W. Grainger, Inc.; Kewaunee Scientific Corp.* | | | *Professor*<br>*Harvard University*<br>*Other Directorships: Union Pacific Corp.; The Mutual Life Insurance Company* |
| • | **Mary Johnston Evans** | | • | **Charles W. Moritz** |
| | *Former Vice Chairman of the Board*<br>*Amtrak*<br>*(National Passenger Corporation)*<br>*Other Directorships: Baxter International Inc.; Delta Airlines, Inc.; Household International, Inc.; Sun Company, Inc.; Scudder AARP Funds; Scudder New Europe Fund* | | | *Chairman & Chief Executive Officer* |
| • | **Robert A. Hanson** | | • | **James R. Peterson** |
| | *Former Chairman & Chief Executive Officer*<br>*Deere & Company*<br>*(Farm and Industrial Equipment)*<br>*Other Directorships: The Procter & Gamble Co.; Merrill Lynch & Co., Inc.; R.R. Donnelley & Sons Co.; Texas Instruments Incorporated* | | | *Former Chairman & Chief Executive Officer*<br>*The Parker Pen Company*<br>*(Writing Instruments and Temporary Help Services)*<br>*Other Directorships: Waste Management, Inc.* |
| • | **Robert J. Lanigan** | | • | **Michael R. Quinlan** |
| | *Former Chairman of the Board*<br>*Owens-Illinois, Inc.*<br>*(Glass, Paper, Plastics and Other Packaging Products)*<br>*Other Directorships: Owens-Illinois, Inc.; Sonat, Inc.; Chrysler Corporation* | | | *Chairman & Chief Executive Officer*<br>*McDonald's Corporation*<br>*(Development, Operation, Franchising and Servicing of Quick Service Restaurants)* |

**1991 (cont.)**

| | | | | |
|---|---|---|---|---|
| • | **John C. Holt** | | • | **Volney Taylor** |
| | *Executive Vice President*<br>*Other Directorships: Primark Corp.* | | | *Executive Vice President* |
| | | | | |
| • | **James R. Lesch** | | • | **Robert E. Weissman** |
| | *Former Chairman of the Board & Chief Executive Officer*<br>*Hughes Tool Company*<br>*(Equipment and Services for the Oil and Gas Industry)*<br>*Other Directorships: Houston Industries Incorporated; Houston Lighting & Power Co.; Rowan Companies, Inc.* | | | *President & Chief Operating Officer*<br>*Other Directorships: State Street Boston Corp.* |

**1992**

| | | | | |
|---|---|---|---|---|
| • | **William E. C. Dearden**<br>*Former Chairman of the Board & Chief Executive Officer*<br>*Hershey Foods Corporation*<br>*(Chocolate, Confectionery and Pasta Products and Food Services)*<br>*Other Directorships: Carpenter Technology Corp.; AMP Incorporated; Super Value Stores, Inc.* | | • | **Vernon R. Loucks, Jr.**<br>*Chairman & Chief Executive Officer*<br>*Baxter International Inc.*<br>*(Medical Care Products and Services)*<br>*Other Directorships: Emerson Electric Co.; The Quaker Oats Company; Anheuser-Busch Companies, Inc.* |
| • | **Kingman Douglass**<br>*Corporate Counselor*<br>*Other Directorships: W. W. Grainger, Inc.; Kewaunee Scientific Corp.* | | • | **John R. Meyer**<br>*Professor*<br>*Harvard University*<br>*Other Directorships: Union Pacific Corp.; Missouri Pacific Railroad Company; The Mutual Life Insurance Company* |
| • | **Mary Johnston Evans**<br>*Former Vice Chairman of the Board*<br>*Amtrak*<br>*(National Passenger Corporation)*<br>*Other Directorships: Baxter International Inc.; Delta Airlines, Inc.; Household International, Inc.; Sun Company, Inc.; Scudder AARP Funds; Scudder New Europe Fund* | | • | **Charles W. Moritz**<br>*Chairman & Chief Executive Officer* |
| • | **Robert A. Hanson**<br>*Former Chairman & Chief Executive Officer*<br>*Deere & Company*<br>*(Farm and Industrial Equipment)*<br>*Other Directorships: The Procter & Gamble Co.; Merrill Lynch & Co., Inc.; R.R. Donnelley & Sons Co.; Texas Instruments Incorporated* | | • | **James R. Peterson**<br>*Former Chairman & Chief Executive Officer*<br>*The Parker Pen Company*<br>*(Writing Instruments and Temporary Help Services)*<br>*Other Directorships: Waste Management, Inc.* |

**1992 (cont.)**

| | | | | |
|---|---|---|---|---|
| • | **Robert J. Lanigan**<br>*Chairman Emeritus*<br>*Former Chairman & Chief Executive Officer*<br>*Owens-Illinois, Inc.*<br>*(Glass, Paper, Plastics and Other Packaging Products)*<br>*Other Directorships: Owens-Illinois, Inc.; Sonat, Inc.; Chrysler Corporation* | | • | **Michael R. Quinlan**<br>*Chairman & Chief Executive Officer*<br>*McDonald's Corporation*<br>*(Development, Operation, Franchising and Servicing of Quick Service Restaurants)* |
| • | **John C. Holt**<br>*Executive Vice President*<br>*Other Directorships: Primark Corp.* | | • | **Volney Taylor**<br>*Executive Vice President* |
| • | **Hall Adams, Jr.**<br>*Former Chairman & Chief Executive Officer*<br>*Leo Burnet Company, Inc.*<br>*(Advertising Agency)* | | • | **Robert E. Weissman**<br>*President & Chief Operating Officer*<br>*Other Directorships: State Street Boston Corp.* |

**1993**

| | | | |
|---|---|---|---|
| • | **Hall Adams, Jr.**<br>*Former Chairman & Chief Executive Officer*<br>*Leo Burnet Company, Inc.*<br>*(Advertising Agency)*<br>*Other Directorships: McDonald's Corp.* | • | **Vernon R. Loucks, Jr.**<br>*Chairman & Chief Executive Officer*<br>*Baxter International Inc.*<br>*(Medical Care Products and Services)*<br>*Other Directorships: Emerson Electric Co.; The Quaker Oats Company; Anheuser-Busch Companies, Inc.* |
| • | **Kingman Douglass**<br>*Corporate Counselor*<br>*Other Directorships: W. W. Grainger, Inc.; Kewaunee Scientific Corp.* | • | **John R. Meyer**<br>*Professor*<br>*Harvard University*<br>*Other Directorships: Union Pacific Corp.; Missouri Pacific Railroad Company; The Mutual Life Insurance Company* |
| • | **Mary Johnston Evans**<br>*Former Vice Chairman of the Board*<br>*Amtrak*<br>*(National Passenger Corporation)*<br>*Other Directorships: Baxter International Inc.; Delta Airlines, Inc.; Household International, Inc.; Sun Company, Inc.; Scudder AARP Funds; Scudder New Europe Fund* | • | **Charles W. Moritz**<br>*Chairman* |
| • | **Robert A. Hanson**<br>*Former Chairman & Chief Executive Officer*<br>*Deere & Company*<br>*(Farm and Industrial Equipment)*<br>*Other Directorships: The Procter & Gamble Co.; Merrill Lynch & Co., Inc.; R.R. Donnelley & Sons Co.; Texas Instruments Incorporated* | • | **James R. Peterson**<br>*Former Chairman & Chief Executive Officer*<br>*The Parker Pen Company*<br>*(Writing Instruments and Temporary Help Services)*<br>*Other Directorships: Waste Management, Inc.* |

**1993 (cont.)**

| | | | | |
|---|---|---|---|---|
| • | **Robert J. Lanigan** | | • | **Michael R. Quinlan** |
| | *Chairman Emeritus*<br>*Former Chairman & Chief Executive Officer*<br>*Owens-Illinois, Inc.*<br>*(Glass, Paper, Plastics and Other Packaging Products)*<br>*Other Directorships: Owens-Illinois, Inc.; Sonat, Inc.; Chrysler Corporation* | | | *Chairman & Chief Executive Officer*<br>*McDonald's Corporation*<br>*(Development, Operation, Franchising and Servicing of Quick Service Restaurants)* |
| • | **Clifford L. Alexander, Jr.** | | • | **Volney Taylor** |
| | *President*<br>*Alexander & Associates, Inc.*<br>*(Consulting Firm Specializing in Work-Force Inclusiveness)*<br>*Other Directorships: MCI Communications Corp.; Dreyfus Third Century Fund; Dreyfus General Family of Funds; Dreyfus Premier Family of Funds; Equitable Resources, Inc.; Mutual of America Life Insurance Co.* | | | *Executive Vice President* |
| | | | | |
| • | **Robert E. Weissman** | | | |
| | *President & Chief Operating Officer*<br>*Other Directorships: State Street Boston Corp.* | | | |

## 1994

| | | | | |
|---|---|---|---|---|
| • | **Hall Adams, Jr.** | | • | **Vernon R. Loucks, Jr.** |
| | *Former Chairman & Chief Executive Officer*<br>*Leo Burnet Company, Inc.*<br>*(Advertising Agency)*<br>*Other Directorships: McDonald's Corp.; Sears Roebuck & Co.* | | | *Chairman & Chief Executive Officer*<br>*Baxter International Inc.*<br>*(Medical Care Products and Services)*<br>*Other Directorships: Emerson Electric Co.; The Quaker Oats Co.; Anheuser-Busch Companies, Inc.* |
| • | **Mary Johnston Evans** | | • | **John R. Meyer** |
| | *Former Vice Chairman of the Board*<br>*Amtrak*<br>*(National Passenger Corporation)*<br>*Other Directorships: Baxter International, Inc.; Delta Air Lines, Inc.; Household International, Inc.; Sun Company, Inc.; Scudder AARP Funds; Scudder New Europe Fund* | | | *Professor*<br>*Harvard University*<br>*Other Directorships: Union Pacific Corp.; Missouri Pacific Railroad Company; The Mutual Life Insurance Company of New York* |
| • | **Robert A. Hanson** | | • | **Charles W. Moritz** |
| | *Former Chairman & Chief Executive Officer*<br>*Deere & Company*<br>*(Farm and Industrial Equipment)*<br>*Other Directorships: The Procter & Gamble Co.; Merrill Lynch & Co., Inc.; R.R. Donnelley & Sons Co.* | | | *Chairman* |
| • | **Robert J. Lanigan** | | • | **James R. Peterson** |
| | *Chairman Emeritus*<br>*Former Chairman & Chief Executive Officer*<br>*Owens-Illinois, Inc.*<br>*(Glass, Paper, Plastics and Other Packaging Products)*<br>*Other Directorships: Owens-Illinois, Inc.; Sonat, Inc.; Sonat Offshore Drilling Inc.; Chrysler Corporation* | | | *Former Chairman & Chief Executive Officer*<br>*The Parker Pen Company*<br>*(Writing Instruments and Temporary Help Services)*<br>*Other Directorships: WMX Technologies, Inc.* |

**1994 (cont.)**

| | | | | |
|---|---|---|---|---|
| • | **Clifford L. Alexander, Jr.** | | • | **Michael R. Quinlan** |
| | *President*<br>*Alexander & Associates, Inc.*<br>*(Consulting Firm Specializing in Work-Force Inclusiveness)*<br>*Other Directorships: MCI Communications Corp.; Dreyfus Third Century Fund; Dreyfus General Family of Funds; Dreyfus Premier Family of Funds; Equitable Resources, Inc.; Mutual of America Life Insurance Co.; American Home Products Corp.* | | | *Chairman & Chief Executive Officer*<br>*McDonald's Corporation*<br>*(Development, Operation, Franchising and Servicing of Quick Service Restaurants)*<br>*Other Directorships: The May Department Stores Co.* |
| • | **Robert E. Weissman** | | • | **Volney Taylor** |
| | *President & Chief Operating Officer*<br>*Other Directorships: State Street Boston Corporation* | | | *Executive Vice President* |

**1995**

| | | | | |
|---|---|---|---|---|
| • | **Hall Adams, Jr.**<br>*Former Chairman & Chief Executive Officer*<br>*Leo Burnet Company, Inc.*<br>*(Advertising Agency)*<br>*Other Directorships: McDonald's Corp.; Sears Roebuck & Co.* | | • | **Vernon R. Loucks, Jr.**<br>*Chairman & Chief Executive Officer*<br>*Baxter International Inc.*<br>*(Medical Care Products and Services)*<br>*Other Directorships: Emerson Electric Co.; The Quaker Oats Co.; Anheuser-Busch Companies, Inc.* |
| • | **Mary Johnston Evans**<br>*Former Vice Chairman of the Board*<br>*Amtrak*<br>*(National Passenger Corporation)*<br>*Other Directorships: Baxter International, Inc.; Delta Air Lines, Inc.; Household International, Inc.; Sun Company, Inc.; Scudder AARP Funds; Scudder New Europe Fund* | | • | **John R. Meyer**<br>*Professor*<br>*Harvard University*<br>*Other Directorships: Union Pacific Corp.; Missouri Pacific Railroad Company; The Mutual Life Insurance Company of New York* |
| • | **Robert J. Lanigan**<br>*Chairman Emeritus*<br>*Former Chairman & Chief Executive Officer*<br>*Owens-Illinois, Inc.*<br>*(Glass, Paper, Plastics and Other Packaging Products)*<br>*Other Directorships: Owens-Illinois, Inc.; Sonat, Inc.; Sonat Offshore Drilling Inc.; Chrysler Corporation; The Coleman Company Inc.* | | • | **Volney Taylor**<br>*Executive Vice President* |
| • | **Clifford L. Alexander, Jr.**<br>*President*<br>*Alexander & Associates, Inc.*<br>*(Consulting Firm Specializing in Work-Force Inclusiveness)*<br>*Other Directorships: MCI Communications Corp.; Dreyfus Third Century Fund; Dreyfus General Family of Funds; Dreyfus Premier Family of Funds; Equitable Resources, Inc.; Mutual of America Life Insurance Co.; American Home Products Corp.* | | • | **James R. Peterson**<br>*Former Chairman & Chief Executive Officer*<br>*The Parker Pen Company*<br>*(Writing Instruments and Temporary Help Services)*<br>*Other Directorships: WMX Technologies, Inc.* |

**1995 (cont.)**

| | | | | |
|---|---|---|---|---|
| • | **Robert E. Weissman** | | • | **Michael R. Quinlan** |
| | *President & Chief Operating Officer*<br>*Other Directorships: State Street Boston Corporation* | | | *Chairman & Chief Executive Officer*<br>*McDonald's Corporation*<br>*(Development, Operation, Franchising and Servicing of Quick Service Restaurants)*<br>*Other Directorships: The May Department Stores Co.* |

**1996**

| | | | | |
|---|---|---|---|---|
| • | **Hall Adams, Jr.**<br>*Former Chairman & Chief Executive Officer*<br>*Leo Burnet Company, Inc.*<br>*(Advertising Agency)*<br>*Other Directorships: McDonald's Corp.; Sears Roebuck & Co.* | | • | **Vernon R. Loucks, Jr.**<br>*Chairman and Chief Executive Officer*<br>*Baxter International Inc.*<br>*(Medical Care Products and Services)*<br>*Other Directorships: Emerson Electric Co.; The Quaker Oats Co.; Anheuser-Busch Companies, Inc.* |
| • | **Mary Johnston Evans**<br>*Former Vice Chairman of the Board*<br>*Amtrak*<br>*(National Passenger Corporation)*<br>*Other Directorships: Baxter International, Inc.; Delta Air Lines, Inc.; Household International, Inc.; Sun Company, Inc.; Scudder AARP Funds; Scudder New Europe Fund* | | • | **John R. Meyer**<br>*Professor*<br>*Harvard University*<br>*Other Directorships: Union Pacific Corp.; Missouri Pacific Railroad Company; The Mutual Life Insurance Company of New York* |
| • | **Robert J. Lanigan**<br>*Chairman Emeritus*<br>*Owens-Illinois, Inc.*<br>*(Glass, Paper, Plastics and Other Packaging Products)*<br>*Other Directorships: Owens-Illinois, Inc.; Sonat, Inc.; Sonat Offshore Drilling Inc.; Chrysler Corporation; The Coleman Company Inc.* | | • | **Robert E. Weissman**<br>*President & Chief Operating Officer*<br>*Other Directorships: State Street Boston Corporation* |
| • | **Clifford L. Alexander, Jr.**<br>*President*<br>*Alexander & Associates, Inc.*<br>*(Consulting Firm Specializing in Work-Force Inclusiveness)*<br>*Other Directorships: MCI Communications Corp.; Dreyfus Third Century Fund; Dreyfus General Family of Funds; Dreyfus Premier Family of Funds; Equitable Resources, Inc.; Mutual of America Life Insurance Co.; American Home Products Corp.* | | • | **James R. Peterson**<br>*Former Chairman & Chief Executive Officer*<br>*The Parker Pen Company*<br>*(Writing Instruments and Temporary Help Services)*<br>*Other Directorships: WMX Technologies, Inc.* |

**1996 (cont.)**

| | | | | |
|---|---|---|---|---|
| • | **Volney Taylor** | | • | **Michael R. Quinlan** |
| | *Chairman & Chief Executive Officer* | | | *Chairman & Chief Executive Officer*<br>*McDonald's Corporation*<br>*(Development, Operation, Franchising and Servicing of Quick Service Restaurants)*<br>*Other Directorships: The May Department Stores Co.* |
| | | | | |
| • | **M. Bernard Puckett** | | | |
| | *Former President & Chief Executive Officer*<br>*Mobile Telecommunication Technologies Corp.*<br>*(Telecommunications)*<br>*Other Directorships: P-Com, Inc.; R.R. Donnelley & Sons Company* | | | |

