STATEMENT

of

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at the

HEARING

on

APPROACHES TO IMPROVING CREDIT RATING AGENCY REGULATION

before the

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

of the

FINANCIAL SERVICES COMMITTEE

U.S. HOUSE OF REPRESENTATIVES

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Thank you for the opportunity to participate in this hearing on "Approaches to Improving Credit Rating Agency Regulation." By way of background, Realpoint is the most recent company to be designated by the SEC as a Nationally Recognized Statistical Rating Organization. We were designated for asset-backed securities and, within the structured finance market, our specialty is rating commercial mortgage-backed securities (CMBS). Realpoint has approximately 50 employees and is located in suburban Philadelphia.

I would like to begin by commenting favorably upon the legislation passed by the Congress in 2006, which was designed to improve the regulatory procedures whereby rating agencies could be given national designation by the SEC. Under the rules implementing the Credit Rating Agency Reform Act of 2006, we found the application process to be straightforward and the staff of the agency to be both professional and helpful. The Commission is continuing to propose and adopt additional rules under that Act, but, as will be discussed more fully in the course of my testimony, Realpoint is of the view that both Congress and the financial regulatory agencies need to step in once again to address the glaring failures by the major credit rating agencies which are at the heart of the current credit crisis. Actions taken by the prior and current Administrations have stabilized the situation, but lack of confidence in credit ratings continues to eviscerate the financial markets.

The CMBS market amply demonstrates the depth of this free-fall. At the height of the market, total securitizations were in the range of $150-200 billion per year. Since June, 2008, however, there have been no new issuances, and very few CMBS transactions are under consideration at this time. At the same time, there are over $150 billion of securitized commercial mortgages coming due between now and 2012.

In light of the coming wave of refinancings, it is essential that the CMBS market be reconstituted and the Term Asset-Backed Securities Lending Facility (TALF), which has recently been expanded to cover CMBS, will certainly help. In our view, however, unassisted investors both here and abroad will not return to the market until confidence in ratings has been restored through meaningful governmental intervention. The key will be to use the TALF program not just as a catalyst for restarting the market, but to use that government program as a vanguard to reform the credit rating industry.

There is no need to spend any time on causal concerns. As noted in the recent Report on Regulatory Reform of the Congressional Oversight Panel, the "major credit rating agencies played an important—and perhaps decisive—role in enabling (and validating) much of the behavior and decision making that now appears to have put the broader financial system at risk."[1] The SEC examination of issuer-paid ratings likewise found that the ratings were not merely inaccurate, but that there were serious questions about the "integrity of the ratings process as a whole."[2]

Realpoint's Business Model

Your letter of invitation asked us to describe our business model and how it differs from the issuer-pay model. Realpoint operates as an independent, subscriber-paid business which, incidentally, is how Moody's, S&P and Fitch operated for the first 75 years they were in business. This means our revenues are derived from investors, portfolio managers, analysts, broker/dealers and other market participants who pay on a quarterly or other

1 Special Report on Regulatory Reform of the Congressional Oversight Panel (January 29, 2009) at Page 40.

2 Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies by the Staff of the Securities and Exchange Commission (July, 2008).

recurring basis for our services. These services, based on post-sale data, consist of in-depth, monthly ratings reports on all current CMBS transactions (over 700). These reports include analytical performance summaries, “watch-list” alerts and other information about a rated security or the underlying collateral for that security such as the property-level reports for CMBS.

The principal difference, of course, is that the larger firms such as Moody’s, S&P and Fitch are now issuer-paid rating agencies. As such, they are paid substantial, up-front fees on the sales event by the corporations which are issuing the securities or by investment banking companies which are underwriting the transaction. Another major difference is that our monthly reports provide ongoing surveillance of the CMBS real estate securities, properties, loans and markets.

