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Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored
Enterprises

Committee on Financial Services
United States House of Representatives

Approaches to Improving Credit Rating Agency Regulation

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Mr. Chairman and Members of the Subcommittee: Thank you for the opportunity to testify at this important hearing on examining the need for further regulation of the credit rating agencies. My name is Robert Auwaerter, and I am the Head of the Fixed Income Group at the Vanguard Group, a mutual fund company based in Valley Forge, Pennsylvania. Vanguard is the world's largest mutual fund family, managing approximately \$1 trillion for more than 24 million investor accounts. I am responsible for the management of \$514 billion of money market and bond fund assets.

Credit ratings provided by credit rating agencies (CRA) serve a useful purpose in the financial markets. For the small investor, credit ratings provide a standardized way for investors to do an initial screen of potential investment choices for credit risk. For institutional investors they provide a consistent way to set investment parameters for credit risk, whether for use in internal management, or in the form of instructions for external investment advisors.

They also serve a constructive purpose in government regulations. The most prominent example of this is their use in the Securities and Exchange Commission Rule 2a-7 governing money market mutual funds. Nationally Recognized Statistical Rating Organization (NRSRO) ratings provide an independently established baseline for money market fund investments and are a valuable assurance to investors that money market fund investments are not subject to unnecessary risk. Independent third-party credit ratings protect investors by limiting the fund's ability to chase higher yields through riskier securities, based on their own subjective assessment. While NRSRO ratings serve as an objective and necessary qualification for buying a security, they are not sufficient on their own to warrant an investment.

Credit ratings are a starting point. Investors must do their own analysis when determining the appropriateness of an investment. Investors choose Vanguard to invest on their behalf in part because of our ability to employ significant resources toward

assessing credit risk in our fixed income portfolios. In total, Vanguard has 25 Senior Credit Analysts with over 400 years of cumulative industry experience.

It is important to recognize that in the efforts to avoid the mistakes of the past, 100% perfection and accuracy in ratings cannot be the goal. Ratings will change over time. It is not reasonable to fully anticipate every development that impairs a business model, or foresee changes in management priorities.

Vanguard believes that there is a need for further regulation of credit rating agencies. However, the focus of these efforts should be on improving the transparency and reliability of credit ratings, while at the same time, controlling and disclosing the conflicts of interest that exist in all credit rating agency business models.

Credit rating agencies provide a critical service in several different markets. For example, the ratings process for corporate borrowers such as industrial and utility companies and financial institutions must address the need to protect material non-public information from being disseminated. Currently, issuer-pay credit rating agencies will take material nonpublic information (management forecasts) into account in the ratings assessment process. The nature of the direct relationship between the corporate issuer and the rating agency governs this disclosure and protects against unwanted dissemination of material nonpublic information. We are concerned that proposals that force full disclosure of all credit rating material from corporate issuers, including nonpublic information, to all potential credit rating agencies, will end up limiting the disclosure to all credit rating agencies. Under this scenario, we would expect credit ratings to become less reliable, not more reliable.

On the other hand, we are in favor of greater and more frequent disclosure by issuers of municipal and structured finance securities. With structured finance securities, over reliance on quantitative models based on outmoded assumptions that did not take into account changes in the economic environment and the failure to use qualitative judgment played important roles in the problems in this part of the market. Structured finance, and for that matter municipal, ratings are impaired by a lack of transparency of key credit rating determinants by the issuer of the security. We would like to see greater transparency and disclosure from the issuers to the investors as a feature of improved regulations.

On the NRSRO Designation

Rating agencies provide a key public service. Regardless of the business model, the ratings product must be subject to very high standards of independence, diligence, and accountability. To serve the public interest, ratings cannot pander to either issuer or investor concerns. For this reason, Vanguard supports an increase in the authority of the SEC to provide appropriate oversight of the NRSROs.

Improved regulations and oversight for NRSROs should focus on the transparency and reliability of the ratings process. The NRSROs should be subject to regular audits that test compliance to internal procedures, the independence of rating actions, and the diligence of the ratings process. The goal of these audits should not be to regulate the actual ratings, but rather the process by which the rating agencies derived these ratings.

The NRSRO designations should be limited to CRAs that are in compliance with strict regulatory requirements. There is an opinion that by inducing greater competition into the CRA marketplace, ratings quality will automatically improve. While competition itself can be constructive, it may come at a significant cost. By artificially leveling the playing field and inducing many new participants, the market will be littered with a wider dispersion of credit ratings for issuers and structured finance transactions. It is very important that in designating a credit rating agency as a NRSRO, the SEC determines that there is sufficient analytical and operational resources to perform appropriate level of independent credit analysis. By definition, NRSRO's should have a wide market appeal and should not be niche ratings agencies focusing on narrowly defined segments of the market.

The government should not seek to remove the NRSRO designation from all regulations. The designation itself did not force an overreliance on ratings, instead the reliance on ratings stems from the market's need to baseline credit risk. The problem with the existing NRSRO process is the ineffectiveness of current NRSRO oversight. Having new rules, with the ability to pull a NRSRO designation, provides a powerful incentive for compliance.

Non-NRSRO Rating Agencies

Non-NRSRO unregulated credit rating agencies can exist in harmony with the NRSRO process. Subscribers that appreciate their value-added will elect to pay for their services. Customers that do not appreciate the value proposition should not be forced to subsidize their existence in the name of competition. If new rules focus on improving the transparency and disclosure to investors, non-NRSRO rating agencies will have adequate information to make ratings assessments, without forcing an 'even playing field' with NRSRO rating agencies.

Standing Advisory Board

The regulators should consider the creation of a standing advisory board comprised of key rating agency constituents. It could serve an important role in providing feedback on new product types, ratings performance, and regulatory proposals to both the credit rating agencies and the appropriate regulators.

Summary

In summary, credit ratings serve a useful purpose in the marketplace and in government regulations. It is important that there be improvements in both their transparency and reliability. Vanguard supports an increase in the authority of the SEC to provide oversight of the NRSROs. It must use that oversight to ensure that the credit rating agency has the appropriate resources and procedures to deliver a ratings product that meets very high standards of independence, diligence, and accountability.