**1997**

| | | | | |
|---|---|---|---|---|
| • | **Hall Adams, Jr.**<br>*Former Chairman & Chief Executive Officer*<br>*Leo Burnet Company, Inc.*<br>*(Advertising Agency)*<br>*Other Directorships: McDonald's Corp.; Sears Roebuck & Co.* | | • | **Vernon R. Loucks, Jr.**<br>*Chairman & Chief Executive Officer*<br>*Baxter International Inc.*<br>*(Medical Care Products and Services)*<br>*Other Directorships: Emerson Electric Co.; The Quaker Oats Co.; Anheuser-Busch Companies, Inc.; Affymetrix, Inc.; Coastcast Corp.* |
| • | **Mary Johnston Evans**<br>*Former Vice Chairman of the Board*<br>*Amtrak*<br>*(National Passenger Corporation)*<br>*Other Directorships: Baxter International, Inc.; Delta Air Lines, Inc.; Household International, Inc.; Sun Company, Inc.; Scudder New Europe Fund* | | • | **John R. Meyer**<br>*Professor Emeritus*<br>*Harvard University*<br>*Other Directorships: Union Pacific Corp.; Missouri Pacific Railroad Company; The Mutual Life Insurance Company of New York; AC Nielsen Corp.* |
| • | **Robert J. Lanigan**<br>*Chairman Emeritus*<br>*Owens-Illinois, Inc.*<br>*(Glass, Paper, Plastics and Other Packaging Products)*<br>*Other Directorships: Owens-Illinois, Inc.; Sonat, Inc.; Transocean Offshore Inc.; Chrysler Corporation; The Coleman Company Inc.; Cognizant Corporation* | | • | **Ronald L. Kuehn, Jr.**<br>*Chairman, President & Chief Executive Officer*<br>*Sonat Inc.*<br>*(Natural Gas Transmission and Marketing Services, Oil and Gas Exploration and Production Activities)*<br>*Other Directorships: Union Carbide Corp.; AmSouth Bancorporation; Protective Life Corp.; Praxair, Inc.; Transocean Offshore Inc.* |
| • | **Volney Taylor**<br>*Chairman & Chief Executive Officer* | | • | **James R. Peterson**<br>*Former Chairman & Chief Executive Officer*<br>*The Parker Pen Company*<br>*(Writing Instruments and Temporary Help Services)*<br>*Other Directorships: WMX Technologies, Inc.; Cognizant Corporation* |

**1997 (cont.)**

| • | Clifford L. Alexander, Jr. | | • | Michael R. Quinlan |
|---|---|---|---|---|
| | *President*<br>*Alexander & Associates, Inc.*<br>*(Consulting Firm Specializing in Work-Force Inclusiveness)*<br>*Other Directorships: MCI Communications Corp.; Dreyfus Third Century Fund; Dreyfus General Family of Funds; Dreyfus Premier Family of Funds; Equitable Resources, Inc.; Mutual of America Life Insurance Co.; American Home Products Corp.; Cognizant Corporation; TLC Beatrice International Holdings, Inc.* | | | *Chairman & Chief Executive Officer*<br>*McDonald's Corporation*<br>*(Development, Operation, Franchising and Servicing of Quick Service Restaurants)*<br>*Other Directorships: The May Department Stores Co.* |

**1998**

| | | | | |
|---|---|---|---|---|
| • | **Ronald L. Kuehn, Jr.** | | • | **Mary Johnston Evans** |
| | *Chairman, President & Chief Executive Officer*<br>*Sonat Inc. (Natural Gas Transmission, Oil and Gas Exploration and Energy Services)*<br>*Other Directorships: Union Carbide Corp.; AmSouth Bancorporation; Protective Life Corp.; Praxair, Inc.; Transocean Offshore Inc.* | | | *Former Vice Chairman*<br>*Amtrak*<br>*(National Railroad Passenger Corporation)*<br>*Other Directorships: Baxter International, Inc.; Delta Air Lines, Inc.; Household International, Inc.; Sun Company, Inc.; Scudder New Europe Fund* |
| | | | | |
| • | **Clifford L. Alexander, Jr.** | | • | **Vernon R. Loucks Jr.** |
| | *President*<br>*Alexander & Associates, Inc. (Consulting Firm Specializing in Workforce Inclusiveness)*<br>*Other Directorships: MCI Communications Corp.; Dreyfus Third Century Fund; Dreyfus General Family of Funds; Dreyfus Premier Family of Funds; Equitable Resources, Inc.; Mutual of America Life Insurance Co.; American Home Products Corp.; Cognizant Corporation; TLC Beatrice International Holdings, Inc.* | | | *Chairman*<br>*Baxter International Inc. (Global Leader in Technologies Related to the Blood and Circulatory System)*<br>*Other Directorships: Emerson Electric Co.; The Quaker Oats Co.; Anheuser-Busch Companies, Inc.; Affymetrix, Inc.; Coastcast Corp.* |
| | | | | |
| • | **Ronald J. Lanigan** | | • | **Hall Adams, Jr.** |
| | *Chairman Emeritus*<br>*Former Chairman & Chief Executive Officer*<br>*Owens-Illinois, Inc. (Glass, Paper, Plastics and Other Packaging Products)*<br>*Other Directorships: Owens-Illinois, Inc.; Sonat, Inc.; Transocean Offshore Inc.; Chrysler Corporation; The Coleman Company Inc.; Cognizant Corporation* | | | *Former Chairman & Chief Executive Officer*<br>*Leo Burnett Company, Inc. (Advertising Agency)*<br>*Other Directorships: McDonald's Corp.; Sears Roebuck & Co.* |
| | | | | |
| • | **Michael R. Quinlan** | | • | **Henry A. McKinnell, Jr.** |
| | *Chairman*<br>*McDonald's Corporation (Global Food Service Retailer)*<br>*Other Directorships: The May Department Stores Co.* | | | *Executive Vice President*<br>*Pfizer Inc. (Research-based Global Pharmaceutical Company)*<br>*Other Directorships: Pfizer, Inc.; Aviall, Inc.; John Wiley & Sons* |

**1998 (cont.)**

| | | | | |
|---|---|---|---|---|
| • | **Volney Taylor** | | | |
| | *Chairman & Chief Executive Officer*<br>*The Dun & Bradstreet Corporation* | | | |

**1999**

| | | | |
|---|---|---|---|
| • | **Hall Adams, Jr.** | • | **Mary Johnston Evans** |
| | *Former Chairman & Chief Executive Officer*<br>*Leo Burnett Company, Inc. (Advertising Agency)*<br>*Other Directorships: McDonald's Corp.; Sears Roebuck & Co.* | | *Former Vice Chairman*<br>*Amtrak (National Railroad Passenger Corporation)*<br>*Other Directorships: Baxter International, Inc.; Delta Air Lines, Inc.; Household International, Inc.; Sunoco, Inc.* |
| | | | |
| • | **Clifford L. Alexander, Jr.** | • | **Robert R. Glauber** |
| | *Chairman & Chief Executive Officer*<br>*The Dun & Bradstreet Corporation*<br>*and*<br>*President*<br>*Alexander & Associates, Inc. (Consulting Firm Specializing in Workforce Inclusiveness)*<br>*Other Directorships: MCI WorldCom, Inc.; Dreyfus Third Century Fund; Dreyfus General Family of Funds; Dreyfus Premier Family of Funds; Mutual of America Life Insurance Co.; American Home Products Corp.; IMS Health Incorporated* | | *Adjunct Lecturer*<br>*John F. Kennedy School of Government*<br>*Harvard University*<br>*Other Directorships: XL Capital Ltd.; ten of the Dreyfus mutual funds* |
| | | | |
| • | **Victor A. Pelson** | • | **Ronald L. Kuehn, Jr.** |
| | *Senior Advisor*<br>*Warburg Dillon Read (Investment Banking Firm)*<br>*Former Chairman of Global Operations of AT&T*<br>*Other Directorships: former Director of Dillon Read* | | *Chairman of the Board*<br>*El Paso Energy Corporation (Integrated Energy Company)*<br>*Other Directorships: Union Carbide Corp.; AmSouth Bancorporation; Protective Life Corp.; Praxair, Inc.; Transocean Offshore Inc.* |
| | | | |
| • | **Michael R. Quinlan** | • | **Henry A. McKinnell, Jr.** |
| | *Director*<br>*McDonald's Corporation (Global Food Service Retailer)*<br>*Other Directorships: The May Department Stores Co.; Catalyst* | | *President & Chief Operating Officer*<br>*Pfizer Inc. (Research-based Global Pharmaceutical Company)*<br>*Other Directorships: Pfizer, Inc.; Aviall, Inc.; John Wiley & Sons* |

**1999 (cont.)**

| | | | | |
|---|---|---|---|---|
| • | **Volney Taylor** | | | |
| | *Chairman & Chief Executive Officer*<br>*The Dun & Bradstreet Corporation* | | | |

# Schedule of Directors

# of

# MOODY'S CORPORATION

Years 2000 through 2004

## 2000

| | |
|---|---|
| • **Hall Adams, Jr.**<br>*Former Chairman & Chief Executive Officer*<br>*Leo Burnett Company, Inc. (Advertising Agency)*<br>*Other Directorships: McDonald's Corp.; Sears Roebuck & Co.* | • **Mary Johnston Evans**<br>*Former Vice Chairman*<br>*Amtrak (National Railroad Passenger Corporation)*<br>*Other Directorships: Baxter International, Inc.; Delta Air Lines, Inc.; Household International, Inc.; Sunoco, Inc.* |
| • **Clifford L. Alexander, Jr.**<br>*Chairman*<br>*Moody's Corporation*<br>*and*<br>*President*<br>*Alexander & Associates, Inc. (Consulting Firm Specializing in Workforce Inclusiveness)*<br>*Other Directorships: MCI WorldCom, Inc.; Dreyfus Third Century Fund; Dreyfus General Family of Funds; Dreyfus Premier Family of Funds; Mutual of America Life Insurance Co.; American Home Products Corp.; IMS Health Incorporated* | • **Henry A. McKinnell, Jr.**<br>*President & Chief Executive Officer*<br>*Pfizer Inc. (Research-based Global Pharmaceutical Company)*<br>*Other Directorships: Aviall, Inc.; John Wiley & Sons* |
| • **Robert R. Glauber**<br>*Chief Executive Officer & President*<br>*National Association of Securities Dealers, Inc.*<br>*Chairman of Measurisk.com*<br>*Other Directorships: XL Capital Ltd.; ten of the Dreyfus mutual funds* | • **John Rutherfurd, Jr.**<br>*Chairman & Chief Executive Officer*<br>*Moody's Corporation* |

**2001**

| | | | |
|---|---|---|---|
| • | **Hall Adams, Jr.**<br>*Former Chairman & Chief Executive Officer*<br>*Leo Burnett Company, Inc. (Advertising Agency)*<br>*Other Directorships: McDonald's Corp.; Sears Roebuck & Co.* | • | **Mary Johnston Evans**<br>*Former Vice Chairman*<br>*Amtrak (National Railroad Passenger Corporation)*<br>*Other Directorships: Delta Air Lines, Inc.; Household International, Inc.; Sunoco, Inc.; Saint-Gobain Corp.* |
| • | **Clifford L. Alexander, Jr.**<br>*Chairman*<br>*Moody's Corporation*<br>*and*<br>*President*<br>*Alexander & Associates, Inc. (Consulting Firm Specializing in Workforce Inclusiveness)*<br>*Other Directorships: MCI WorldCom, Inc.; Dreyfus Third Century Fund; Dreyfus General Family of Funds; Dreyfus Premier Family of Funds; Mutual of America Life Insurance Co.; American Home Products Corp.; IMS Health Incorporated* | • | **Robert R. Glauber**<br>*Chairman and Chief Executive Officer*<br>*National Association of Securities Dealers, Inc.*<br>*Chairman of Measurisk.com*<br>*Other Directorships: XL Capital Ltd; the Federal Reserve Bank of Boston* |
| • | **John Rutherfurd, Jr.**<br>*Chairman & Chief Executive Officer*<br>*Moody's Corporation* | • | **Henry A. McKinnell, Jr.**<br>*Chairman & Chief Executive Officer*<br>*Pfizer Inc. (Research-based Global Pharmaceutical Company)*<br>*Other Directorships: John Wiley & Sons* |

**2002**

| | | | | |
|---|---|---|---|---|
| • | **Hall Adams, Jr.** | | • | **Mary Johnston Evans** |
| | *Former Chairman & Chief Executive Officer*<br>*Leo Burnett Company, Inc. (Advertising Agency)*<br>*Other Directorships: McDonald's Corp.; Sears Roebuck & Co.* | | | *Former Vice Chairman*<br>*Amtrak (National Railroad Passenger Corporation)*<br>*Other Directorships: Delta Air Lines, Inc.; Household International, Inc.; Sunoco, Inc.; Saint-Gobain Corp.* |
| | | | | |
| • | **Clifford L. Alexander, Jr.** | | • | **Robert R. Glauber** |
| | *Chairman*<br>*Moody's Corporation*<br>*and*<br>*President*<br>*Alexander & Associates, Inc. (Consulting Firm Specializing in Workforce Inclusiveness)*<br>*Other Directorships: Dreyfus Third Century Fund; Dreyfus General Family of Funds; Dreyfus Premier Family of Funds; Mutual of America Life Insurance Co.; American Home Products Corp.; IMS Health Incorporated* | | | *Chairman and Chief Executive Officer*<br>*National Association of Securities Dealers, Inc.*<br>*Chairman of Measurisk.com*<br>*Other Directorships: XL Capital Ltd.* |
| | | | | |
| • | **John Rutherfurd, Jr.** | | • | **Henry A. McKinnell, Jr.** |
| | *Chairman & Chief Executive Officer*<br>*Moody's Corporation*<br>*Other Directorships: NASD; ICRA Limited* | | | *Chairman & Chief Executive Officer*<br>*Pfizer Inc. (Research-based Global Pharmaceutical Company)*<br>*Other Directorships: John Wiley & Sons* |
| | | | | |
| • | **Senator Connie Mack** | | | |
| | *Senior Policy Advisor*<br>*Shaw Pittman LLP*<br>*Other Directorships: Darden Restaurants, EXACT Sciences Corporation; Genzyme Corporation; Mutual of America Life Insurance Company; the H. Lee Moffitt Cancer Center; LNR Property Corporation* | | | |

**2003**

| | | | | |
|---|---|---|---|---|
| • | **Hall Adams, Jr.** | | • | **Mary Johnston Evans** |
| | *Former Chairman & Chief Executive Officer*<br>*Leo Burnett Company, Inc. (Advertising Agency)*<br>*Other Directorships: McDonald's Corp.; Sears Roebuck & Co.* | | | *Former Vice Chairman*<br>*Amtrak (National Railroad Passenger Corporation)*<br>*Other Directorships: Saint-Gobain Corp.* |
| | | | | |
| • | **Clifford L. Alexander, Jr.** | | • | **Robert R. Glauber** |
| | *Chairman*<br>*Moody's Corporation*<br>*and*<br>*President*<br>*Alexander & Associates, Inc. (Consulting Firm Specializing in Workforce Inclusiveness)*<br>*Other Directorships: Dreyfus Third Century Fund; Dreyfus General Family of Funds; Dreyfus Premier Family of Funds; Mutual of America Life Insurance Co.; Wyeth* | | | *Chairman and Chief Executive Officer*<br>*National Association of Securities Dealers, Inc.*<br>*Chairman of Measurisk.com*<br>*Other Directorships: XL Capital Ltd.; American Stock Exchange; Measurisk.com* |
| | | | | |
| • | **John Rutherfurd, Jr.** | | • | **Henry A. McKinnell, Jr.** |
| | *Chairman & Chief Executive Officer*<br>*Moody's Corporation*<br>*Other Directorships: NASD; ICRA Limited* | | | *Chairman & Chief Executive Officer*<br>*Pfizer Inc. (Research-based Global Pharmaceutical Company)*<br>*Other Directorships: John Wiley & Sons; Exxon Mobil Corporation* |
| | | | | |
| • | **Senator Connie Mack** | | • | **Raymond W. McDaniel, Jr.** |
| | *Senior Policy Advisor*<br>*Shaw Pittman LLP*<br>*Other Directorships: Darden Restaurants, EXACT Sciences Corporation; Genzyme Corporation; Mutual of America Life Insurance Company; the H. Lee Moffitt Cancer Center; LNR Property Corporation* | | | *Executive Vice President*<br>*Moody's Corporation* |

## 2004

| | | | | |
|---|---|---|---|---|
| • | **John K. Wulff**<br>*Non-Executive Chairman*<br>*Hercules Incorporated*<br>*Other Directorships: Sunoco, Inc.; Fannie Mae* | | • | **Mary Johnston Evans**<br>*Former Vice Chairman*<br>*Amtrak (National Railroad Passenger Corporation)*<br>*Other Directorships: Saint-Gobain Corp.* |
| • | **Raymond W. McDaniel, Jr.**<br>*Chief Operating Officer*<br>*Moody's Corporation* | | • | **Robert R. Glauber**<br>*Chairman and Chief Executive Officer*<br>*National Association of Securities Dealers, Inc.*<br>*Other Directorships: XL Capital Ltd.; American Stock Exchange* |
| • | **John Rutherfurd, Jr.**<br>*Chairman & Chief Executive Officer*<br>*Moody's Corporation*<br>*Other Directorships: NASD; ICRA Limited* | | • | **Henry A. McKinnell, Jr.**<br>*Chairman & Chief Executive Officer*<br>*Pfizer Inc. (Research-based Global Pharmaceutical Company)*<br>*Other Directorships: Wiley & Sons; Exxon Mobil Corporation* |
| • | **Senator Connie Mack**<br>*Senior Policy Advisor*<br>*Shaw Pittman LLP*<br>*Other Directorships: Darden Restaurants, EXACT Sciences Corporation; Genzyme Corporation; Mutual of America Life Insurance Company; the H. Lee Moffitt Cancer Center; LNR Property Corporation* | | • | **Basil L. Anderson**<br>*Vice Chairman*<br>*Staples Inc.*<br>*Other Directorships: Hasbro, Inc.; Charles River Associates Inc.; Becton Dickenson* |
| • | **Ewald Kist**<br>*Retired Chairman*<br>*ING Groep N.V. (ING Group)*<br>*Other Directorships: DSM Corporation; Dutch National Bank; Royal Phillips Electronics* | | | |

FitchRatings

**Charles D. Brown**
General Counsel

One State Street Plaza
New York, NY 10004

T 212 908 0626 F 212 968 8839
E charles.brown@fitchratings.com
www.fitchratings.com

March 8, 2005

The Honorable Jim Bunning
United States Senate
Committee on Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Responses to Questions by Senator Bunning at *Examining the Role of Credit Rating Agencies in the Capital Markets*

Dear Senator Bunning:

As General Counsel to Fitch, Inc. ("Fitch"), I write this letter in response to the question for which you requested a written response from Fitch during the US Senate Committee on Banking, Housing and Urban Affairs hearing entitled "*Examining the Role of Credit Rating Agencies in the Capital Markets.*"

At the hearing, you asked us to identify any of Fitch's employees, officers or directors who served on any corporate boards, government boards or agencies or any self-regulatory organization, such as the New York Stock Exchange or the National Association of Securities Dealers, during the past twenty years.

We have based the information contained in our response on the corporate records of Fitch, its predecessor entities and Fitch's current parent company, Fimalac, a *société anonyme* organized and existing under the laws of the French Republic ("Fimalac"), and publicly available databases about board membership and corporate affiliations. Our response covers the period from 1989 to the present. Fitch does not have access to the corporate records of Fitch's predecessor entity for the period prior to 1989, the year in which a group including several members of its current management acquired and recapitalized Fitch. Fimalac subsequently acquired Fitch in 1997. Fimalac is a public company and its shares are listed on the *Premier Marché* of Euronext Paris SA.