In the issuer-paid model, the compensation and the attention is focused almost exclusively on the pre-sale situation. The SEC recently published data showing that Moody’s has had to downgrade 94.2 percent of all the subprime residential mortgage backed securities it rated in 2006. We see this trend repeating itself in the CMBS market for all three of the major rating agencies. This is the equivalent of major league baseball players striking out in 19 of 20 at bats.

Realpoint’s initial ratings and ongoing analyses have been consistently lower and more stable than those of the issuer-paid rating agencies. Even during these unprecedented times, downgrades at Realpoint stand below the 30 percent level and have occurred six to 12 months sooner than the corresponding rating actions taken by our larger competitors.

The Issuer-Paid Rating Agency Bidding and Selection Process

The core problem and the most important message that I would like to leave with the Subcommittee today, is that the integrity of the ratings process is undermined by the pervasive practice of "shopping" for preliminary ratings. When issuers solicit a bid from a rating agency for new-issue rating work, the issuer requires the rating agency to provide preliminary ratings as part of that bidding process. Unlike corporate bonds and general obligation municipal bonds, which may be rated using publicly-available financial information, an initial issuance of CMBS and other structured finance bonds is rated by an agency using privately-held information disclosed on a selective basis. As a consequence, the issuer or arranger of structured finance bonds has the ability to control the ratings process of a new issue by awarding the rating contracts and its very substantial fees to rating agencies that provide favorable preliminary ratings.

The issuer generally begins the "rating shopping" process of selecting its issuer-paid rating agencies by providing data (property information and existing mortgage loan terms) to selected rating agencies. These companies then analyze the largest properties and a sample of the other properties, to provide preliminary feedback regarding proposed tranches, i.e., the subordination level attachment points, for the securities to be backed by the pool. An agency that provides unfavorable preliminary response (namely a lower rating profile) risks not being hired by the issuer.

Since higher ratings generally equate to lower borrowing costs, there is a strong inclination for the issuer to select the NRSROs that provide favorable preliminary feedback to rate the new issue. The issuer then provides these NRSROs with the remainder of the information with which to develop the final tranches. In short, the current practice of obtaining undisclosed preliminary ratings, coupled with the current reliance on issuer-paid credit ratings, fosters “ratings-shopping” and a lack of independence, accountability and integrity with respect to the new-issue ratings.

Potential Benefits from the Availability of Pre-Sale Independent Ratings

We hear much about the complexities of modern financial instruments and this is certainly the case in many instances, but the process by which the public seeks to learn the value of debt instruments, namely credit ratings, is not complex. I have just described how it works and it is not at all complicated – the parties which control the information control the end result.

The solution is equally simple and it only takes one step – let all the designated rating companies have the same information and prepare their own pre-sale ratings and reports regardless of whether or not they are ultimately paid by the issuer of the securities. This information is almost always available on a *post-sale* basis and thus the only step which the Congress or the federal regulators have to take is to mandate that issuers simultaneously disclose the information provided to its solicited rating agencies to all other SEC designated rating agencies on a *pre-sale* basis.

By requiring issuers to simultaneously disclose to all SEC-designated agencies the same information that the issuer provides to its hired rating agencies, investors will have the opportunity to receive pre-sale ratings and ratings reports from other agencies which were not hired by and who can thus be independent of the issuer. In our view, there is simply no better and more straightforward way to enhance the integrity of the ratings process than to share the information with all the agencies which the SEC has deemed of sufficient stature to be Nationally Recognized Statistical Rating Organizations.

In fact, the SEC has already proposed precisely such a rule through an amendment to its Fair Disclosure rules (Regulation FD).[3] That regulation prohibits companies from selectively disclosing material information, but it allows disclosure to a rating agency for the purpose of developing a credit rating that will be made publicly available. Realpoint supports the Commission's proposals since it would permit a company like ours to prepare pre-sale reports for the investment community. The public benefits of having six or seven independent and qualified credit ratings, rather than just the two selected and paid by the parties selling the securities, are obvious, immediate and manifest.

