STATEMENT

of

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at the

HEARING

on

LEGISLATIVE PROPOSALS TO IMPROVE THE EFFICIENCY OF OVERSIGHT OF MUNICIPAL FINANCE

before the

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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I appreciate the invitation to present testimony on the Committee's pending proposals to improve the oversight of the municipal finance market. These proposals include: (1) federal reinsurance; (2) a targeted liquidity program comparable to what the Federal Reserve has done in other areas of the capital markets; (3) SEC registration of municipal finance advisors; and, (4) the establishment of more specific standards for credit analysis and related functions for Nationally Recognized Statistical Rating Organizations (NRSROs).

Egan-Jones is an NRSRO and thus the last item is within our specific market niche, but all of these proposals are directly related to the performance or, more precisely, the lack of credible performance by S&P, Moody's and Fitch in the execution of their core mission to produce accurate and timely credit ratings. For example:

1. Reinsurance – Municipal bonds have the equivalent of guarantees or reinsurance from the private sector companies that successfully performed this function for years until they decided that using their AAA ratings to guarantee mortgage-backed securities was more remunerative.

2. Liquidity Programs – Until the credit markets collapsed in mid-2008, it was never necessary to have a federal backstop for debt obligations such as the Commercial Paper Funding Facility, the Money Market Investor Funding Facility, and the Term Asset-Backed Securities Loan Facility. Investors fled these markets and many others for one reason and one reason only: they were misled into thinking that the AAA ratings being given out by the nation's dominant rating agencies were accurate. These investors, particularly in foreign countries, are not coming back to

the U.S. credit market until they see the Congress or the federal financial regulatory agencies put meaningful rating agency reforms in place.

3. Regulation of Municipal Finance Advisors – In Birmingham, Alabama, municipal officials budgeted $250 million for a project that eventually ballooned into a $3.2 billion bankruptcy after Moody's and S&P downgraded the debt issue from AAA to D (for default) over a four-month period. Of course, they were misguided by their advisors, but this could not have been done if the bonds had been properly graded in the first place.

4. Modification of NRSRO Standards – These proposals are well-intentioned and may move the process in a better direction, but like many of the reforms suggested to date they share a common problem: they proceed from the erroneous premise that the major rating agencies are in the business of providing timely and accurate ratings for the benefit of investors and now taxpayers when, in fact, these companies have, for the last 35 years, been in the business of facilitating the issuance of securities for the benefit of issuers and underwriters.

Municipal Bond Market

Like all financial markets, the municipal bond markets are being adversely affected by general economic recession, but a large part of it is due to the financial deterioration of the municipal bond insurers or “monolines” as they are sometimes called. Ambac, MBIA, ACA, and FGIC have performed highly valuable services for decades as a credit enhancement tool for cities, towns and other governmental entities across the nation. The bond insurers’ problems arose in recent years, of course, from the fact that they went from enhancing relatively safe state and local obligations to the complex asset-based credit instruments which have been defaulting across the board for the last two years.

Because of this shift away from their traditional and less-risky business model, Egan-Jones issued the following rating report in 2002 that MBIA, which is the largest of the monolines, did not merit the Triple-A rating which Moody's, S&P, and Fitch accorded them.

> **MBIA INC**
> We do not view MBIA Inc. or MBIA Insurance Corp. as "AAA" credits and believe they face significant risks over the next couple of years. Major risks are: 1) Slim capital - MBI has only $5.5BB of equity (book value) compared to $490BB of guarantees, 2) Weakness in assets -Collateralized Debt Obligations and Credit Default Swaps comprise $66 billion of MBI's exposure and have suffered significant declines in market values, 3) Pressure on Municipalities - tax revenues are down thereby increasing the probability of losses, 4) Business model - if MBI is not rated "AAA" its business is likely to fall.

The earnings, capital and stock process of the monolines collapsed in late 2007, but even in 2008 when state insurance officials were actively pursuing multi-billion restructuring of these companies, our competitors were still rating them AAA.

How is it possible that the major rating agencies which have substantially more analysts than at Egan-Jones be six years behind us on a subject matter as critical as the municipal finance industry? I will come back to that subject in the course of my testimony, but the municipal finance ratings scandal is actually worse than I have already described.

From a credit quality perspective, it has always been the case that public securities have both a low probability of default and an extremely low level of anticipated loss even in the event of default. Hence, the probability of investors not receiving their payments on time and in full was minimal. Nevertheless, it is accurate to point out, as the Committee did in its Statement of May 14, 2009, that "municipal bonds with equal or lower default rates than corporate bonds have been given lower ratings by the major NRSROs."