None of Fitch's current employees and officers are on any corporate boards, other than those of companies related to Fitch, none of which we rate.

With respect to the current members of the Board of Directors of Fitch, two directors serve or have served on the board of other companies rated by Fitch: Marc Ladreit de Lacharrière, Chairman and Chief Executive Officer of Fimalac, who became the non-executive Chairman of the Board of Directors of Fitch in 1997, and Véronique Morali, Chief Operating Officer and director of Fimalac, who also became a member of Fitch's Board of Directors in 1997.

Mr. de Lacharrière has served as a director of the following French listed companies rated by Fitch: L'Oreal SA (director since 1984), France Télécom SA (1995-1998), Renault SA (director since 2002) and Casino Guichard-Perrachon SA (director since 1994). Mr. de Lacharrière is not involved in the ratings process and does not participate in any rating decisions. Beginning February 2005, all publications and press releases issued in connection with rating actions taken for L'Oreal, Renault and Casino Guichard-Perrachon will include disclosure that Mr. de Lacharrière's is a member of the board of those companies. During the time that Mr. de Lacharrière has been the Chairman of the Board of Fitch, he also has served on the boards of the following French listed companies not rated by Fitch: Euris SA (1991-2002), Groupe Andre SA (1991-1999), Rubis SCA (1995-1997), Air France SA (1996-1998), Compagnie d'Investissements de Paris SA (1987-1997), Canal + SA (1998-2003) and Groupe Flo SA (1998-2002).

Ms. Morali served on the board of Tesco PLC, a UK public company that Fitch rates, from 2004 until February 2005. Like Mr. de Lacharrière, Ms. Morali is not involved in the ratings process and does not participate in any rating decisions. Ms. Morali also serves on the board of the following French companies that Fitch does not rate: Eiffage SA (since 2002), Valéo SA (since 2003) and Club Méditerranée SA (since 2004).

As noted above, Fimalac is a French public company listed on the Paris Bourse and a number of members of its board are officers and/or directors of other public companies, some of which Fitch rates. None of the employees, officers or directors of Fimalac are involved in the rating process and do not participate in any rating decisions. We have attached hereto as Annex A the portion of the English version of Fimalac's 2003 Annual Report setting forth the corporate affiliations of the directors of Fimalac. The English version of Fimalac's 2004 Annual Report is not currently available.

With respect to Fitch's former employees, officers and directors, two employees joined the boards of companies rated by Fitch after deciding to leave the employ of Fitch. Steven Fetter, who was a Managing Director of Fitch's Global Power Group in the United States, became a director of CH Energy Group, Inc. in March 2002 after he decided to leave Fitch to pursue consulting opportunities. Mr. Fetter left Fitch on April 1, 2002. Fitch rates Central Hudson Gas & Electric Corp., one of CH Energy Group's subsidiaries. For the brief time before Mr. Fetter left Fitch, Mr. Fetter recused himself from all rating matters relating to Central Hudson Gas & Electric Corp., CH Energy Group, Inc., or any of its affiliates and members of the

Global Power Group were instructed not to discuss any matter relating to such entities with Mr. Fetter.

In April 2004, Hernan Cheyre, who was the Managing Director of Fitch's office in Chile until leaving Fitch on March 31, 2004, joined the Board of Directors of Telefonica CTC Chile, a company that Fitch rates. Although Fitch no longer employs Mr. Cheyre, through his company Econsult Ltda., he continues to act in a limited capacity as a consultant to Fitch providing business development support as well as a monthly presentation on Chilean macroeconomics to the Chilean banking association as part of a joint presentation with Fitch. Mr. Cheyre is no longer involved in the ratings process and does not participate in any rating decisions.

In addition, several employees are involved in a variety of local governments, government bodies, self-regulatory entities or advisory groups.

Michael Belsky, who is a Group Managing Director and heads Fitch's Public Finance Group, currently serves as the Mayor of Highland Park, Illinois. Mr. Belsky was elected as Mayor in April 2003 in a non-partisan election. Highland Park, Illinois, is a Council Manager Government. The Mayor's duties are to chair City Council meetings twice a month (where activities include, among other things, review of the budget) and to represent the City of Highland Park at charity events and other public functions. The office of Mayor is primarily a titular position, as the finances of the city are the responsibility of the City's Finance Director, who oversees Highland Park's debt issuances. Fitch does not rate Highland Park, Illinois and Fitch will not rate any bonds of Highland Park while Fitch employs Mr. Belsky. As Mayor, Mr. Belsky is also a member of the Board of Highland Park's Health Care Foundation (the "Foundation"), whose purpose is to support hospital and community healthcare endeavors. The Foundation gives part of its endowment to a local hospital owned by Evanston Nortwestern Healthcare, a company that Fitch does not and will not rate because of Mr. Belsky's involvement in the Foundation. Prior to his election as Mayor, Mr. Belsky served on Highland Park's City Council from 1995 to 2003 and served on Highland Park's Economic Development Commission from 1993 to 1995. Mr. Belsky joined Fitch in 1993.

William Dallman, currently a Director of Business Development in the Corporate Finance Group, serves as a Commissioner on the Glen Ellyn (Illinois) Park District Board of Commissioners, which is an elected position for a four-year term. He is currently in the middle of his second term. Fitch does not rate Glen Ellyn's municipal and general obligation bonds. Other than authorizing bond sales, the Board of Commissioners is not involved with the rating or bidding process.

Alain Mera, currently a Deputy Managing Director in Fitch's office in France, serves as an elected member of the Town Council in a small village (less than 250 inhabitants) in Normandy, France, which entails participation in approximately 5 meetings per year to discuss local matters. There is no contact with anyone at the regional level (which Fitch does not rate in any case). The position is purely voluntary, without any compensation.

Claire Cohen, former Vice Chairman of Fitch who is currently a consultant to the Public Finance Group, is a member of the Federal Accounting Standards Advisory Board ("FASAB"), which she joined in 2002. The Board, sponsored by the General Accounting Office, the Treasury and the Office of Management and Budget, meets every other month, and is responsible for promulgating accounting standards for the United States Government. The position pays a nominal sum annually.

Amy Doppelt, currently a Managing Director in the Public Finance Department, is a member of the Technical Advisory Committee ("TAC") to the California Debt and Investment Advisory Commission ("CDIAC"), which is chaired by California's State Treasurer. The TAC consists of private sector representatives that advise CDIAC on various matters relating to local government debt issuance.

Janet Rosen, currently a consultant to the Public Finance Group, serves on an unofficial task force that assists the Governmental Accounting Standards Board in developing accounting standards for derivatives.

Amit Tandon, currently the Managing Director of Fitch's India office, is a member of the Listing Committee of the Bombay Stock Exchange. The Listing Committee's primary function is to determine whether a security or entity is eligible for listing on the stock exchange. The Committee meets once every four to six weeks.

Rui Barros, currently an Analyst in the European Structured Finance Group in London, is a member of the Portuguese Investment Performance Committee ("PIPC"). PIPC deals with the implementation in Portugal of the Global Investment Performance Standards, which are ethical standards used by investment managers for creating performance presentations that ensure fair representation and full disclosure with the goal towards global standardization of investment performance reporting.

Jens Schmidt-Bürgel, currently a Senior Director in the Capital Markets Group in Frankfurt, Germany, is a member of the advisory board (Beirat) of the German True Sales Initiative.

Fernando Mayorga, currently a Managing Director of International Public Finance in Barcelona, Spain, is a voting member of the Consultative Group of the Public Sector Committee of the International Federation of Accountants.

Jeff Watzke, currently an Associate Director in the Commercial Mortgage Backed Group, is a community representative to the Building and Finance Committee of Illinois Consolidated High School District 230, Orland Park, Illinois. Although Fitch does rate a 1999 series of debt of the district, Fitch bases the credit rating of that debt on the financial strength rating of Ambac Assurance Corp, a financial guaranty insurance company, not the creditworthiness of the district. Mr. Watzke position on the committee is voluntary. Mr. Watzke was not involved in the rating of the district and will not participate in any future rating decision concerning the district.

We would also like to point out that Fitch, through one of its subsidiaries, is an equity owner in a local rating agency in Thailand, Fitch Ratings (Thailand) Limited ("Fitch Thailand"), which issues credit ratings for local debt in Thailand. Fitch owns 49.898% of Fitch Thailand. Fitch rates Tisco Finance Public Co Ltd., the 99.9% owner of Tisco Asset Management Co. Ltd., which is a 10% equity owner in Fitch Thailand. Fitch Thailand also rates Kasikornbank that holds approximately 71% in Kasikorn Asset Management, the latter of which holds 10% in Fitch Thailand. Disclosure of these relationships is made in all press releases and research reports published in connection with the rating of Tisco Finance Public Co Ltd. and Kasikornbank. Furthermore, no shareholder, other than a Fitch subsidiary, is involved in the day-to-day operations of, or credit rating reviews undertaken by, Fitch Thailand.

In addition, slightly more than 3% of Fitch's Polish subsidiary is owned by various corporations, approximately 0.24% of which is held by a Polish financial institution rated by Fitch.

Please let me know if we can provide you any further information.

Very truly yours,

Charles D. Brown

Charles D. Brown

cc: The Honorable Richard C. Shelby, Chairman
The Honorable Paul S. Sarbanes, Ranking Member
Mr. Bryan Corbett

Annex A

# Fimalac

ANNUAL REPORT
*2003*

Directors are elected for renewable four-year terms of office. Each director must hold at least five registered shares.

## Board of Directors

### ◆ Basis of the Company's General Management

Under article L.225-51-1 of the Commercial Code, the Company is managed either by the Chairman of the Board of Directors or by another individual appointed by the Board, who has the title of Chief Executive Officer (*Directeur Général*).

On June 4, 2002 the Board of Directors decided that Marc Ladreit de Lacharrière, the Chairman of the Board of Directors, would also act as Chief Executive Officer for the remainder of his term of office as director.

### ◆ Members of the Board of Directors

The Board of Directors has ten members:
Marc LADREIT de LACHARRIÈRE
*Chairman and Chief Executive Officer*
Véronique MORALI
*Chief Operating Officer*
Pascal CASTRES SAINT-MARTIN
Georges CHARPAK
David DAUTRESME
Arnaud LAGARDÈRE
Philippe LAGAYETTE
Bernard MIRAT
Bernard PIERRE
Fimalac Participations, represented by Pierre BLAYAU

The membership of the Board is structured to enable the Group to fully leverage both the experience and the independence of its directors.

Directors are elected for a four-year term.

In accordance with the recommendations of the Bouton report on corporate governance a director is deemed to be independent when he or she has no relationship of any kind with the company, its group or the management of either that is such as to color his or her judgment. Six of Fimalac's directors are independent in accordance with this definition: Pierre Blayau, Pascal Castres Saint-Martin, Georges Charpak, David Dautresme, Arnaud Lagardère, Philippe Lagayette.

The Company does not have any directors elected by employees.

Arnaud Lagardère and Philippe Lagayette, were appointed to the Board on May 23, 2003, subject to ratification by shareholders at the Annual General Meeting of June 8, 2004. During the meeting, shareholders will also be asked to re-elect as directors Fimalac Participations, Marc Ladreit de Lacharrière, Philippe Lagayette and Véronique Morali.

There are also six non-voting directors (*censeurs*) on Fimalac's Board, all of whom are independent directors with the exception of Michel Castres Saint-Martin:

René BARBIER de la SERRE
Michel CASTRES SAINT-MARTIN
Henri LACHMANN
Jean-Charles NAOURI
Etienne PFLIMLIN
Edouard de ROYÈRE

Non-voting directors are elected for a two-year term.

## ◆ Information about directors and non-voting directors

### Marc LADREIT de LACHARRIÈRE

**Chairman and Chief Executive Officer**
Born on November 6, 1940; age: 63.
First elected: June 14, 1990 (Director)
April 21, 1993 (Chairman)
Re-elected: June 7, 2000
Current term expires at the close of the 2004 Annual General Meeting

Number of shares held
at December 31, 2003: 721,587

***Biographical details***

After graduating from Ecole Nationale d'Administration, Marc Ladreit de Lacharrière began his career with Banque de Suez et de l'Union des Mines which merged with Banque de l'Indochine to form Indosuez. In 1976, when he held the position of Investment Banking Director, he left Indosuez to join L'Oréal as Chief Financial Officer, rising to the position of Vice-Chairman and Chief Executive Officer. In March 1991, he left L'Oréal to set up his own company, Fimalac.

***Directorships and executive positions held in 2003:***

**Chairman and Chief Executive Officer**
Fimalac
**Chairman of the Board of Directors**
Fitch Ratings (USA)
Fimalac Inc. (USA)
**Honorary Chairman**
Comité National des Conseillers du Commerce
Extérieur de la France
**Director**
L'Oréal
Casino
Renault
Cassina (Italy)
**Member of the Advisory Committee**
Banque de France
**Managing partner**
Groupe Marc de Lacharrière

**Manager**

Fimalac Participations

**Member of the Board of the following philanthropic organizations**

Conseil Artistique des Musées Nationaux

Fondation Bettencourt Schueller

Fondation Nationale des Sciences Politiques

Louvre Museum

## Véronique MORALI

**Chief Operating Officer and director**

Born on September 12, 1958; age: 45

First elected: April 24, 2001

Current term expires at the close of the 2004 Annual General Meeting

Number of shares held at December 31, 2003: 13,792

***Biographical details***

After graduating from Ecole Nationale de l'Administration, Véronique Morali joined the French civil service (Inspection Générale des Finances) in 1986. She left the civil service in 1990 to join Fimalac, where she has successively held the positions of Manager, Special Projects, Deputy Chief Operating Officer and, currently, Chief Operating Officer and member of the Board.

***Directorships and executive positions held in 2003:***

**Chairman and Chief Executive Officer**

Fimalac Investissements

**Director**

Cassina (Italy)

Core Ratings Ltd (UK)

Eiffage

Fimalac

Fitch Ratings (USA)

Fimalac Inc. (USA)

Fitch Risk Management

Minerais & Engrais

Tesco Plc (UK)

Valeo

**Permanent representative of Fimalac**

Facom

**Permanent representative of Fimalac Inc.**

Fitch France SA

**Sole director**

FCBS Gie

**Manager**

Pandour

Silmer

## Pascal CASTRES SAINT-MARTIN

**Director**

Director of Sanofi-Synthelabo

Born on April 12, 1936; age: 67

First elected: June 26, 1998

Re-elected: June 4, 2002

Current term expires at the close of the 2006 Annual General Meeting

Number of shares held at December 31, 2003: 74

***Biographical details***

Pascal Castres Saint-Martin is a graduate of the HEC business school.

Between 1962 and 1979, he held various management positions with Banque Générale Industrielle La Hénin (now renamed Banque Indosuez).

In 1979, he joined L'Oréal as Legal Director. He subsequently held the positions of Chief Financial Officer and General Counsel, Vice-President responsible for General Management and Administration, and deputy Chief Executive Officer. He retired in 1999.

***Directorships and executive positions held in 2003:***

**Chairman**

Le Portefeuille Diversifié

**Chairman of the Supervisory Board**

Groupe Marc de Lacharrière

**Director**

Fimalac

Sanofi Synthelabo

Seb

**Member of the Supervisory Board**

Arc International

Chairman of the Fimalac Selection, Nominations and Remunerations Committee

**Georges CHARPAK**

**Director**

Holder of the Nobel Prize for Physics

Born on August 1, 1924; age: 79

First elected: June 18, 1997

Re-elected: June 5, 2001

Current term expires at the close of the 2005 Annual General Meeting

Number of shares held at December 31, 2003: 25

***Biographical details***

Georges Charpak arrived in France in 1931 and studied at the Ecole des Mines de Paris.

He joined the CNRS and the Collège de France nuclear chemistry laboratory in 1947.

After completing his thesis in 1954, he began conducting research into particle physics, working at CERN in Geneva from 1959 to 1992. During this period, he won the Nobel Prize for Physics. He went on to study physics instruments used in biology and medicine, within a company he set up, named Biospace.

***Directorships and executive positions held in 2003:***

**Director**

Biospace Instruments

Biospace Mesure

Fimalac

Molecular Engines Laboraties (MEL)

**David DAUTRESME**

**Director**

Senior Advisor at Lazard Frères

Born on January 5, 1934; age: 70

First elected: June 4, 2003

Current term expires at the close of the 2007

Annual General Meeting

Number of shares held at December 31, 2003: 7,133

***Biographical details***

1958-1960: Officer in charge of Algerian Affairs

1960-1962: Ecole Nationale d'Administration

1962-1966: Auditor, then Advisor with the Cour des Comptes (National Audit Office)

1966-1967: Comptroller, Caisse des Dépôts et Consignations

1967-1968: Member of the staff of Michel Debré, Minister of the Economy and Finance

1968-1982: Under Director, deputy director, director, deputy Chief Executive Officer, Crédit Lyonnais

1982-1986: Chairman and Chief Executive Officer, Crédit du Nord

1986-2000: Managing Partner, Banque Lazard Frères et Cie

Since 2001: Senior Advisor at Lazard Frères and manager of DD Finance.

***Directorships and executive positions held in 2003:***

**Chairman**

Parande Développement (Euris Group)

**Director**

Axa Investment Managers

Fimalac

Rue Impériale

**Member of the Supervisory Board**

Axa

Casino

Club Méditerranée

**Non-voting director**

Lazard Frères Banque

Groupe Go Sport

**Manager**

DD Finance

Member of the Axa Audit Committee

Chairman of the Casino Audit Committee

Member of the Fimalac Audit Committee

**Arnaud LAGARDÈRE**

**Director**

Managing Partner of Lagardère SCA

Born on March 18, 1961; age: 43

First elected: May 23, 2003

Current term expires at the close of the 2007 Annual General Meeting

Number of shares held at December 31, 2003: 5

***Biographical details***

After graduating from Université Paris-Dauphine, Arnaud Lagardère began his career in 1987 working for his father, Jean-Luc Lagardère. He successively held the positions of Vice-Chairman of the Supervisory Board of Banque Arjil, Head of Emerging Businesses and Electronic Media at Matra and Chief Executive Officer of Lagardère SA. In 1994, he became Chairman and Chief Executive Officer of Grolier Inc. in the United States, where he lived with his family for four years. Since his return to France in 1998, he has focused on the Group's media division, which he has reorganized and strengthened.

***Directorships and executive positions held in 2003:***

**Chairman and Chief Executive Officer**

Hachette SA (Lagardère Media)

Lagardère Capital & Management

**Chairman**

Lagardère Active SAS

Lagardère Active Broadband SAS

Lagardère Images SAS

Lagardère SAS

**Deputy Chairman**

Lagardère Active Broadcast

**Chairman of the Board of Directors**

Eads Participations B.V.