Specific legislation accomplishing this goal is likewise simple, and could be crafted in one paragraph as follows:

> EQUAL DISCLOSURE REQUIREMENTS.— Not later than 90 days after the date of enactment of this Act, the Securities and Exchange Commission shall revise the regulations relating to the term "Nationally Registered Statistical Rating Organization" to require: "Any issuer, underwriter, sponsor, depositor, servicer or trustee providing information to an NRSRO being solicited or paid for a credit rating for a security or money market instrument, shall simultaneously disclose such information to all NRSROs designated to develop credit ratings for that particular product."

In order to be meaningful, it is essential that the issuer-provided information also be provided in the same manner and with the same search, access and other capabilities, as it is being made available to the paid rating agency during the pre-sale process. For surveillance purposes, it is likewise critical that trustee, servicer or special servicer information also be provided simultaneously to the other eligible rating agencies, at the same time and in the

3 Re-Proposed Rules for Nationally Recognized Statistical Rating Organizations, Release No. 34-59343 (February 2, 2009), 74 Fed. Reg. 6485 (February 9, 2009), File No.: S7-04-09 [herein, "Re-Proposing Release"], Proposed Amendments to Rule 17g-5(a)(3)(iii)(B).

same manner, and with the same search, access and other capabilities as it is being made available to the issuer-paid agency.

The SEC has also proposed and we agree that the delivery of this information can be easily effectuated through a password-protected website. This is a well-established market mechanism and is used every day by investment banking firms to disseminate confidential information in merger and acquisition transactions. Doing so in the ratings context would allow every SEC designated agency sufficient time to review and analyze pre-sale information and provide pre-sale reports and ratings for each tranche of the new issue it wishes to rate. Having this information equally and more broadly shared will also allow the surveillance function to be conducted on an even more effective basis throughout the entire life cycle of the bond.

Disclosures

You have also asked about disclosure practices regarding ratings methodologies and, in this regard, many market observers have taken the position that requiring credit rating agencies to provide investors with access to their internal procedures and methodologies would constitute effective corrective action. At Realpoint, we do not believe it makes much sense to shift the burden from the rating agency's analysis of the debt issue to the public's analysis of which rating agency has the best debt analysis system. One difficulty will be to implement a uniform means by which these complex (not to mention proprietary) systems are to be made readily available and understandable in Chinese, Russian and the languages of the many other countries where investors desire to purchase dollar-denominated securities.

An issuer-paid rating agency can be paid seven to10 basis points and these fees typically exceed one million dollars for a new issue. The assignment is to produce an accurate rating from the standpoint of the investor and, once again, this is a very simple policy goal. Investors want to know if the bond is AAA or some lower grade; they are not interested in comparing different methodologies, or whether one version produces a real AAA while another results in a lesser version of AAA.

The same point applies to the question of whether ratings should be switched to numerology or whether there should be unique disclosure requirements for issuers of structured finance products such as carrying an "sf" addendum. The investment community does not want a new system; investors just want the old system to be restored to its former credibility.

Lastly on the disclosure issue, it has also been suggested by some that another "easy" answer is to have all rating agencies make their ratings publicly available in some type of time-sensitive comparability format. This simply does not work for the subscriber-based business model since selling this information is the primary source of our revenues. Realpoint and other companies like it are able to produce independent and reliable bond-rating analysis because certain investors are willing to pay for it and these subscribers rightly believe that the information for which they are paying is not made freely available to others. Not only would disclosure requirements of this type undermine competition from the subscriber-paid companies, but some have argued that the mandate to make proprietary information freely available to the public may constitute a form of government taking.

Again, the point should not be to make investors self-generate debt evaluation because the major rating agencies have failed to do the work for which they were paid. A person using the professional services of reputable companies should be able to do so without having to consult a historical cross-comparison chart. There is no reason that SEC-designated rating firms should be an exception to this rule.