What has happened, unfortunately, is for years, state and local issuers have been told that they should purchase insurance which they really did not need. Ironically, these public entities now find themselves scrambling to maintain marketability of their securities due to the financial weakness of the very companies which were thought to be enhancing their securities.

The municipal bond situation bears on another important point that is often overlooked in the debate over rating agencies. While this Committee has highlighted the shortcoming of the major rating agencies in the municipal bond market,[1] much of the public policy debate on the industry's performance would leave the impression that the problems have been confined to the structured finance debt such as mortgage-backed securities.

As an aside, the municipal bond debate is also a good example of the liability issue which received much discussion at the Capital Markets Subcommittee rating agency hearing earlier this week. When Egan-Jones continued to rate MBIA, we received a threatening letter from the company's Chief Executive Officer. The letter began by stating that "I find it difficult to understand how you could have an informed opinion" as to the financial strength of MBIA, but it concluded by suggesting that I refrain from making "public statements" about the company. We

[1] Hearing before the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee on "The State of the Bond Insurance Industry." 110th Cong. 2nd Sess. (Feb. 14, 2008).

declined to take this advice, but obviously we rely on the First Amendment freedom of speech protection when our modest-sized company takes on these multi-billion entities.

Federal Municipal Support

Given the state of the monoline insurers, certainly the Congress and the Administration should be working with the state insurance commissioners to develop federal support programs. As noted, TALF, TARP, and numerous related government assistance programs are in place for commercial paper, and a broad range of asset-backed securities including consumer and small-business loans, student loans, heavy industrial equipment, agricultural-equipment leases, rental-car fleets, and, most recently, commercial backed-mortgages and insurance premium loans. One can argue about the justification, costs and even structure of these programs, but there is no compelling logic for saying that some forms of credit are eligible and others are less worthy.

My personal opinion is that these programs – and there is no doubt that they have helped to stabilize the situation – must be viewed as dealing only with the symptoms of the credit crisis rather than their cause; and the cause, as well enunciated in a recent Report on Regulatory Reform of the Congressional Oversight Panel, was as follows:

> If companies issuing high-risk credit instruments had not been able to obtain AAA ratings from the private credit rating agencies, then pension funds, financial institutions, state and local municipalities, and others that relied on those ratings would not have been misled into making dangerous investments.[2]

[2] Special Report on Regulatory Reform of the Congressional Oversight Panel (January 29, 2009), p. 40.

The Minority views in that Report reached the same conclusion noting that "the credit rating agencies were caught up in the pursuit of fees."[3] I will not belabor the causal issues at this time as this Committee accorded me the privilege of testifying on previous occasions but we remain convinced that serial rating agency failures will continue to plague the credit markets until the compensation issue is addressed. As SEC Chairman Shapiro pointed out in a recent speech before the Council of Institutional Investors, "we all know that compensation drives behavior."[4] This is precisely the case, although much of the debate over credit rating agencies continues to ignore this compelling factor.

Earlier, I made the statement that the major ratings agencies are principally in the business of facilitating the issuance of securities for the benefit of issuers and underwriters. Should there be any doubt about that, here is how Harold McGraw, Chairman & CEO of McGraw-Hill, which is the owner of S&P, described that company's mission:

> "What we do is provide access to the capital market. If the markets want those kinds of products and the institutional investors want those products, then we move with the market and we're going to rate whatever." (October, 2007).

At Egan-Jones, we have a different mission and a different business model. Our revenues are produced by investors who subscribe to our services and investors want credible ratings. If our ratings are not timely and accurate, we lose our accounts.

[3] *Id*., at 71.

[4] Spring 2009 Meeting (April 6, 2009).

Issuers, on the other hand, want the highest rating possible since that reduces their funding costs. Under the issuer-paid business model, a rating agency which does not come in with the highest rating will, before long, be an underemployed ratings firm. It's that simple and all the explanations and excuses cannot refute the market evidence.

This is not an academic debate for municipalities and counties which have had to deal with the societal costs of rising foreclosures and declining tax assessments. As well summarized by the National Community Reinvestment Coalition (NCRC) in its Complaint filed with the SEC last year: "the rating agencies knowingly issued false and inflated ratings for securities backed by problematic high-cost loans that have created a financial nightmare for millions of families across the country whose homes have been lost to foreclosure or are now in jeopardy of foreclosure…" Because rating agencies are paid by the companies whose bonds they rate, the NCRC pointed out, the agencies suffer from "an inherent conflict that created one of the worst financial crisis this country has ever faced."[5]

Recommendations for Changing NRSRO Standards

With due respect to the proponents of the legislation intended to address the unfair treatment of municipal bonds, these proposals are too narrow to address the inherent and truly unmanageable rating agency conflicts lying at the core of the current multi-trillion dollar global financial crisis.   As Damon Silvers of the AFL-CIO (and a member of the Congressional Oversight Panel) indicated at the SEC's

[5] Press Release of April 8, 2008: "Civil Penalties & Equitable Relief Sought For Consumers & Communities Injured By Rating Agencies Role In Foreclosure Epidemic; SEC Urged To Suspend Licenses Of Culpable Rating Agencies."