European Aeronautic Defence & Space Company – Eads Nv

Lagardère Thématiques

**Vice-Chairman of the Supervisory Board**

Arjil & Compagnie SCA

**Vice-Chairman and Chief Operating Officer**

Arjil Commanditée – ARCO

**Chief Executive Officer**

Lagardère Thématiques

**Director**

Canal Satellite

Fimalac

France Telecom

Hachette Distribution Services

Hachette Livre

Hachette Filipacchi Medias

Lagardère Ressources SAS

Lagardère Sociétés

LVMH-Moët Henessy Louis Vuitton

Société d'agences et de Diffusion

**Member of the Supervisory Board**

T.Online International AG

Virgin Stores SA

**Permanent representative of Hachette SAS**

SEDI TV-TEVA (management board)

**Permanent representative of Lagardère Active Publicité**

Lagardère Active Radio International

**Manager**

Lagardère Élevage

Lagardère Active Publicité

Nouvelles Messageries de la Presse – N.M.P.P.

**Co-manager**

I.S.-9

**Member**

Fondation Hachette

Member of the Fimalac Selection, Nominations and Remunerations Committee

**Philippe LAGAYETTE**

**Director**

Director of JP Morgan & Cie SA

Born on June 16, 1943; age: 60

First elected: May 23, 2003

Current term expires at the close of the 2007 Annual General Meeting

Number of shares held at December 31, 2003: 5

***Biographical details***

Philippe Lagayette is a graduate of Ecole Polytechnique and Ecole Nationale d'Administration

1970: French civil service (Inspection Générale des Finances)

1974: Treasury department of the Ministry of the Economy and Finance

1980: Under Director in the Inspection Générale des Finances

1981: Director in the staff of the Minister of the Economy and Finance

1984: Deputy Governor of Banque de France

1992-1997: Chief Executive Officer of Caisse des Dépôts et Consignations

Since July 20, 1998, Philippe Lagayette has been running JP Morgan's operations in France, as Chairman and Chief Executive Officer of JP Morgan et Cie SA, the French subsidiary of the JP Morgan Chase Group. He is President of Institut des Hautes Etudes Scientifiques (research in mathematics and theoretical physics) and President of the French American Foundation.

***Directorships and executive positions held in 2003:***

**Director**

JP Morgan & Cie SA

Eurotunnel

Fimalac

La Poste

**Member of the Supervisory Board**

PPR

Member of the Fimalac Audit Committee

**Bernard MIRAT**

**Director**

Non-voting director of Cholet Dupont (holding company)

Born on July 3, 1927; age: 76

First elected: April 21, 1993

Re-elected: June 4, 2002

Current term expires at the close of the 2006 Annual General Meeting

Number of shares held at December 31, 2003: 25

***Biographical details***

Bernard Mirat holds degrees in law and literature, and is a graduate of Institut d'Etudes Politiques de Paris and Ecole Nationale d'Administration.

1955-1959: Assistant to senior management of Société d'Optique et de Mécanique de Haute Précision

1961-1987: Deputy Company Secretary of Compagnie des Agents de Change

1988-1991: Deputy Managing Director

1966-1983: Professor at Ecole des Hautes Etudes Commerciales

1991-1992: Vice-Chairman and Chief Executive Officer, Société des Bourses Françaises

1993-1999: Advisor to the Fimalac Group

1993-1999: Chairman and Chief Executive Officer of Ibca Notation SA, renamed Fitch-Ibca

Since 1999: Advisor to Cholet-Dupont

***Directorships and executive positions held in 2003:***

**Director**

Fimalac

Fitch France SA

Minerais & Engrais

**Member of the Supervisory Board**

GT Finance

Lagardère SCA

**Non-voting director**

Holding Cholet Dupont

**Auditor**

FCBS Gie

Member of the Lagardère SCA Audit Committee

**Bernard PIERRE**

**Director**

Chairman and Chief Executive Officer of Fremapi

Born on January 9, 1939; age: 65

First elected: June 18, 1997

Re-elected: June 5, 2001

Current term expires at the close of the 2005 Annual General Meeting

Number of shares held at December 31, 2003: 14,704

***Biographical details***

After graduating from Ecole Polytechnique, Bernard Pierre began his career with the Direction Technique des Armements Terrestres, the government army weapons development and manufacturing agency, where he held positions in the areas of both engineering and manufacturing. In 1973, he joined the Alcatel-Alsthom Group where he held management positions in various subsidiaries, including Chairman and CEO of Saft (batteries) and Alcatel Câbles (underground and underwater power and telecommunications cables). He subsequently joined the Group management team, with responsibility for technical, industrial and international operations.

He left Alcatel-Alsthom in 1996 to become Chairman and CEO of the franco-american joint venture Engelhard-Clal.

***Directorships and executive positions held in 2003:***

**Chairman and Chief Executive Officer**

Engelhard-Clal Ltd (UK)

Fremapi

H. Drijfhout & Zoon's (Netherlands)

Holdec MP

Orbitec

Semp SA (Spain)

**Chairman**

Engelhard-Clal SAS

**Director**

Clal-Msx

Engelhard-Clal (Australia)

Engelhard-Clal LP (Hong-Kong)

Engelhard-Clal LP (Singapore)

Fimalac

Hiperinver SA Platecxis

Platecxis (Spain)

Soldaduras DE Plata Industrial

**Member of the Supervisory Board**

Groupe Marc de Lacharrière

Chairman of the Fimalac Audit Committee

**FIMALAC PARTICIPATIONS**

**Director**

First elected: April 30, 1996

Re-elected: June 7, 2000

Current term expires at the close of the 2004 Annual General Meeting

Number of shares held at December 31, 2003: 271,045

**Director**

Fimalac

**Pierre BLAYAU**

**Permanent representative of Fimalac Participations**

Chairman and Chief Executive Officer of Géodis

Born on December 14, 1950; age: 53

First appointed: April 30, 1996

Re-appointed: June 7, 2000

Current appointment expires at the close of the 2004 Annual General Meeting

***Biographical details***

Pierre Blayau is a graduate of Ecole Normale Supérieure de Saint Cloud and of Institut d'Etudes Politiques de Paris, where he earned a post-graduate degree in German studies. After graduating from Ecole Nationale d'Administration, he joined the French civil service (Inspection des Finances). He subsequently moved to the Saint Gobain Group, where he held various positions including Chairman of Pont-à-Mousson and Director of the Mechanical Pipework Division.

In 1993, he joined the Pinault-Printemps-Redoute Group as Chairman of the Management Board. His positions included Chairman of FNAC (1994-1995) and Chairman of La Redoute (1994).

As Chairman of Moulinex, from 1996 to 2000, he was responsible for masterminding the Moulinex-Brandt merger.

Currently Chairman of Géodis, Pierre Blayau was named advisor to the Chairman of SNCF and member of the SNCF Executive Committee in April 2003.

***Directorships and executive positions held in 2003:***

**Chairman and Chief Executive Officer**

Géodis

**Director**

Ligue de Football Professionnel

Zust Ambrosetti SpA

**Member of the Supervisory Board**

S.I. Finance

Transports Bernis

**Permanent representative of Géodis**

Bourgey Montreuil

Calberson

Géodis Logistics

Géodis Overseas France

Teisa

**Permanent representative of Fimalac Participations**

Fimalac

**René BARBIER de LA SERRE**

**Non-voting director**

Director of Sanofi-Synthélabo

Born on July 3, 1940; age: 63

First elected: June 4, 2002 (as non-voting director)

Term expires: 2004

***Biographical details***

René Barbier de la Serre is a graduate of Ecole Polytechnique, Manufactures de l'Etat engineering school and Institut d'Etudes Politiques de Paris (IEP). He began his career in 1963 with Banque de l'Union Européenne. In 1973, he moved to Crédit Commercial de France, where he held a variety of positions including Vice Chairman and Chief Executive Officer, Financial Services (1993-1999) and Advisor to the Chairman (1999-2000). During the same period, he was also Chairman of Conseil des Bourses de Valeurs (1994-1996) and then of Conseil des Marchés Financières (1996-1998), the French securities regulator.

***Directorships and executive positions held in 2003:***

**Chairman**

Tawa UK Ltd (UK)

**Director**

Crédit Lyonnais

Sanofi Synthelabo

Schneider Electric

**Chief Executive Officer**

Harwanne Compagnie de Participations Industrielles et Financières SA (Switzerland)

**Member of the Supervisory Board**

Euronext NV (Netherlands)

Compagnie Financière E. de Rothschild Banque

Compagnie Financière Saint-Honoré

Pinault Printemps Redoute

**Non-voting director**

Fimalac

Nord Est

**Michel CASTRES SAINT-MARTIN**

**Non-voting director**

Director of LBC

Born on May 21, 1926; age: 77

First elected: June 17, 1996

Re-elected: June 4, 2002

(as non-voting director)

Term expires: 2004

***Biographical details***

1952-1964: Director of the Port of Marseille

1964-1967: Marché d'intérêt national – Gare routière de Rungis

1968-1981: Compagnie Financière de Suez – Director, private equity

1980-1994: Compagnie Industrielle Maritime

1972-1994: Alspi and LBC

***Directorships and executive positions held in 2003:***

**Director**

LBC

***Auditor***

FCBS Gie

***Non-voting director***

Fimalac

**Henri LACHMANN**

**Non-voting director**

Chairman and Chief Executive Officer of Schneider Electric Industries SA

Born on September 13, 1938; age: 65

First elected: December 3, 2002 (as non-voting director)

Term expires: 2004

***Biographical details***

Graduate of Ecole des Hautes Etudes Commerciales (1961)

French Chartered Accountant

1963: Auditor then Audit Manager, Arthur Andersen

1970: Director, Business Plans and Budgets, then Chief Executive Officer, Compagnie Industrielle et Financière de Pompey

1976: Chief Operating Officer of Forges de Strasbourg, a subsidiary of Pompey

1983-1998: Chairman and Chief Executive Officer of Forges de Strasbourg and Chief Operating Officer of Pompey

1999: Chairman and Chief Executive Officer of Schneider Electric Industries SA

***Directorships and executive positions held in 2003:***

**Chairman and Chief Executive Officer**

Schneider Electric

**Director**

Ansa

Finaxa and various other subsidiaries of the Axa Group

Vivendi Universal

**Member of the Supervisory Board**

Axa

Groupe Norbert Dentressangle

**Non-voting director**

Fimalac

Member of the Steering Committee of Institut de l'Entreprise

**Jean-Charles NAOURI**

**Non-voting director**

Chairman of Groupe Euris

Born on March 8, 1949; age: 55

First elected: June 4, 2002 (as non-voting director)

Term expires: 2004

***Biographical details***

11976: Deputy government auditor (inspecteur adjoint des finances)

1980: Under director in the Treasury Department of the Ministry of the Economy and Finance

General Secretary of various interministerial committees (CIDISE, CODIS, FSAI, Comité interministériel pour la création d'emplois dans les zones de conversion industrielle).

1982: Director in the staff of the Minister of Social Affairs and National Solidarity

1984: Director in the staff of the Minister of the Economy, Finance and the Budget

1986: Head of special projects in the Treasury Department of the Ministry of the Economy, Finance and Privatization.

*Directorships and executive positions held in 2003:*

**Chairman**

Groupe Euris

**Chairman and Chief Executive Officer**

Rallye

**Chairman of the Board of Directors**

Casino, Guichard-Perrachon

Euris

Finatis

**Director**

Crédit Commercial de France

Continuation Investments NV

**Member of the Supervisory Board**

Groupe Marc de Lacharrière

**Non-voting director**

Fimalac

**Managing Partner**

Rothschild & Compagnie Banque

**Manager**

SCI Penthièvre Seine

SCI Penthièvre Neuilly

Member of the Fimalac Selection, Nominations and Remunerations Committee

**Etienne PFLIMLIN**

**Non-voting director**

Chairman of Banque Fédérative du Crédit Mutuel

Born: October 16, 1941; age: 62

First elected: June 4, 2002 (as non-voting director)

Term expires: 2004

*Biographical details*

Graduate of Ecole Polytechnique and Ecole Nationale d'Administration, honorary advisor to the Cour des Comptes (National Audit Office), Etienne Pflimlin is Chairman of Crédit Mutuel Centre Est in Strasbourg and Banque Fédérative du Crédit Mutuel, National Chairman of Crédit Mutuel and Chairman of the Supervisory Board of CIC. He is also a member of the Executive Committee of Fédération Bancaire Française and, in Brussels, of the European Association of Cooperative Banks.

*Directorships and executive positions held in 2003:*

**Chairman of the Board of Directors**

Banque Fédérative du Crédit Mutuel

Caisse Centrale du Crédit Mutuel

Caisse de Crédit Mutuel Esplanade

Caisse Fédérale du Crédit Mutuel Centre Est Europe

Confédération Nationale du Crédit Mutuel

Fédération du Crédit Mutuel Centre Est

**Chairman of the Supervisory Board**

Banque de l'Économie du Commerce et de la Monétique

Crédit Industriel et Commercial

Éditions Coprur

Société Alsacienne de Publications "L'Alsace"

Société d'Études et de Réalisation pour les Équipements Collectifs – Soderec

**Chairman**

Le Monde Entreprises

**Director**

Assurances du Crédit Mutuel Vie et Iard

Assurances du Crédit Mutuel Vie-SFM

Groupe des Assurances du Crédit Mutuel

Société Française d'Édition de Journaux et d'Imprimés Commerciaux "L'Alsace"

**Member of the Supervisory Board**

Le Monde

le Monde et Partenaires Associés

Société Éditrice du Monde

**Non-voting director**

Fimalac

**Permanent representative of CIC**

Banque Scalbert Dupont

Crédit Industriel d'Alsace et de Lorraine

Crédit Industriel de Normandie

Crédit Industriel de l'Ouest

Société Bordelaise de CIC

**Permanent representative of Banque Fédérative du Crédit Mutuel**

Crédit Mutuel Finance

**Permanent representative of Fédération du Crédit Mutuel Centre Est Europe**

Euro Information

Sofedis

## Edouard de ROYÈRE

**Non-voting director**

Honorary Chairman of Air Liquide

Born on June 26, 1932; age: 71

First elected: June 4, 2002 (as non-voting director)

Term expires: 2004

***Biographical details***

Graduate of Ecole Supérieure de Commerce de Paris

Edouard de Royère's early career was spent with Crédit Lyonnais and Union Immobilière et Financière. In 1966, he joined Air Liquide, becoming Vice President and Deputy Chief Executive Officer in 1979, Vice Chairman in 1982 and Chairman and Chief Executive Officer in 1985, a position he held until his retirement in 1995.

***Directorships and executive positions held in 2003:***

**Chairman**

Ansa

**Honorary Chairman**

Air Liquide

**Director**

Groupe Danone

L'Oréal

Sodexho Alliance

**Member of the Supervisory Board**

Air Liquide

**Non-voting director**

Fimalac

Member of the Fimalac Selection, Nominations and Remunerations Committee

FitchRatings

**Charles D. Brown**
General Counsel

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New York, NY 10004

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www.fitchratings.com

March 8, 2005

The Honorable Jon S. Corzine
United States Senate
Committee on Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Responses to Questions by Senator Corzine at *Examining the Role of Credit Rating Agencies in the Capital Markets*

Dear Senator Corzine:

As General Counsel to Fitch, Inc. ("Fitch"), I write this letter in response to the questions for which you requested written responses from Fitch during the US Senate Committee on Banking, Housing and Urban Affairs hearing entitled "*Examining the Role of Credit Rating Agencies in the Capital Markets.*"

At the hearing, you asked us to give our view on New Jersey's high cost mortgage act and the expensing of stock options and the dates of past two examinations of Fitch by the Securities and Exchange Commission (the "SEC").

We have published our views on the New Jersey Home Ownership Act of 2002 when enacted and again when amended. Attached hereto as Annex A are our published commentaries on the New Jersey Act from June 2003 and August 2004. These published commentaries reflect our position on the New Jersey Act. We have also included for your information our published commentaries on predatory lending in general and screening for loans that might violate predatory lending laws.

With respect to expensing stock options, our views are set forth in our special report *Accounting for Stock Options: Should Bondholders Care?* published last April, a copy of which is attached hereto as Annex B.

With respect to the SEC's examination of Fitch, the SEC conducted an examination of Fitch beginning on May 1, 2002. While Fitch has had meetings with, and provided requested information to, the SEC staff from time to time over the years, the 2002 examination is the only formal examination of Fitch that the SEC conducted since 1989. Fitch does not have access to the corporate records of Fitch's predecessor entity for the period prior to 1989, the year in which a group including several members of its current management acquired and recapitalized Fitch.

Please let me know if we can provide you any further information.

Very truly yours,

Charles D. Brown

Charles D. Brown

cc: The Honorable Richard C. Shelby, Chairman
The Honorable Paul S. Sarbanes, Ranking Member
Mr. Bryan Corbett

FitchRatings
FitchResearch

# Annex A

Fitch : Info Center : Press Releases

Tagging Info

## Fitch Comments on NJ's Amendment to the 2002 NJ Homeownership Security Act

25 Aug 2004 11:16 AM (EDT)

Fitch Ratings-New York-August 25, 2004: On July 6, 2004, Gov. James E. McGreevey of New Jersey, signed Senate Bill 279 (the amendment) that amends the New Jersey Homeownership Security Act of 2002 (the act). The amendment, which is effective immediately, addresses many concerns that have been expressed, particularly by mortgage originators, since passage of the act that became effective on Nov. 28, 2003. In particular, the amendment removes any reference to 'covered home loans' and 'flipping.' The 'total points and fees threshold' for high cost home loans is changed from 5% to 4.5%; and importantly, the Department of Banking and Insurance (DOBI) is now given more regulatory authority. However, the amendment does not change, or further clarify, the assignee liability or safe harbor issues. Thus, Fitch's policies and procedures in regard to 'high-cost home loans' in New Jersey, as detailed in our press release dated June 5, 2003, are not affected by passage of this Amendment.

The removal of covered home loans and flipping from the act, as per the amendment, should eliminate some impediments and uncertainties for existing and potential mortgage lenders in the State of New Jersey. According to the Act, covered home loans and flipping are conjoined concepts that effectively prevent mortgage lenders from refinancing an existing home loan made within the prior 60 months, if the new loan does not provide a 'reasonable, tangible net benefit' to the borrower. However, the act does not define reasonable, tangible net benefit. This lack of definition is largely seen as one of the primary reasons that lenders pulled back from the New Jersey mortgage market. Elimination of covered home loans and flipping should benefit the New Jersey mortgage market, since it can be expected that more lenders will now begin, or resume, making mortgage loans in New Jersey. However, as a reminder that some uncertainty still remains, the amendment also added a caveat that these deletions 'shall create no presumption that any home loan that is refinanced does not constitute an unlawful practice under P.L. 1960, c.39 (C.56:8-1 et seq.).'