If we do not produce accurate ratings at Realpoint, we lose our subscribers but under the issuer-paid model, the record shows that there are no adverse consequences for being wrong. The major rating agencies were assessing the debt of Enron, WorldCom, and Global Crossing at investment grade practically to the point of these companies' filing for bankruptcy, but in the ensuing years their profits reached record levels. The existing system does not work and, with the collapse of the credit market with trillions of dollars of losses, individuals, companies and governmental entities demand that we fix it now and fix it right.

TALF and Other Government Assistance Programs Should Mandate Reforms

Late last year, the Treasury Department, Federal Reserve and other financial regulators began implementing TALF and several other government-assisted programs intended to support the financial markets. Initially, the ratings component of TALF was limited to "major NRSROs" which meant only Moody's, S&P and Fitch. The same limitation was adopted with respect to other programs such as that backstopping the commercial paper market, which has now grown to over $250 billion.

We are pleased that the Federal Reserve is taking the steps necessary to pre-screen all rating companies for eligibility in these programs in which taxpayers' guarantees are being placed behind the collateral assets. We appreciate that these programs had to be developed and launched under stressful and time-sensitive circumstances, but it is likewise important that there be consequences for failing to perform their mission.

TALF and other comparable programs utilize the standard industry practice of requiring two ratings for the securities to be deemed suitable collateral, and there is no valid public policy reason for not insisting that at least one of these ratings be an independent, subscriber-based rating. A mandate to have TALF and other government-assistance programs include at least one independent rating agency would enhance investor confidence in those programs and set the stage ultimately for the resurrection of reliable ratings in the private sector. The American taxpayer should not have to settle for more of the "ratings shopping" syndrome that I have previously described.

Liability

A number of "reform' initiatives have focused on the judicial aspect of the ratings industry and, in particular, the First Amendment or "freedom of speech" defense which has traditionally been invoked to defeat civil claims for rating failures. Resorting to the courts for effective remedy resolution is not more of what we need in the business community. Credit ratings are opinions regarding the likelihood of payment of a financial obligation in accordance with the stated terms of the debt agreement; we are not and cannot be financial guarantors either directly or indirectly.

By way of example, at Realpoint, we have issued outstanding ratings on approximately $780 billion of CMBS. The idea that our modest company could be confronted with potential liabilities on this scale does not align with our business model. Even if we could afford it, no company would or should commit to that level of errors and omissions insurance. Whether or not the larger companies could manage that risk is for them to determine, but at Realpoint, we would be forced to surrender our SEC designation. The Credit Rating Reform Agency Act of 2006 was designed and has, in fact, fostered growth in the number of SEC-designated national rating agencies,[4] but the removal of our liability protections would have the opposite effect.

Conclusion

We have attempted to be quite candid in our presentation today. First, the integrity of the ratings process is flawed because the industry fee structure relies too heavily on the issuers and arrangers of debt offerings to control the process through the direction of fees for new issues. Second, this is not a complex problem and, in fact, it is not that different from when we were all in high school and everyone sought out the teachers who were known as "easy-graders." This is what drove the massive level of high-grade defaults during the last two years and it still driving the remainder of the pre-sale process today. Third, current industry practices place too much emphasis on new issue ratings as opposed to ongoing surveillance on what are debt obligations of ten or twenty years or even longer durations.

AAA investors abandoned the market for private asset-backed securities and they are not coming back until the system is changed. In our view, the best solution is the simple one of letting the issuers' pre-sale information be made available to all qualified rating agencies. In the short run, this can best be done through TALF and comparable programs which could be further enhanced by having their securities rated co-equally by subscriber-based rating agencies. The government can set this higher standard now and let it serve as the mark for reforming the rest of the industry over the longer term.

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[4] Among the findings on which the Credit Rating Agency Reform Act of 2006 was based was that: "the two largest credit rating agencies serve the vast majority of the market, and additional competition is in the public interest." Section 2 of the Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291 (2006).