April 15, 2009 Roundtable on Rating Agencies, the current issuer paid credit rating system is fundamentally flawed and it will take more than a tweak here and a tweak there to fix it.[6]

Professor John Grundfest of the Stanford law School has suggested a very bold approach which would call for the creation of a category of credit rating agencies called Buyer Owned and Controlled Rating Agencies (BOCRAs).[7] Because BOCRAs would be controlled by the investor community they would have powerful incentives to issue prudent, even skeptical ratings, as opposed to the current system where the compensation model promotes inflated ratings. To provide a revenue stream for these new entities under the Grundfest plan, the SEC would require that every rating by a NRSRO paid for by an issuer be accompanied by a BOCRA rating that is also paid for by the issuer.

At Egan-Jones, our reform proposals for the credit rating industry have been more modest, but they are consistent with Messrs. Silvers and Grundfest and a recent report by the Group of 30, led by Paul Volcker, which also recommended that regulators encourage the development of payment models that "improve the alignment of incentives" in the rating industry, by which is meant, of course, the alignment of interests between the ratings firms and investors and now, of course, taxpayers as well since the federal government is taking these rated assets as collateral on a non-recourse basis.

We have a free market system and the government cannot and should not compel the use of one business model over another. However, it is the role of the

[6] Statement before the SEC Roundtable on Credit Rating Agencies, Wash., DC (April 15, 2009).

[7] *Id.*

SEC and other policy makers charged with the responsibility to align these incentives and, at a minimum, to protect investors to make sure that investors and taxpayers and other users of credit ratings know whether the seller or the buyer is paying for the work product. Our specific recommendations would include the following to accomplish these goals.

1. DISCLOSURE BY RATING AGENCY

The publication of any debt rating, whether in written reports or on websites, should be accompanied by a prominent disclosure statement that indicates how the entity providing the rating was compensated. For example, if a rating agency is paid by the issuer of the securities, a securities dealer, a securities broker or any other party being compensated from the proceeds of the sale of the debt obligations being rated, this fact would be disclosed:

"IMPORTANT RATING AGENCY DISCLOSURE"

"This rating was arranged and paid for by the issuer, sponsor or underwriter of the debt obligation being rated."

If the rating agency's report is paid for by investors or any other party, it would likewise be required to disclose the generic source of its compensation.

2. DISCLOSURE BY INSTITUTIONAL MONEY MANAGERS

Fiduciaries such as mutual funds, pension funds and investment advisors currently disclose the general risk profile of a particular fund in their annual or more frequent investor reports. If the fiduciaries invest in rated debt instruments, they should also be required to disclose and describe the extent to which they rely on external ratings and whether or not those ratings were generated by rating firms compensated directly or indirectly from the sales proceeds of the debt issuance.

3. FINANCIAL REGULATORY REQUIREMENTS

Bank capital requirements, particularly after the recent adoption of the so-called Basel II revisions, rely on NRSRO ratings for purposes of prescribing appropriate capital levels. Assets with high quality ratings are subject to lower capital requirements than lesser rated and non-investment grade bonds. Financial regulatory bodies in the U.S. and abroad are increasingly concerned about the impact which inflated ratings may have on the banking system.

Since banks use external ratings to compute their capital compliance, they should also be required to disclose in their SEC and other regulatory filings the extent to which they rely on NRSRO ratings to value their bond portfolios and the rationale for this reliance, including whether or not those external ratings were generated by rating firms compensated directly or indirectly from the sales proceeds of the debt issuance.

4. RELEASE OF ISSUER INFORMATION TO ALL NRSROs

The SEC currently has proposed that any issuer or other sponsor of a security seeking a credit rating from an NRSRO provide the same financial information given to a solicited NRSRO to all other NRSROs designated to offer ratings for that particular type of security. This would be true competition in that it would allow unsolicited NRSROs to issue pre-sale and ongoing reports to the investment community.

CONCLUSION

The only real reform for the ratings industry is to return the industry to the business of representing those who invest in securities, not those who issue them. This is how the industry was structured when John Moody founded his company in the early 1900s and the same was true for S&P and Fitch. This principle of putting investors first can be reclaimed through proper incentives, proper market disclosures and through a system that promotes actual competition through the flow of information used to rate securities to all NRSROs.

Thank you for inviting Egan-Jones to testify. I would be pleased to address any questions the Committee Members may have.