The amendment expands the number of high cost home loans that potentially fall under the scope of the act by decreasing the total points and fees threshold from 5% to 4.5% for loans that are $40,000 or more. Since the amendment is effective immediately (i.e., as of July 6, 2004), this has implications for a lender's existing pipeline of loans. Lenders should reexamine their pipeline of loans, as well as their current policies and procedures for identifying predatory loans to ensure that this threshold change is properly accounted for. In addition, Fitch will continue to incorporate an assessment of a lender's predatory controls for New Jersey high cost home loans as part of its ongoing originator review process.

A third key area of the amendment eliminates regulatory uncertainty from the act. The Commissioner of Banking and Insurance, within the Department of Banking and Insurance (DOBI) and in consultation with the Division of Consumer Affairs in the Department of Law and Public Safety is now empowered to promulgate and govern any provisions of the act and this amendment. Previously, their powers of interpretation and regulation were confined to certain, highly restrictive sections of the act. With this expanded authority, DOBI can be expected to issue interpretations of the act and amendment that creditors will be able to rely upon.

It should be noted that the amendment did not substantively change the assignee liability or safe harbor portions of the act. Therefore, to rate RMBS transactions, which contain any loans originated in New Jersey after the act's effective date of Nov. 28, 2003, Fitch will continue its policy of reviewing the results of an independent analysis of loans by an acceptable, unaffiliated third party that states that due diligence was conducted on the New Jersey loans. Please refer to Fitch's press release dated June 5, 2003 for further information.

Fitch will continue to monitor anti-predatory lending legislation and provide the market with commentary on its rating approach.

Contact: Mark Douglass +1-212-908-0229 or Steve Grundleger +1-212-908-0234, New York.

Media Relations: Sandro Scenga +1-212-908-0278, New York.

**Fitch Ratings Responds to New Jersey Predatory Lending Legislation**
05 Jun 2003 10:01 AM (EDT)

Fitch Ratings-New York-June 5, 2003: On May 1, 2003, Governor McGreevey signed into law the 'New Jersey Home Ownership Act of 2002' (the Act), which will be effective Nov. 27, 2003. Fitch has previously indicated and confirms that it will not rate residential mortgage backed securities (RMBS) transactions which contain loans that are originated in jurisdictions which contain legislation that may result in unlimited purchaser or assignee liability for predatory lending practices of an originator, broker or servicer (see press release dated May 1, 2003, 'Fitch Revises its Rating Criteria in the Wake of Predatory Lending Legislation', available on the Fitch Ratings web site at 'www.fitchratings.com'). Based on its review of the Act, as well as discussions with officials from New Jersey, Fitch believes that it can rate residential mortgage-backed securities (RMBS) transactions which contain certain loans that are originated in New Jersey after Nov. 26, 2003, subject to additional credit enhancement. Fitch will not rate RMBS transactions which contain high cost home loans originated in New Jersey after Nov. 26, 2003 since the unlimited liability provisions may result in unquantifiable losses to transactions.

The Act categorizes as 'home loans', all loans, other than reverse mortgages, which are secured by either 1) a mortgage or deed of trust on a one to six family dwelling in New Jersey occupied by a borrower as the borrower's principal dwelling or, 2) a security interest in a manufactured home in New Jersey occupied by the borrower as the borrower's principal dwelling. The Act further designates certain specific types of home loans: 1) a home loan made, arranged or assigned by a person selling either a manufactured home or home improvements to a borrower, 2) a 'high cost home loan' or 3) a 'covered home loan' - which also includes a high cost home loan.

Under the Act, the exposure of an assignee or purchaser of 1) a covered loan, 2) a manufactured home loan, 3) a home improvement loan or 4) a home loan which is not a covered loan, a manufactured home loan or a home improvement loan which violates the act, so long as any such loan is not also a high cost home loan, appears to be limited (although the exposure with regard to manufactured home loans and home improvement loans is higher than the exposure to covered loans and home loans). Therefore, Fitch will rate RMBS transactions containing any of the following loans which are subject to the Act and are also not high-cost home loans: 1) home loans, 2) covered loans, 3) home improvement loans, or 4) manufactured home loans.

There are two ways in which a transaction may contain a high cost home loan. The first instance is when an issuer knows that a loan is a high cost home loan, and in such a case the issuer would remove the loan from the transaction. The second instance is when a loan is thought to not be a high cost home loan, but due to an error in the origination process the loan is, in fact, a high cost home loan. As indicated in its May 1, 2003 press release, Fitch is concerned that loans which are originally coded as other than high cost home loans, based on such specifications as the principal balance, interest rates and/or points, may actually be high cost home loans. This may subject purchasers and assignees of loans originally coded not as high cost home loans to unlimited liability.

The Act limits the exposure of an assignee or purchaser of any high cost home loan if, as proven by a preponderance of the evidence: (1) there are in place at the time of the purchase or assignment of the loan, policies that expressly prohibit its purchase or acceptance of assignment of any high-cost home loan; and (2) there is a requirement by contract that a seller or assignor of home loans to the purchaser or assignee represents and warrants to the purchaser or assignee that either (a) it will not sell or assign any high-cost home loan to the purchaser or assignee or (b) that the seller or assignor is a beneficiary of a representation and warranty from a previous seller or assignor to that effect; and (3) the assignee or purchaser exercises reasonable due diligence at the time of purchase or assignment of home loans or within a reasonable period of time thereafter intended by the purchaser or assignee to prevent the purchaser or assignee from purchasing or taking assignment of any high-cost home loan. The Act is unclear as to what will be considered reasonable due diligence in New Jersey under the limited damages provision of the Act. Fitch will not rate any transactions containing loans originated in New Jersey after the effective date of the Act where the seller or purchaser cannot provide adequate evidence that the particular transaction will have the benefits of the aforementioned safe harbor because of its concern that a lender may originate a high cost loan in error, thereby subjecting the transaction to unlimited liability.

In order to rate RMBS transactions which contain any loans originated in New Jersey after the Act's effective date, Fitch must receive an acceptable certification from a third party unaffiliated with the originator of the loans that such third party has conducted due diligence on the New Jersey loans and indicating the results of such due diligence. Under the due diligence process, after a pool of loans has been identified to Fitch, the third party should recalculate the APRs based on information gathered directly from the loan documents, including relevant interest rate, points and fees. The APR, points and fees should then be compared to the high cost home loan thresholds in the Act. If there are ten or fewer New Jersey loans in a transaction, all such loans must be subject to the due diligence. If there are more then ten New Jersey loans in a transaction, a random sample may be taken. The minimum sample size should be in the range of 10%-25% of the New Jersey loans in the pool. If, however, the diligence performed on such sample uncovers any loan which has been determined to be a high cost home loan under the Act, the above calculations must be performed on every New Jersey loan in the pool. Due to the unlimited liability that can be assessed against an RMBS transaction that contains high cost home loans originated in New Jersey, Fitch takes comfort that 'reasonable due diligence' has occurred only if the aforementioned certificate has been produced.

Fitch will continue to monitor anti-predatory lending legislation and provide the market with timely commentary on its rating approach.

Contact: Michael Nelson +1-212-908-0227 or Steve Grundleger +1-212-908-0234, New York.

Media Relations: Matt Burkhard +1-212-908-0540, New York.

Fitch Ratings
FitchResearch

Fitch : Info Center : Press Releases

Tagging Info

## Fitch Revises RMBS Guidelines for Antipredatory Lending Laws

23 Feb 2005 11:46 AM (EST)

Fitch Ratings-New York-February 23, 2005: Fitch Ratings has revised the guidelines for rating residential mortgage-backed securities for which the loan pools include mortgage loans originated in New Jersey, New Mexico, Kentucky, Massachusetts, and Indiana. These states have enacted antipredatory lending laws, which potentially expose RMBS issuers to unlimited or unquantifiable assignee liability for damages resulting from loans determined to be predatory under the laws ('high cost loans'). Fitch's rating criteria does not permit the inclusion of these high cost loans in rated pools. In an effort to monitor compliance with Fitch's high cost loan criteria, when any mortgage loans from these states are included in an RMBS transaction, it has been Fitch's policy to review the results of an analysis of a sample of the loans conducted by an acceptable, unaffiliated third party. Effective immediately, Fitch will no longer require such third-party reports for each rated transaction.

Based on results of the transaction loan sampling over the past 22 months, Fitch has determined that there has been excellent compliance with Fitch's high cost loan criteria. Furthermore, compliance systems have become a critical component of the underwriting and quality control process, and the investment in these systems and the reliance on them has grown accordingly. Fitch's policy modification recognizes the progress the industry has made managing compliance with the myriad antipredatory laws and regulations. Therefore, effective immediately, originators/sellers will no longer need to provide third-party sampling reports at the time of transaction closing.

Fitch will continue to expect representations and warranties indicating that no high cost loans, as defined by any applicable federal, state, and/or local legislation or regulations are included in an RMBS pool, as well as a similar statement in the conveyance section of the relevant agreement if it will allow an RMBS issuer to avail itself of any safe harbor provisions.

Fitch will continue to review an originator's compliance processes for identifying loans that are high cost as defined by state, federal, and local laws. Additionally, Fitch will review an originator's ability to make use of any safe harbor provisions that may be available.

While loan-sampling for each transaction is no longer a requirement, Fitch may request loan-sample reviews when deemed appropriate. Fitch will continue to monitor antipredatory lending legislation as such legislation is enacted and provide the market with commentary on its rating approach.

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**Fitch Ratings Updates Rating Criteria Regarding Predatory Loans**
15 Jan 2004 10:26 AM (EST)

Fitch Ratings-New York-January 15, 2004: Fitch Ratings revises its rating criteria in respect of review of loans originated in jurisdictions with unlimited assignee liability.

Fitch previously indicated that it will not rate any residential mortgage-backed securities (RMBS) transactions containing high cost home loans originated in jurisdictions with effective legislation which contains unlimited assignee liability, to date, Kentucky and New Jersey. Fitch indicated that in order for it to rate an RMBS transaction containing any loans from such jurisdiction, it expected receipt of a certification from a third party unaffiliated with the originators of the relevant loans that such third party conducted due diligence on a random sample in the range of 10% to 25% of the loans from such jurisdiction and that no high cost home loans were uncovered in the sample. (See press releases dated June 5, 2003, 'Fitch Ratings Responds to New Jersey Predatory Lending Legislation' and June 27, 2003, 'Fitch Ratings Responds to Kentucky Predatory Lending Legislation', also available at 'www.fitchratings.com'). If the review of the sample of loans uncovered any high-cost home loans, Fitch expected a review of every loan in the pool originated in that jurisdiction in order to comply with the criteria.

Under the revised criteria, the number of loans to be reviewed in the random sample should be the greater of a) 5 loans from each such jurisdiction with unlimited liability and b) 10% of the loans in the pool from each such jurisdiction with unlimited liability. As under the prior criteria, if the review of the sample of loans uncovers any high-cost home loans, a review of every loan in the pool originated in that jurisdiction is expected in order to comply with the criteria.

Fitch will continue to monitor anti-predatory lending legislation and provide the market with timely commentary on its rating approach.

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FitchRatings

Structured Finance

Residential Mortgage
Special Report

# Can You See Me Now?

## Screening for RMBS Predatory Lending Loans

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### Summary

A residential mortgage-backed securities (RMBS) lender is able to originate a loan that is in violation of antipredatory lending legislation and generate bond losses, which is a serious risk. On May 1, 2003, in response to this issue, Fitch Ratings published a press release indicating that credit enhancement levels for RMBS transactions might be adjusted upward as a result of this additional predatory lending-related risk *(see Fitch press release entitled "Fitch Revises Rating Criteria in Wake of Predatory Lending Legislation," available on Fitch's web site at www.fitchratings.com)*. An increase in enhancement levels reflects the conservative assumption that all originators have some flaws in their compliance practices. However, the increase might be somewhat mitigated if an analysis of mortgage originators' and underwriters' compliance procedures — including the origination process and systems and the application of quality control tools — indicates significant strengths in this area. Credit enhancement might then be reduced, although some increased enhancement would remain since no originator is viewed as completely free of concern.

### Originator Due Diligence Practices

To assess relative strengths in this area, Fitch has recently conducted discussions with major mortgage originators and conduits in the RMBS market, which resulted in the following observations:

- Originators typically utilize a technology-based filter that is either internally produced or purchased from a vendor.
- Originators use some form of legal guidance to set the parameters for such systems, based on rules that follow jurisdictional laws.
- Originators include some form of quality control check against a system's output, before and/or after funding.

An originator's use of a technology-based filter in the compliance process is viewed positively by Fitch. In fact, Fitch cannot provide credit for the compliance process without it. Fitch believes that it is virtually impossible for originators of any meaningful size to monitor compliance with predatory lending laws, as is required on a loan-level basis, without the assistance of technology. Some originators have created their own systems, and others have chosen to incorporate an outside vendor's system into their own. Whether in-house or third-party, these systems can be either stand-alone modules or components of the origination systems. Although it is more difficult for originators to incorporate vendor-based technology into their front-end systems, some originators find this to be the most cost-effective way to comply with the myriad regulatory requirements. The use of such vendor-based technology may result in improved credit enhancement levels from Fitch.

To remain current with the changing compliance landscape, originators are expanding resources, particularly legal and compliance staff, to handle the increased workload. Large originators, whose compliance staff, including attorneys, may exceed 10 members, devote a significant part of these resources to the creation, maintenance, and monitoring of technology-based compliance systems. Even the smaller companies have an internal counsel whose function includes confirming that the originator complies with all relevant laws related to origination.

Fitch views the use of an internal counsel as the barest minimum for effective compliance with predatory lending laws. Fitch considers use of both internal compliance resources, including an internal counsel and an additional person who addresses origination compliance issues, and external compliance-specific legal advice to be ideal in maintaining sufficient legal guidance in this area.

Use of a quality assurance/control process is integral to the compliance process. Despite an originator's use of a technology-based filter, certain loans may slip through the cracks. For example, if the data input into the filtering system have been incorrectly entered, the results will be flawed. In addition, if the filtering system uses information from a Department of Housing and Urban Development HUD-1 settlement statement that is not the final HUD-1, or if the closing agent adjusts a fee at closing, necessitating a last-minute change to the HUD-1, the results could be flawed. Furthermore, if the system simply has faulty computer logic that does not properly represent the correct regulatory test, the results would be inaccurate.

To compensate, originators have created a secondary test against these occurrences in the form of a quality control process. Originators examine certain loans and performing recalculations to determine if any loans slipped through that should have been caught by the filtering process. Quality control reviews vary greatly. Some companies only review a 10% random sample of loans after the loans have been funded (and sold). Others provide a more extensive review, which entails examining 100% of the loans before funding and then, after funding, reviewing either: 100% of all the loans; or 10% of all the loans but 100% of loans in sensitive states (such as Georgia or New York).

The prefunding audit verifies the accuracy of the filter and addresses small changes that may occur on the HUD-1 prior to funding. The postfunding audit often covers the entire origination process, including identification of issues related to poor data entry or incorrect filters.

Most companies provide a quality control process that falls between the two ends of the spectrum. The closer an originator's process is to the more extensive one described in the second example above, the more comfortable Fitch is that the originator correctly identifies the types of loans in the transaction and the more credit Fitch can provide for the process.

## Issuer Due Diligence Practices

Fitch has conducted discussions regarding transactional due diligence performed for issuers at the behest of securities underwriters of RMBS transactions, resulting in the following observations:

- For all transactions, some level of due diligence is performed, with most underwriters contracting out the work.
- Most of the contracted due diligence is performed by a small group of companies due to the specialized nature of the work. Most of these companies appear to perform similar tasks. However, the due diligence is subject to the comprehensiveness of system-based filters and the scope of the contract, which may vary.

Additionally, the securities underwriters perform due diligence not only for themselves but also for the benefit of the RMBS issuer. The vast majority of this work is contracted by these underwriters to a small group of companies, rather than the underwriters performing the diligence themselves. This small group combines the use of technological systems, either proprietary or vendor-based, with teams of mortgage underwriting professionals. In many cases, these professionals — mostly contract mortgage underwriters — perform a loan-level compliance review of a sample of the loans in addition to a credit underwriting of the loans. In the past year or two, the balance of the loan review has shifted toward compliance first, with credit still important but secondary. In some cases, if a compliance review is the only service necessary, the review may be conducted either solely through technology or, more likely, in conjunction with mortgage underwriting professionals.

As with originator compliance reviews, securities underwriters' due diligence reviews vary greatly. These underwriters determine the scope and sample size of the loan reviews. Some underwriters choose to review only 5% or 10% of the loans in a transaction, depending on the underwriter's comfort with the originator and/or product type (for example, there is usually a higher sample for subprime loans than for prime loans). Some companies choose a small overall sample but have a higher sample for sensitive regions, and yet others require a compliance review of 100% of the transaction's loans.

Fitch views the use by a securities underwriter of an independent due diligence company as more beneficial than in-house diligence. In addition, Fitch believes that these securities underwriter compliance reviews are a necessary part of any transaction, with 10% typically the minimum sample size. The closer the sample size is to 100%, the more favorably Fitch views the due diligence.

## Technology

It is clear from discussions with both originators and underwriters of RMBS transactions that the use of technology in complying with predatory lending laws continues to increase dramatically. Fitch views the increased use of technology as a positive step in complying with complex predatory lending laws, and these increases should be viewed positively by the RMBS market. In fact, the independent testing of these systems would provide further comfort to the market by specifically assessing the benefit of each system.

## Fitch's Perspective

As part of the criteria announced in a May 1, 2003 press release, Fitch indicated that it would continue to focus on a review of both originators' compliance programs and due diligence practices in connection with transfers of loans to RMBS transactions *(see Fitch press release entitled "Fitch Revises Rating Criteria in Wake of Predatory Lending Legislation," available on Fitch's web site at www.fitchratings.com)*. Based on discussions with originators and securities underwriters, Fitch has enhanced its annual review of originators to include a more detailed analysis related to predatory lending. The enhanced review contains documentation requests by Fitch that focus on global compliance issues, including the use of any technology to filter loans. Originators' responses and Fitch's opinions of the originator's processes are incorporated into the annual review and evaluation of these originators by Fitch.

Fitch continues to expect applicable transaction documents to contain representations and warranties, which state that: a) all loans are originated in compliance with state, local, and federal laws; and b) no loan, except as identified in detail to Fitch, is a high-cost loan, a covered loan, or any other similarly designated loan as defined under any state, local, or federal law, which contains provisions that may result in liability to the purchaser or assignee of the loan.

Fitch relies on such representations and warranties in assessing the creditworthiness of a mortgage pool. Fitch does not audit or verify the information provided to it by any originator, issuer, or underwriter related to these parties, the origination process, the loans, or the characteristics of the loans.

In the event of a breach of these representations or warranties, the repurchase price of any affected loan should be equal to: the outstanding indebtedness of the loan (including, but not limited to, late fees), plus accrued interest; plus reasonable attorneys' fees and costs and all other damages that may be incurred by an RMBS transaction under any applicable predatory or abusive lending law.

Additionally, Fitch is providing two guides to aid in understanding its perspective on certain jurisdictions' predatory lending laws. A chart summarizing Fitch's response to predatory lending laws for which it has published press releases is on page 4. In addition, a link to a comprehensive summary of the assignee liability provisions of the predatory lending laws, provided by Hudson Cook, LLP, is available online *(click here to access this resource)*.

Fitch will continue to monitor predatory lending issues and provide the market with timely commentary on its rating approach.

**Predatory Lending Summary**

| Jurisdiction | Law Date | Effective Date | Fitch Press Release Date | Loan | Loan Type | Rate Threshold | Is Assignee Liability Limited? |
|---|---|---|---|---|---|---|---|
| HOEPA (Federal) | 9/23/94 | 10/1/95 | — | — | • Refinance, MH, one to four family, condominium or co-op, not HELOC or reverse mortgage | • T + 8% first liens, T + 10% second liens | Yes |
| Arkansas | 4/16/03 | 7/16/03 | 6/20/03 | High-Cost Home Loan | • Owner occupied, refinance, one to four family, primary, $150,000 or less, includes HELOC, not reverse mortgage | • T + 8% first liens, T + 10% second liens | Yes |
| Washington, D.C. | 3/1/02 | 5/7/02 | 7/31/03 | Covered Loan | • Mortgage loan, includes HELOC, not federal or state insured or reverse mortgage | • T + 6% first liens, T + 7% second liens | Yes |
| Florida | 4/22/02 | 10/2/02 | 7/31/03 | High-Cost Home Loan | • Matches HOEPA | • T + 8% first liens, T + 10% second liens | Yes |
| Georgia | 3/7/03 | 3/7/03 | 12/24/02, 2/4/03, 3/14/03 | High-Cost Home Loan | • Owner occupied, conforming, primary, one to four family, MH, condominium, HELOC, not reverse mortgage | • T + 8% first liens, T + 10% second liens | Yes |
| Kentucky | 3/20/03 | 6/24/03 | 6/27/03 | High-Cost Home Loan | • Owner occupied, $15,001–$200,000, primary, not HELOC or reverse mortgage | • T + 8% first liens, T + 10% second liens | No |
| Los Angeles | 12/18/02 | 60 Days* | 10/24/03 | High-Cost Refinance Home Loan | • Owner occupied, refinance, conforming, primary, one to four family, condominium or co-op, not reverse mortgage | • T + 6% | No |
| Maine | 4/17/03 | 9/13/03 | 9/29/03 | High-Rate, High-Fee Mortgage | • Matches HOEPA | • T + 8% first liens, T + 10% second liens | Yes |
| Nevada | 6/10/03 | 10/1/03 | 10/1/03 | Home Loan | • Matches HOEPA | • T + 8% first liens, T + 10% second liens | Yes |
| New Jersey | 5/1/03 | 11/28/03 | 6/5/03 | Covered Loan | • Owner occupied, $350,000 or less (CPI adjusted), primary, one to six family, not reverse mortgage | • If high cost, T + 8% first liens, T + 10% second liens; otherwise, 4.0–4.5 points | Yes |
| New Jersey | 5/1/03 | 11/28/03 | 6/5/03 | MH or HI | • Owner occupied, $350,000 or less (CPI adjusted), primary, one to six family, not reverse mortgage | • None (unless high-cost home loan) | Yes |
| New Jersey | 5/1/03 | 11/28/03 | 6/5/03 | High-Cost Home Loan | • Owner occupied, $350,000 or less (CPI adjusted), primary, one to six family, not reverse mortgage | • T + 8% first liens, T + 10% second liens | No |
| New York City | 11/20/02 | 2/18/03 | 2/28/03 | High-Cost Home Loan | • Owner occupied, $300,000 or less, primary, one to four family, condominium or co-op, not reverse mortgage | • T + 6% first liens, T + 8% second liens | Yes‡ |
| New York State | 10/3/02 | 4/1/03 | 3/26/03 | High-Cost Home Loan | • Owner occupied, $300,000 or less, primary, one to four family, condominium or co-op, not reverse mortgage | • T + 8% first liens, T + 9% second liens | Yes |
| Oakland, CA | 10/2/01 | 11/1/01** | 10/24/03 | High-Cost Home Loan† | • Owner occupied, conforming, primary, one to four family, condominium or co-op, not reverse mortgage | • FNMA 90-day rate + 3% first liens, FNMA 90-day rate + 5% second liens | No |
| Oklahoma | 5/30/03 | 1/1/04 | 10/30/03 | Subsection 10 Mortgage | • Refinance, not HELOC or reverse mortgage | • T + 8% first liens, T + 10% second liens | Yes |

*60 days after regulations are adopted. **Stayed. †As written, law includes all home loans. ‡Liability restricts conducting business with New York City. HOEPA – Home Ownership and Equity Protection Act. MH – Manufactured housing. HELOC – Home equity line of credit. T – U.S. Treasury rate. HI – Home improvement. CPI – Consumer Price Index. FNMA – Fannie Mae.

**Fitch Revises Rating Criteria in Wake of Predatory Lending Legislation**
01 May 2003 10:36 AM (EDT)

Fitch Ratings-New York-May 1, 2003: Fitch Ratings has announced its changes to its policies for addressing securitizations which contain residential loans that are subject to predatory lending legislation. Policies include application of additional credit enhancement as appropriate, which ranges from 52% to .001%, additional representations and warranties and a compliance review.

Fitch has previously indicated and confirms that it will not rate residential mortgage backed securities (RMBS) transactions which contain residential mortgage loans that are originated in jurisdictions which contain legislation that may result in unlimited purchaser or assignee liability for predatory lending practices of an originator, broker or servicer. Accordingly, the criteria announced today addresses only those transactions which Fitch will continue to rate, either because the transaction does not contain any loans subject to such legislation or the loans are subject to legislation which limits any recovery against a purchaser or assignee.

Fitch is concerned that the interpretation and implementation of new predatory lending legislation poses great challenges for issuers due to assignee and purchaser liability. These new laws have the potential to result in losses suffered by securityholders in residential mortgage backed securities (RMBS) structured finance transactions.

In order to identify the potential size of the risk presented in any particular RMBS transaction, Fitch expects the applicable documents to contain the following representation and warranty: 'All loans are originated in compliance with state, local, and federal laws.' If there are no high cost loans in the transaction, Fitch also expects the applicable documents to contain the following representation and warranty: 'No loan is a 'high cost' loan, a 'covered' loan or any other similarly designated loan as defined under any state, local, or federal law, which law contains provisions which may result in liability to the purchaser or assignee of such loan'.

On a jurisdiction by jurisdiction basis, Fitch may decide to rate RMBS transactions which contain residential mortgage loans which subject purchasers or assignees to liability, if such liability is reasonably limited. If the issuer specifies to Fitch that there are high cost loans in the proposed transaction, Fitch expects the representation and warranty from the issuer to identify the loans by: 1) type (high cost, covered, etc.), 2) quantity, 3) aggregate dollar amount, and, 4) jurisdiction. For example, Fitch expects the representation and warranty to read as follows: 'No loan is a 'high cost' loan, a 'covered' loan or any other similarly designated loan as defined under any state, local or federal law, which law contains provisions which may result in the liability [of] the purchaser or assignee of such loan, except that there are [quantity] equal to [total dollar amount] of [high cost/covered/other designation] loans originated in [jurisdiction].' In addition, each loan in the pool must be individually identified on the loan file that is transmitted to Fitch - both by type and jurisdiction.

In the event of a breach of any such representation or warranty, Fitch will expect a repurchase of the affected loan at the applicable repurchase price. The repurchase price should be equal to: 1) the outstanding indebtedness of the loan (including, but not limited to late fees), plus accrued interest, plus, 2) reasonable attorneys' fees and costs and all other damages which may be incurred by an RMBS transaction under any applicable predatory or abusive lending law. Since the repurchase of the loan will not necessarily insulate an RMBS transaction from assignee or purchaser liability, credit enhancement levels may be adjusted for those RMBS transactions which contain loans originated in jurisdictions with laws that contain such provisions.

In cases where high cost, covered or similarly designated loans in a particular jurisdiction are subject to limited assignee liability, Fitch has stated that it will rate transactions containing loans from those jurisdictions; however, each of those loans may be subject to additional credit enhancement. The additional credit enhancement is calculated by determining a severity of loss and a frequency of loss for each such loan. The severity is determined simply by analyzing the maximum amount of recovery a borrower is entitled to under the applicable legislation. Statutes are not always clear as to the maximum calculation of the recovery. For example, under the Georgia Fair Lending Act (GFLA), recoveries are limited to the sum of the remaining indebtedness outstanding on a loan plus reasonable attorney's fees. Since 'remaining indebtedness' can be interpreted to include not only the principal balance of the loan but also any late fees incurred, which may equal up to 10% of the loan balance, Fitch assumes a worst case scenario. Fitch expects that a court would not deem attorneys' fees to be reasonable if such fees were more than 100% of the remaining indebtedness of the loan. Therefore, Fitch expects the loss severity applied to each high cost loan in Georgia to be 210%.

In calculating a projected frequency, Fitch determines the likelihood of an RMBS transaction being subject to assignee liability legislation. Fitch has identified the following items in assigning its frequency factors:

1) The number of 'prohibited acts' enumerated under the statute and whether those prohibited acts are applied to all residential mortgage loans or a subset thereof;

2) Whether any safe harbor provisions exist under the statute that may protect the assignee from additional risk, such that the RMBS issuer may be subject to no liability or limited liability;

3) The potential to incorrectly categorize a loan.

Under the first frequency factor, loans subject to a high number of prohibitive acts (e.g. 'high cost' or 'covered' loans) result in an increased likelihood of a violation. These loans are subject to a higher frequency than loans which are subject to a low number of prohibitive act violations (e.g. 'home' loans).

The second frequency factor accounts for the availability of 'safe harbor' clauses. For example, under the GFLA and other pending legislation, if 'reasonable due diligence' has been performed by the assignee or purchaser in connection with its acquisition of a loan, the assignee or purchaser of such loan may not be liable for damages - or may be liable for a limited amount of damages to the borrower - even though the loan is predatory under the particular legislation. Fitch believes that assignee 'safe harbor' clauses may reduce the ability of a borrower to recover from an assignee or purchaser of a loan. Therefore, if the legislation contains safe harbor provisions which limit the exposure of the RMBS transaction to the borrower and if Fitch is comfortable that the safe harbor provisions are available to the RMBS transaction, the additional frequency assigned to a particular loan in that jurisdiction may be significantly reduced.

Finally, a third frequency risk must be addressed. This frequency factor addresses the risk that a loan was originated and presumed to be a 'home loan' (generally less likely to be a predatory loan) and was labeled as such on the data tape provided to Fitch. Due to potential errors, such as APRs being calculated incorrectly for loans in certain categories, lenders may unintentionally code a loan as a 'home loan' that is later determined to be a 'high cost' or 'covered' loan - which may ultimately subject the RMBS issuer to assignee liability. In order to protect against this risk, Fitch may assign an added frequency factor to loans originated in jurisdictions with laws that contain assignee or purchaser liability provisions.

As an example of the effect of such increased credit enhancement, a standard subprime transaction is examined. The assumed 'AAA' credit enhancement is currently 20%. If all of the loans were originated in Georgia and are 'high cost' loans under the GFLA, the required enhancement will range from 52.5% to 5.25% for loans on which no credit has been given for reasonable due diligence to a range of 5.25% to .05% for loans on which credit has been given for reasonable due diligence. If all of the loans were originated in Georgia and are 'home loans' under the GFLA, the required enhancement will range from 7.875% to .80% for loans on which no credit has been given for reasonable due diligence to a range of .08% to .01% for loans on which credit has been given for reasonable due diligence. Ranges for increased credit enhancement for 'high cost' loans in prime transactions range from 1.30% to .25% for loans on which no reasonable due diligence credit has been given, and range from .25% to .01% for loans on which reasonable due diligence credit has been given. Credit enhancement increases for all 'home loans' in prime transactions range from .02% to .01%.

Each loan's additional credit enhancement for predatory lending risk is subject to the following considerations: applicable law by jurisdiction, by product type (subprime vs. prime), strength of the originator/issuer's compliance procedures, and underwriting or due diligence review by the relevant parties (originator and/or investment bank).

As the RMBS market evolves in response to predatory lending legislation, Fitch will consider proposals which may mitigate the frequency or severity assumptions made by Fitch. For example, indemnification from a highly rated entity in favor of the RMBS transaction to cover losses suffered (by virtue of a successful predatory lending claim or a settlement with respect to such claim) in connection with mortgage loans included in an RMBS transaction. A demonstration of enhanced processes and procedures which prove to minimize losses to an RMBS transaction may also result in decreasing the potential additional credit enhancement.

These processes and procedures are expected to address two concerns. The first concern is whether a compliance review on the loans has been completed indicating that the loans are, in fact, in compliance with applicable law. The second concern is that the loan data as presented to Fitch is, in fact, a correct representation of the loans. As indicated previously, there is a concern that a loan indicated as not a high-cost loan may, in fact, actually be a high-cost loan - as a result of a mistake by the originator. These two concerns may be addressed if certain procedures are in place. If Fitch is comfortable that these concerns have been addressed, the additional credit enhancement allocated to the subject mortgage loans may be reduced. Fitch believes that steps I and II delineated below will aid in addressing these concerns.

I. An enhanced review of the originator / sponsor's compliance program will be performed once per year by Fitch to address heightened concerns on new and changing predatory legislation;

II. An enhanced review by Fitch of the due diligence practices in connection with the transfer of loans to the RMBS transaction;

It is expected that the implementation for all Fitch-rated RMBS transactions of: 1) Fitch's calculation of the extra credit enhancement required for loans subject to predatory lending legislation 2) the inclusion of the representations and warranties indicated above, and, 3) the commencement of the review of such processes and procedures as indicated in steps I and II above, will all be effective as of June 1, 2003, if applicable.

Fitch will continue to monitor anti-predatory lending legislation and provide the market with timely commentary on its rating approach.

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# Annex B

FitchRatings

Credit Policy

Special Report

# Accounting for Stock Options: Should Bondholders Care?

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## ■ Summary

The issue of how stock options should be accounted for has become particularly contentious in recent years as more companies have introduced option schemes as part of their compensation programs. The global proliferation of such plans in addition to their potentially large cost has led various accounting standards setting bodies to re-examine their standards for stock options. A recent example of this is in the U.S. where, on March 31, 2004, the Financial Accounting Standards Board (FASB) issued a long-awaited exposure draft (Proposed Standard) on accounting for stock options. Unlike previous standards, the Proposed Standard would require all public companies to recognize an expense for employee stock options using fair value estimates. Currently, companies are not required to expense employee options, although they must provide pro forma disclosure of the fair value of option grants.

Debate over mandatory expensing of stock options has largely focused on the earnings per share issues affecting equity investors. Fitch Ratings believes that bondholders also have an interest in understanding the proposal, including cash flow and balance sheet implications. Analysts at Fitch have traditionally considered the impact of employee option exercises but have viewed it primarily as a leverage issue, particularly when share repurchases are funded through debt issuance. With mandatory expensing of options imminent, Fitch's analytical approach will evolve to capture the true economic cost and the cash requirements of option programs, provided the final standard contains adequate disclosure provisions.

In reviewing the Proposed Standard, Fitch has made several observations concerning issues that could be relevant to bondholders, including:

- Because of their dilutive effect, many companies have a high propensity to repurchase shares issued upon exercise of employee stock options. In this context, from a bondholder perspective, employee options often have a true cash cost and can be thought of as a form of deferred compensation, which has the effect of reducing available cash to service debt and increasing leverage.
- Expensing of options under the proposal results in a point-in-time estimate of compensation expense that may have little or no relationship with the actual future cost. Furthermore, there is no requirement to reconcile, either after the fact or period to period, the compensation expense to actual cost.
- Adjustments may be necessary to reconcile compensation expense reported in the income statement with free cash flow.
- There may be unintended balance sheet effects, including the creation of "phantom" or intangible equity via the creation of deferred tax assets.

- The Proposed Standard advances the FASB's agenda with respect to convergence with International Financial Reporting Standards (IFRS), mirroring the provisions of IFRS No. 2 (IFRS 2).

## Overview of FASB Proposal

Expense recognition would be required under the Proposed Standard, rather than voluntary, as is currently the case. The Proposed Standard takes a multistep approach in which an estimate of the compensation cost is made at the grant date and then recognized in earnings proportionally as the options vest. Expense related to options that do not vest is therefore not recognized, but no adjustment is made for changes in the price of the underlying shares or other variables subsequent to the grant date or upon exercise of options. The FASB recommends the use of a lattice model, such as the binomial model, which incorporates expected exercise and expected postvesting employment termination behavior instead of a single weighted average term, which is inherent in the closed-end version of Black-Scholes that is currently favored.

The concept of comparability, one of the primary tenets of U.S. Generally Accepted Accounting Principles (GAAP) as expressed in the FASB's recently re-emphasized Conceptual Framework, is a key consideration behind this proposal. During 2002, beginning with companies like Coca-Cola, large corporations began adopting the income recognition provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123), which allows, but does not require, fair value recognition of options at the date of grant. Since then, over 500 publicly traded companies have chosen to voluntarily expense employee options under SFAS 123. However, there are still thousands of publicly traded companies that account for stock options under the Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), intrinsic value method, providing only pro forma disclosure of fair value option expense. This makes it necessary for investors to subtract the pro forma options expense from earnings, or add-back recognized options expense, as the case may be, in order to compare companies that are expensing to those that are not.

Furthermore, the newly promulgated IFRS 2 requires expense recognition for employee option grants, making the proposed standard consistent with the FASB's objective of convergence. IFRS 2 also requires a mathematically derived estimate of option expense to be recognized in the income statement but differs in that it does not encourage the use of one model over the other. In addition, IFRS 2 requires that deferred taxes associated with option vesting be adjusted each period for changes in share price.

## Should Bondholders Care?

From the perspective of equity investors and bondholders alike, persuasive arguments have been made in favor of expensing employee stock options as a clearly definable, if not easily measurable, operating item. For companies in highly competitive, technology-based industries, employee options have proven essential for attracting and retaining a scarce pool of talent, which can be critical to start-up enterprises. In many such cases, the use of options has made a material contribution to the expansion of shareholder value; Microsoft's liberal use of options during its period of massive growth during the late 1980s and early 1990s comes to mind. That said, employee options do not involve an immediate cash expenditure and, as such, have been viewed by some as outside the realm of traditional fixed-income analysis.

For many more mature companies, however, it is perhaps myopic to view options programs as being an entirely noncash expense and, therefore, not relevant to bondholders. The reality is that many companies manage their capital structure to meet certain leverage and earnings per share targets. Issuance of shares on exercise of options, of course, expands the number of shares. This makes it critical that the issuance of these shares be offset with active, ongoing stock repurchase programs to manage the dilutive effect of employee option exercises. Thus, within many of these more mature companies — the type of companies that are likely to have highly rated debt — employee options are viewed as being akin to a deferred expense.

Fitch believes this analysis to be correct. Essentially, the economic cost of employee options can be thought of as the opportunity cost of issuing the associated shares at a below-market price, or simply the difference between the exercise price and the market price at the date of exercise. Recognizing that issuance and repurchase may not occur simultaneously, the price at which the company actually executes the buyback may, in many cases, act as a reasonable proxy for market price at date of exercise. Indeed, in such cases the difference between the proceeds from employee option exercises and the cost of reacquiring an equivalent number of shares in the open market is the real cash cost of the option compensation. The share repurchase can be viewed as the last step in the option compensation cycle or, alternatively, the actual payment of deferred compensation. Fitch notes that this cost is, in fact, recognized in the financial statements under the current intrinsic value accounting rules. The "expense," however, makes its way straight to equity, effectively going around the income statement *(see table at right)*.

Further, one could argue that these share buybacks represent in substance, if not in form, an operating outlay that should be deducted from free cash flow. If the options are compensation whose cash cost is measured as the incremental cost of management's expressed or implied decision to maintain the level of outstanding shares, this incremental cost is most properly classified within cash flow from operations.

These effects can be seen very clearly in the financial statements of Intel for the year ended Dec. 27, 2003. Intel uses the "par value method" of accounting for shares reacquired. Under this method, par value and paid-in capital are adjusted only for the amounts at which the shares were originally issued, and the remaining cost to reacquire goes to reduce retained earnings. A large part of this reduction in retained earnings associated with the repurchase of shares — $1.3 billion in fiscal 2003 for Intel — can be viewed as the payment of deferred compensation to employees. Further, if this amount were reclassified to cash flows from operations, Intel's free cash flow to total debt ratio would be reduced by approximately 10%.

It is interesting to note that while the Proposed Standard partially rectifies the above-mentioned income statement sleight of hand, it does not acknowledge the linkage between employee options and the actual cost associated with stock repurchase programs. Nor does it recognize that funds expended to repurchase shares issued in connection with employee option exercises are properly classified as cash flows from operations. The proposal would have companies recognize an expense at time of vesting based on a model-driven estimation, but never reconcile to the actual economic cost at the date of exercise or, alternatively, to the proxy of repurchase cost. Equity would continue to be adjusted to the proxy, however, as any cash outlays to repurchase

**Current Accounting Under APB 25**
($ Mil.)

| Date | Income | Cash | Equity |
|---|---|---|---|
| 1/1/05; XYZ Grants 1 million Options Exercisable at $100/Share | — | — | — |
| 1/1/06; All Options Vest | — | — | — |
| 1/2/06; All Options Exercised | — | 100 | 100 |
| 1/3/06; XYZ Repurchases 1 million Shares at $200/Share | — | (200) | (200) |
| Total Cost Recognized | — | (100) | (100) |
| Opportunity Cost | (100) | | |

APB 25 – Accounting Principles Board Opinion No. 25.

shares over and above the estimate determined at the option grant date would reduce equity directly, bypassing the income statement. This combination of factors could create permanent and growing imbalances between cumulative net income and cash flows from operating activities for companies that continue to grant options.

## Implications for Bondholders

Fitch believes that the Proposed Standard has several potentially important implications for bondholders. These include the effects of reduced option grants on corporate leverage, the use of subjective estimates in the determination of net income with no mechanism for adjusting to actual cost, the impact on cash flow, and the potential for long-term cumulative equity distortions.

### Potential for Fewer Options May Affect Leverage

The requirement to record an incremental compensation expense under this proposal may reduce the number of options granted by many companies. This has the potential to decrease leverage, all other things being equal. Consider the typical option cycle for a large corporation, by way of a simplified example that ignores the effects of taxes *(see table above)*:

XYZ Corporation grants 1.0 million options at market to its employees on Jan. 1, 2005. The price of a share of XYZ stock at the grant date is $100. The options vest on Jan. 1, 2006. On Jan. 2, 2006, the share price for XYZ is $200. All the options are exercised, and XYZ receives cash proceeds of $100 million.

Further, on Jan. 3, 2006, XYZ repurchases 1.0 million shares in the open market for $200 million, fearing dilution of its equity and the effects on earnings per share.

As a result of issuing options to employees and then repurchasing shares to offset the effect of the exercise of those options, XYZ's leverage has increased. Why? Because the cost of reacquiring shares exceeds the proceeds from exercise (otherwise, the options would not typically be exercised). XYZ must either take this cash out of its operations, which presumably means that it must increase borrowings elsewhere, or borrow it outright. The $100 million premium that the company paid to repurchase the shares can be viewed in this context as deferred compensation, although under current accounting standards (APB 25), it flows directly to equity.

The implication of the above example for bond analysis is that if expensing of options causes companies to reduce the amount of option grants, there will be less use of leverage in the future to buy back shares. Naturally, this assumes that all other factors remain the same, and equity investors act rationally, assigning the same valuation to the company irrespective of whether options are directly expensed or just disclosed on a pro forma basis as is currently the case. To the extent investors assign a lower valuation to reflect the negative earnings of expensed options, this would raise the after-tax cost of equity capital and could shift the dynamic back toward a higher reliance on debt financing. Further, this is a simplified example that specifically assumes a rising stock price.

### Subjective, Point-in-Time Earnings Estimates with No Mechanism for Adjustment to Actual Cost

Regardless of the method chosen by companies to estimate the earnings effect of option grants, the resulting expense will be just that, an estimate; and it will vary by company. Thus, on an earnings basis comparability will remain an issue. Furthermore, the value of the estimates in predicting future cash flows associated with option exercise will vary. For example, if XYZ Corporation estimated the value of the options granted at Jan. 2, 2005 at $50 million, this amount would be added to expense at the vesting date, rather than the "real" cost of $100 million (the difference between the exercise price and the cost to repurchase these shares). *(See table above, right.)*

Under the proposal, there is no adjustment of the model-driven estimated cost of the options and their

### Accounting Under Proposed Standard

($ Mil.)

| Date | Income | Cash | Equity |
|---|---|---|---|
| 1/1/05; XYZ Grants 1 million Options Exercisable at $100/Share | — | — | — |
| 1/1/06; All Options Vest | (50) | — | * |
| 1/2/06; All Options Exercised | — | 100 | 100 |
| 1/3/06; XYZ Repurchases 1 million Shares at $200/Share | — | (200) | (200) |
| Total Cost Recognized | (50) | (100) | (100) |

*The offset to the expense is equity, but this is reversed at the end of the period when net income is closed out.

actual economic value at the time of exercise. This results in a misstatement of income of $50 million in the example. Fitch believes that the Proposed Standard should contemplate an adjustment to actual expense upon option exercise or expiration. For example, at the exercise date of Jan. 2, the actual value of the XYZ employee options becomes known with absolute precision — $100 million in the example above (the difference in the fair market value and the employee exercise price). At that point, XYZ should recognize additional compensation expense of $50 million. Alternatively, the Proposed Standard could require periodic adjustments of compensation expense to reflect the most current market data. Conversely, if the options were to reach their expiration date worthless, then the prior period expense should be reversed.

### Debt Coverage and Cash Flow Subject to Distortion

For fixed-income investors, the implication of the Proposed Standard is that the estimated expense should be stripped out of the current period earnings before interest, taxes, depreciation, and amortization calculation. Further, analysts may want to consider deducting an estimate of stock repurchase expenditures from free cash flow projections. Because of the nature of the expense — i.e. deferred compensation — it should be considered an element of cash flows from operating activities.

What amounts should the analyst deduct from cash flows from operations? Should it simply be the estimated expense over the vesting periods? Probably not, as these are point-in-time estimates and may have no relationship with the actual cost to repurchase shares in the future. In the example above, the company's actual cost was $100 million, compared with an estimated cost of $50 million at the time of vesting. A more reliable estimate of the cash outlays associated with option expense will, in most cases, be discernable by looking at historical propensity and/or stated desire to match share repurchases with option exercises, and projected prices of the entities' equity shares.

In the U.S., cash flows from operations as portrayed in the statement of cash flows will change under the new proposal. Under the Proposed Standard, tax benefits from option exercises will flow through the financing section of the statement of cash flows. Proceeds from option exercises and expenditures related to the repurchase of resulting shares will continue to flow through the financing section. However, the option expense itself will presumably be a reconciling item in cash flow from operating activities; i.e. an add-back. As such, cash flow from operations will continue to ignore the effect of deferred compensation resulting from share repurchases. The upshot of this is that credit analysts may want to consider reclassifying net repurchase cost to operating cash flows, presuming sufficient information exists to make these adjustments.

#### Potential Equity Distortions

From a bondholder perspective, it is notable that a company's balance sheet and equity may be prematurely inflated under the FASB's proposal. How so? Through the generation of a deferred tax asset that represents the timing difference between the book cost of the options and any future tax benefits that may accrue if the options are exercised. The direct offset is a commensurate uplift to paid-in capital, despite the fact no tangible equity has been raised at the time the options vest. Over time, this timing difference and the associated "phantom" equity it creates could become material, necessitating a writedown if the options expired worthless. Obviously, the degree to which this could be material will vary company to company.

### ■ Outlook

Most of the controversy around this topic has been focused on the direct impact on earnings per share and potential unintended consequences for cost of capital. While much of the attention has been on the earnings per share impact, which is largely a matter for equity investors, Fitch believes that bondholders have a stake as well.

Fitch believes that employee options have a real cost for many companies, particularly those in more mature stages of growth. The difficulty is that the true economic cost is often not known with certainty until future periods. Moreover, under the new proposal, the full economic cost may not be captured in income and operating cash flow. Analysts need to understand the implications of yet another complex, estimate-driven accounting standard. As is often the case, appropriate analytical adjustments may be needed to reconcile the bondholder's perspective with what is being reported in the financial statements. This complexity combined with the potential need to make analytical adjustments underlines the key role disclosure will play in ensuring the Proposed Standard is ultimately effective in providing fixed-income investors and analysts with the information they need.

**STATEMENT OF KENT WIDEMAN**

EXECUTIVE VICE PRESIDENT, DOMINION BOND RATING SERVICE

FEBRUARY 8, 2005

My name is Kent Wideman, Executive Vice President of Dominion Bond Rating Service (DBRS). I am pleased to submit these views on behalf of DBRS in connection with this hearing on the role of credit rating agencies in the capital markets. Because credit ratings have become such an integral part of the global financial markets, it is imperative that there be a clear understanding of how rating agencies operate, how they compete and how they should be regulated. As the only rating agency in the past 13 years to receive an NRSRO designation, DBRS is also pleased to share its unique perspective on the SEC's process for making such designations.

Based in Toronto and with offices in New York and Chicago, DBRS was founded in 1976 by Walter Schroeder, who remains the company's President. DBRS is employee-owned, is not affiliated with any other organization, and limits its business to providing credit ratings and related research. DBRS is a "generalist" rating agency, in that we analyze and rate a wide variety of institutions and corporate structures, including government bodies, and various structured transactions. At this time, we rate over 900 entities worldwide and provide credit research on another 200 companies, with most of the latter based in the United States. DBRS has a total of 113 employees, 73 of whom are analysts.

Since its inception, DBRS has been widely recognized as a provider of timely, in-depth and impartial credit analysis. Our opinions are conveyed to the marketplace using a familiar, easy-to-use letter grade rating scale. These ratings are supported by an extensive research product, which includes detailed reports on individual companies, as well comprehensive industry studies. This information is disseminated through various means, including a proprietary subscription service which is used by more than 4,500 institutional investors, financial institutions, and government bodies.

**Overview**

In order to evaluate the role of credit rating agencies in the capital markets, it is necessary to have a clear understanding of what a credit rating is and what it is not. A credit rating is an opinion regarding the creditworthiness of a company, security, or obligation. It is not an absolute predictor of whether a particular debtor will default on a particular obligation. Among the many factors DBRS considers in issuing a credit rating are: A company's financial risk profile, with particular focus on leverage and liquidity; the complexion of the industry in which the company operates and its position in that sector; quality of management; core profitability and cashflow; and other issues which may affect the creditworthiness of the issuer or instrument in question.

As part of the process, we maintain an ongoing dialogue with the managements of the companies we rate. Oftentimes, they provide us with information that may not be publicly available, and we use this information strictly for the purposes of arriving at an accurate rating decision. Prior to finalizing our decisions, we discuss our preliminary views with the company, and we allow them to review any releases prior to public dissemination to assure that our comments are accurate and that we have thoroughly considered all relevant facts. Ratings are reviewed constantly and changes are made whenever we are of the opinion that the relative creditworthiness has changed, positively or negatively.

Credit ratings are a critical assessment tool for investors in fixed-income securities or other debt instruments, as well as for issuers seeking access to the capital markets. In addition, over the past 30 years, the SEC and other State and Federal regulators have used the credit ratings issued by market-recognized credible agencies to distinguish among grades of creditworthiness of various instruments and to help monitor the risk of investments held by regulated entities. As the debt markets have grown more complex and more volatile, investors, issuers, and regulators have grown increasingly reliant on the impartial and independent ratings and credit analyses that the NRSRO's supply.

The confidence the marketplace and the regulators have placed in these rating agencies is well-deserved. Academic and industry studies uniformly show a strong correlation between credit ratings and the likelihood of default over time. We respectfully submit that a few headline-grabbing corporate failures should be seen for what they are: Aberrations caused by spectacular issuer dishonesty and not signs of structural defects in the ratings industry or the regulation thereof. Indeed, the scrutiny to which credit rating agencies have been subjected over the past 3 years has not uncovered any systemic flaws in the way NRSRO's operate. There is no need to dismantle a system that has served the capital markets so well for so long.

With this background in mind we address the specific questions the Committee has raised: (1) the transparency of the ratings process, (2) conflicts of interest, (3) NRSRO designation, and (4) appropriate regulatory oversight of rating agencies.

**Transparency**

DBRS considers transparency to be a key factor in the ratings process. In order to ensure that those who use our ratings understand the bases for our opinions, we back up each of our ratings with detailed reports. on individual companies and industries. These reports openly convey DBRS' views on both current ratings and the direction of ratings. We also hold regular seminars, investor meetings, and conference calls, all of which allow for an open and informative dialogue with the investment community.

Although DBRS believes that it is possible to accurately assess an issuer's creditworthiness using only publicly available information, it is our practice to identify any reports produced without issuer involvement, in order to provide context to subscribers and the public. Where we have ceased to rate or follow an issuer, we disclose the fact that our ratings are not current.

While DBRS is committed to disseminating its ratings and concise explanations for its reasons and methodologies publicly, we also believe that credit rating agencies should be entitled to provide more in-depth coverage and analysis to investors on a subscription basis. In order to ensure that this practice does not harm the financial markets, DBRS has adopted effective controls to prevent the selective disclosure of ratings, rating actions, and other nonpublic information to its subscribers.

**Conflicts of Interest**

Like the other NRSRO's, DBRS derives most of its revenue from fees charged to issuers and also receives fees from investors who subscribe to its credit analyses and reports. Questions have been raised as to whether this fee structure compromises the objectivity of credit ratings; in particular, whether the receipt of fees from issuers presents the potential for rating inflation.

In exploring this topic, it is important to note that the current industry fee structure is the result of the complexity of the debt markets and the desire to have credit ratings broadly disseminated to the investing public. Performing high-quality credit analysis is a costly process, and although the public wants access to credit ratings, they do not necessarily want to pay for it.[1] The only way rating agencies can afford to provide initial valuations and ongoing credit monitoring to the public is to charge the issuers whose securities they rate.

It is also important to recognize that eliminating fees from issuers would not necessarily eliminate rating agency conflicts of interest. Potential conflicts can arise from any number of relationships, including those with government bodies, regulators, investors, prospects, and financial institutions. For example, accepting fees only from investors might still compromise the objectivity of rating agencies since investors have a strong interest in maintaining high ratings on the securities in their portfolios. Moving to an exclusively subscriber-funded business model would also diminish the fairness of the markets, since only those who pay for credit ratings would have access to them. Eliminating public dissemination of ratings could cause market confusion by exposing investors to rumors of rating actions and the like.

We also note that although the current industry fee structure has been in place for decades, there is no evidence that it has had a deleterious effect on the quality of credit ratings. There are a number of reasons why this is so. Perhaps most important is the fact that rating agencies live and die by the quality of their ratings and their reputation for objectivity. The fact that credit rating agencies derive substantial fees from issuers is widely known. If an agency were seen to appease any issuer by supplying an inflated rating, the marketplace would discount that agency's opinions across its ratings universe. Such a discount would be an economic catastrophe for the rating agency. Moreover, a rating agency cannot avoid the reputational impact of any conflict of interest by concealing the reasons for its ratings, since ratings have to be transparent in order to be deemed valuable by market participants.

To safeguard their reputations and ensure the objectivity of their ratings, DBRS and the other NRSRO's have developed a range of internal controls to manage potential conflicts of interest. DBRS is independently owned; engages in no business other than producing credit ratings and related research; and no one issuer accounts

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[1] Testimony of Frank A. Fernandez, Senior Vice President, Chief Economist and Director of Research, The Securities Industry Association, SEC Hearings on the Current Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, Transcript of November 15, 2002 Session (SEC Hearings Transcript) at 110; Testimony of Glen Reynolds, CEO, CreditSights, Inc., Id. at 143.

for a significant percentage of the company's total revenues. Furthermore, all rating decisions at DBRS are determined by a committee comprised of the firm's most senior staff with input from analyst teams that produce initial rating recommendations and the rationales therefor. This collaborative process effectively neutralizes any positive or negative bias on the part of anyone individual and supports the goal of ensuring that ratings are comparable across a wide range of different sectors. In order to further eliminate an analyst's or rating committee member's individual interest in a credit analysis or valuation, DBRS prohibits its employees from purchasing any security issued by companies that it rates or otherwise follows. The company likewise refrains from buying such securities for its own account. Finally, DBRS does not compensate its analysts on the basis of any particular ratings or the amount of revenue generated from issuers within the analysts' respective areas. Rather, analyst compensation depends on the experience, skill, and quality of the analyst's work, as well as on the company's general revenues. DBRS believes that these internal policies effectively address the potential conflicts posed by the current credit rating agency fee structure.

**NRSRO Designation**

The SEC introduced the concept of "Nationally Recognized Statistical Rating Organization" or "NRSRO" in 1975, as a means of identifying ratings of market-recognized credible agencies for purposes of applying the broker-dealer net capital rule. From that modest beginning, the NRSRO concept has spread to other areas of Federal securities regulation, as well as Federal banking regulation, and various Federal and State laws. NRSRO ratings have become so firmly embedded in the U.S. capital markets that eliminating the NRSRO designation at this point would be enormously disruptive. That is not to say, however, that there is no room for improvement in the designation process.

DBRS was designated as an NRSRO in 2003, the first and only rating agency to receive such a designation since 1992.[2] In order to receive its NRSRO designation, DBRS demonstrated that it is widely accepted in the United States as an issuer of credible and reliable ratings by users of securities ratings. It also established that it has adequate staffing, financial resources, and organizational structure to ensure that it can issue credible and reliable ratings of the debt of issuers, including a sufficient number of qualified staff members and the ability to operate independently of economic pressures or control by the companies it rates. In addition, DBRS demonstrated that it uses systematic rating procedures designed to ensure credible and accurate ratings; and that it has and enforces internal procedures to prevent conflicts of interest and the misuse of nonpublic information.

Because DBRS believes that the marketplace is the best judge of what constitutes a reliable credit rating, DBRS also believes that market acceptance is a critical test for determining whether a rating agency should be designated as an NRSRO. DBRS further believes that the SEC should continue to examine whether an agency seeking NRSRO designation maintains policies and procedures reasonably designed to avoid conflicts of interest and to prevent the misuse of material, nonpublic information, and to evaluate whether a rating agency has adequate resources or other safeguards to maintain its independence from the issuers it rates. It would also be appropriate, in DBRS' view, for the Commission to evaluate an agency's commitment to transparency, by assessing the degree to which it makes its ratings publicly available and discloses the reasons for its ratings.

Although we generally support the criteria the SEC uses to designate new NRSRO's, we believe that the current practice of designating such agencies through a no-action letter process is unnecessarily cumbersome and insufficiently transparent. In lieu of the current procedure, DBRS recommends that the SEC adopt a formal application process that provides clearly articulated standards and allows for notice and the opportunity for public comment. Applicants who are not granted an NRSRO designation within a reasonable period of time should be notified of the reasons for their rejection so that they may improve their operations in the specified areas and increase their chances of submitting a successful application in the future. DBRS believes that these measures will greatly increase the transparency of the designation process and enhance investor confidence.

**Appropriate Regulatory Oversight**

Given the benefit to the financial markets of continuing to have designated NRSRO's, DBRS recognizes the need for some form of regulatory oversight on an ongoing basis. It is critical, however, that such oversight not interfere with the process by which a credit analysis is performed or a rating is issued. Whether credit

[2] The recipient of the 1992 designation subsequently merged with Fitch Ratings.

opinions are produced though traditional methods or statistical models, regulators should neither dictate how a rating is done nor define how the quality of a rating should be evaluated. Credible, reliable rating agencies may utilize different methodologies, adopt varying outlooks and reach different conclusions regarding the creditworthiness of an issuer or obligation. This richness of opinion contributes to the safety and soundness of the markets and would be lost if every NRSRO were obliged to follow the same script. Indeed, ratings diversity increases the "watchdog" function credit rating agencies play, and their ability to function independently helps to disperse their power. Furthermore, mandatory standardization of the ratings process would ossify credit risk practice and theory, thereby impeding rating agencies' ability to evolve with the natural evolution of the marketplace. Credit ratings are under constant scrutiny by market participants; the regulators should allow the market to determine whether or not an agency's credit opinions have value.

DBRS supports the recent efforts of the International Organization of Securities Commissions (IOSCO)—of which the SEC is a member—to articulate a set of high-level objectives that rating agencies, regulators, issuers, and other market participants should strive toward in order to improve investor protection and the fairness, efficiency and transparency of the securities markets, while reducing systemic risk.[3] In furtherance of these objectives, in December of last year, the IOSCO Technical Committee published a Code of Conduct Fundamentals for Credit Rating Agencies.[4] These Code Fundamentals address many of the same issues addressed in the NRSRO designation process. Most importantly, the Code Fundamentals are not rigid or formalistic; rather they are designed to afford credit rating agencies the flexibility to incorporate these measures into their internal codes of conduct according to their own business models and market circumstances.

DBRS believes that a sensible regulatory approach might include a requirement that NRSRO's adopt codes of conduct along the lines of the IOSCO Code Fundamentals. It might also be appropriate to institute some form of periodic self-assessment and/or self-certification process under which NRSRO's attest that they maintain these internal codes and that they continue to meet the NRSRO designation criteria. Such a regulatory regime would safeguard the integrity of the credit rating process and promote investor protection without having a chilling effect on the development of new credit analysis techniques and practices.

**Conclusion**

Overall, DBRS believes that the credit rating system as it exists today works well and has helped foster the growth of the financial markets globally. Improving the transparency of the NRSRO designation process and implementing an internal conduct code-based regulatory scheme would help ensure the continued success of this system. We appreciate having the opportunity to share our views with this Committee.

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[3] IOSCO Technical Committee, Statement of Principles Regarding the Activities of Credit Rating Agencies (September 2003). This document can be downloaded from IOSCO's On-Line Library at *www.iosco.org* (IOSCOPD151).

[4] IOSCO's On-Line Library.

**Credit Raters' Power Leads to Abuses, Some Borrowers Say**
BY ALEC KLEIN, WASHINGTON POST STAFF WRITER

NOVEMBER 24, 2004

Last of three articles

The letter was entirely polite and businesslike, but something about it chilled Wilhelm Zeller, chairman of one of the world's largest insurance companies.

Moody's Investors Service wanted to inform Zeller's firm—the giant German insurer Hannover Re—that it had decided to rate its financial health at no charge. But the letter went on to suggest that Moody's looked forward to the day Hannover would be willing to pay.

In the margin of the letter, Zeller scribbled an urgent note to his finance chief: "Hier besteht Handlungsbedarf."

We need to act.

Hannover, which was already writing six-figure checks annually to two other rating companies, told Moody's it did not see the value in paying for another rating.

Moody's began evaluating Hannover anyway, giving it weaker marks over successive years and publishing the results while seeking Hannover's business. Still, the insurer refused to pay. Then last year, even as other credit raters continued to give Hannover a clean bill of health, Moody's cut Hannover's debt to junk status. Shareholders worldwide, alarmed by the downgrade, dumped the insurer's stock, lowering its market value by about $175 million within hours.

What happened to Hannover begins to explain why many corporations, municipalities and foreign governments have grown wary of the big three credit-rating companies—Moody's, Standard & Poor's and Fitch Ratings—as they have expanded into global powers without formal oversight.

The rating companies are free to set their own rules and practices, which sometimes leads to abuse, according to many people inside and outside the industry. At times, credit raters have gone to great lengths to convince a corporation that it needs their ratings—even rating it against its wishes, as in the Hannover case. In other cases, the credit raters have strong-armed clients by threatening to withdraw their ratings—a move that can raise a borrower's interest payments.

And one of the firms, Moody's, sometimes has used its leverage to ratchet up its fees without negotiating with clients. That is what Compuware Corp., a Detroit-based business software maker, said happened at the end of 1999.

Compuware, borrowing about $500 million, had followed custom by seeking two ratings. Standard & Poor's charged an initial $90,000, plus an annual $25,000 fee, said Laura Fournier, Compuware's chief financial officer. Moody's billed $225,000 for an initial assessment, but did not tack on an annual fee.

Less than a year later, Moody's notified Compuware of a new annual fee—$5,000, which would triple if the company did not issue another security during the year to create another Moody's payment. Fournier said Moody's did not do anything extra to earn the fee. But the company paid it anyway—$5,000 in 2001; $15,000 a year later.

"They can pretty much charge the fees they want to," she said. "You have no choice but to pay it."

Moody's declined to comment on Compuware, but the firm said it now charges an annual flat fee of $20,000 for monitoring a corporate borrower to remove any confusion.

Dessa Bokides, a former Wall Street banker who founded a ratings advisory group at Deutsche Bank AG, said rating firms are continually finding new circumstances to extract fees. Frequently, she said, they charge clients for many different securities, even if the ratings all amount to the same thing: an assessment of a company's finances.

"They are rating every [bond issue] and charging for each [bond issue], but in reality, they are only rating the corporate" health, Bokides said. "It is a great business if you can get it."

For Moody's, the numbers add up: It rates more than 150,000 securities from about 23,000 borrowers, whose debt amounts to more than $30 trillion. Its revenue more than doubled in 4 years, to $1.25 billion in 2003, while its profit jumped 134 percent in that time.

The company said a rating costs between $50,000 and $300,000 for corporate borrowers. Moody's declined to provide a fee schedule, but according to a list obtained by The Washington Post, if it is the applicant's first rating in the past 12 months, there is an additional $33,000 fee. Then there is the monitoring fee ($20,000), a "rapid turnaround fee" ($20,000) and a cancellation fee (at least $33,000). For $50,000 more, a client can get an initial confidential rating.

S&P's fees are similar, according to a price list obtained by The Post.

The former finance chief of a major telecommunications firm was stunned when Moody's and S&P sent their initial bills. Each was six figures, not counting the annual maintenance fee. "I remember thinking their fees were outrageous," said the former executive, who spoke on the condition of anonymity for fear of angering the rating firms. When he asked his banker about the fees, the banker said, "You have to pay S&P and Moody's."

So he paid.

"Yeah, it is expensive for a few phone calls and a little analysis," the former executive said. "But guess what? Especially when you are a public company, your options are limited. Really, you have only got S&P and Moody's."

Many schools and cities take the same view. The credit companies rate their debt as well, but charge much less, typically in the thousands or tens of thousands, depending on the size of the bond offering. Still, every fee seems to count.

Louis J. Verdelli Jr., a financial adviser to school districts and other localities, knows as much. A municipality dissatisfied with a credit rater can have a difficult time getting rid of it, said Verdelli, a managing director of Public Financial Management Inc. of Philadelphia.

If, for example, a municipality stops paying a rating fee, the credit company may remove its ratings on previous bonds, which could raise questions in investors' minds and make it harder for the municipality to sell new bonds.

One investment banker in the Southwest said he encountered such a situation. Several years ago, he began representing a cash-strapped school district. Things had gotten so bad, the district raised the price of school meals.

To save money, the banker suggested that the district drop one of its two credit ratings. That would save less than $10,000, but would be better than cutting textbooks. Moody's fee was lower, so the banker decided to drop S&P. That is, until he heard from S&P. The credit rater gave him an option: Pay $5,000 for S&P's service, or it would pull all of its ratings.

The investment banker said he had no choice: He decided to pay for both ratings, which the school district continues to do. "We are just paying off Standard & Poor's, and we are costing taxpayers an additional $5,000, because we are concerned that the negative association of their pulling the rating would cost more than $5,000," he said. He spoke on the condition of anonymity, declining to identify the school district for fear of angering the credit raters.

Vickie A. Tillman, S&P's executive vice president, said, "We reserve the right to withdraw our opinion" when the firm does not have enough information to reach a conclusion, and S&P would never "compromise its objectivity and reputation" by withdrawing it for any other reason.

Some U.S. lawmakers have raised another area of concern: The credit raters have a privilege but little responsibility under a government rule that gives them access to confidential information from a company being rated.

The rating companies say they need such inside data. But when they miss financial meltdowns such as Enron Corp., WorldCom Inc. and the Italian dairy company Parmalat Finanziaria SpA, the raters argue that despite having had insider access in many cases, they cannot be blamed for investor losses because they cannot detect fraud. "The job of insuring the accuracy of those source materials belongs to auditors and regulators," said Frances G. Laserson, a Moody's spokeswoman.

Rating companies sometimes give yet another perspective about inside information. When rating a company without its cooperation, the credit raters occasionally say they do not need non-public information. They call such ratings "unsolicited;" others in the industry call it a hostile rating.

Moody's estimates that less than 1 percent of its ratings are unsolicited. Tillman said S&P rarely does unsolicited ratings, and generally only if a company borrows more than $50 million, explaining that the credit rater considers it a public service to rate major offerings. James Jockle, a Fitch spokesman, said that more than 95 percent of the companies it rates "agreed to pay our fees."

However, corporate officials, investment bankers and others familiar with the rating firms' strategies say there is a reason unsolicited ratings do not appear common: Companies approached that way by credit raters usually agree to pay a fee rather than risk a weak rating made without their cooperation.

An S&P executive, who spoke on the condition of anonymity because the firm hadn't authorized her to comment, said that S&P maintains a sales force—what it calls an "origination team"—whose goal is to improve revenue by finding companies to rate and charge a fee. "Some of it is cold calling," she said.

Northern Trust Corp., the big Chicago-based bank, said in a recent letter to the SEC that it "has been sent bills by rating agencies for ratings that were not requested by Northern, and for which Northern had not previously agreed to pay." In his letter, James I. Kaplan, then the bank's associate general counsel, continued, "On occasion, we have paid such invoices in order to preserve goodwill with the rating agency, but we feel that this practice is prone to abuse." Northern Trust declined to elaborate.

In 1996, the Justice Department looked into similar unsolicited practices by Moody's. At about the same time, a Colorado school district sued Moody's, claiming it got an unsolicited negative rating—a hostile rating—because the district had refused to buy the Moody's service. The Colorado case was dismissed in 1997, after a judge ruled the rating firm's statements about the school district were opinions protected by the First Amendment. Justice took no action, but did fine Moody's $195,000 in 2001 for obstructing justice by destroying documents during its investigation.

Fitch also has been criticized for unsolicited ratings. In the late 1990's, after being dropped as a paid credit rater of Simon Property Group Inc., the largest U.S. owner of regional shopping malls, Fitch did an unsolicited rating of the company. Some mall company officials were dismayed that Fitch did not announce that its rating was done without Simon's cooperation.

Fitch said any requirement that it disclose unsolicited ratings would "inappropriately interfere in the editorial process of the rating agencies."

When asked by The Post about unsolicited ratings, S&P's Tillman said her firm is "in the process" of changing its policies so investors will be able to tell whether they are looking at a rating done with a borrower's cooperation. Moody's said the last time it issued an unsolicited rating without identifying it as such was in 2000. And in October, the company began to publicly identify unsolicited ratings.

Greg Root, a former official of the Canadian rater Dominion Bond Rating Service Ltd. who also worked at S&P and Fitch, said that making such disclosure is important because, "when a rating agency does a rating, there is the impression there is a formal due diligence and that they get non-public information. Investors assume there is a strong ongoing dialogue."

Whether an unsolicited rating is a form of coercion to earn fees is another matter, Root said: "It is always a fine line."

Moody's danced along that line when it began its push into Europe in the late 1980's, according to former company officials. It began writing letters to European companies, saying it was planning to rate them. Moody's invited the companies to participate in the ratings process; however, if they did not, the credit rater said it felt it had adequate public information to do a rating anyway.

"That was the hook. That is where we were trying to get into the door and send them the bill," said W. Bruce Jones, now a managing director at Egan-Jones Ratings Co., a small rival of Moody's. "The implied threat was there."

Moody's took a similar approach in mid-1998 when it approached Hannover, the big German insurance company that provides insurance for other insurance companies, helping to spread the risk in the event of a major catastrophe.

Hannover had become one of the largest reinsurers in the world, with about half of its business in the United States. Insurers must be able to demonstrate to outsiders that they have the financial strength to make good on their policies. Hannover was already paying fees for that purpose to S&P and A.M. Best Co., a leader in the insurance rating industry. They had both given Hannover high ratings.

"So we told Moody's, 'Thank you very much for the offer, we really appreciate it. However, we do not see any added value,'" said Herbert K. Haas, Hannover's chief financial officer at the time.

As Haas recalls it, a Moody's official told him that if Hannover paid for a rating, it "could have a positive impact" on the grade.

Haas, now chief financial officer at Hannover's parent company, Talanx AG, laughed at the recollection. "My first reaction was, 'This is pure blackmail.'" Then he concluded that, for Moody's, it was just business. S&P was already making headway in Germany and throughout Europe in rating the insurance business. Moody's was lagging behind. And, Haas thought, Hannover represented a fast way for the credit rater to play catch-up.

Within weeks, Moody's issued an unsolicited rating on Hannover, giving it a financial strength rating of "Aa2," one notch below that given by S&P. Haas sighed with relief. Nowhere in the press release did Moody's mention that it did the rating without Hannover's cooperation. But, Haas thought, it could have been worse.

Then it got worse. In July 2000, Moody's dropped Hannover's ratings outlook from "stable" to "negative." About 6 months later, Moody's downgraded Hannover a notch to "Aa3." Meanwhile, Moody's kept trying to sell Hannover its rating service. In the fall of 2001, Zeller, Hannover's chairman, said he bumped into a Moody's official at an industry conference in Monte Carlo and arranged a meeting for the next day at the Cafe de Paris. There, the Moody's official pressed his case, pointing out that the analyst who had been covering Hannover—a man whom the insurer disliked—had left Moody's. Zeller still declined Moody's services.

Two months later, Moody's cut the insurer's rating by two more notches to "A2." In December 2002, the rating firm put Hannover on review for another possible downgrade. Somewhere along the way, Haas appealed to his boss to yield.

"I said, 'Ultimately, you cannot win against the rating agency. Let's bite the bullet and pay,'" Haas recalled. "But for Willie [Zeller], it was a matter of principle. He said, 'I am not going to pay these guys.'"

In March 2003, Moody's downgraded Hannover's financial strength rating by two notches and lowered its debt by three notches to junk status, sparking a 10 percent drop in the insurer's stock. S&P and A.M. Best, both of which were privy to the German insurer's confidential data, continued to give Hannover a high rating.

Industry analysts were confounded. "The scale of the Moody's downgrade was a surprise," said Damien Regent, an analyst at UBS AG, in a research report at the time. "There was no new information in the public domain to justify a three-notch downgrade."

Larry Mayewski, A.M. Best's executive vice president, said he thinks Moody's has been using unsolicited ratings to get companies like Hannover to buy its services.

Moody's declined to comment for this article about Hannover, but in its reports on the insurer, it said it was concerned that the German company had "high levels of financial and operational leverage" and a "high level of reinsurance recoverables" due to it. Since then, Moody's has softened its stance, raising Hannover's outlook from "negative" to "positive." But it still rates Hannover's debt as junk.

Zeller called the latest downgrade "ridiculous." But when his company's stock dropped sharply, he began to wonder whether he had any recourse.

As in the United States, lawmakers in Germany and elsewhere in Europe have taken a look at credit raters. But there has been no action. And Zeller is not optimistic about the prospects of change.

"They have built up such a franchise," he said, "it is difficult, if not impossible, to do anything against it."