

**Testimony of Raymond W. McDaniel
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**before the
United States House of Representatives
Subcommittee on Capital Markets, Insurance and
Government-Sponsored Enterprises**

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I. INTRODUCTION

Good afternoon, Chairman Kanjorski, Congressman Garrett and Members of the Subcommittee. I am Ray McDaniel, Chairman and Chief Executive Officer of Moody's Corporation ("MCO"), the parent of Moody's Investors Service. On behalf of Moody's, I would like to thank the Subcommittee for inviting me to contribute our views to the legislative discussions under way in Congress regarding the credit rating agency ("CRA") industry. Moody's supports examination of our industry that encourages best practices and the integrity of the products and services we provide.

The current economic downturn has exposed vulnerabilities in the infrastructure of the financial system. Important lessons for CRAs and other market participants have emerged from the rapid and dramatic changes. In response, we have undertaken a number of initiatives to enhance the quality, independence and transparency of our ratings.¹ These enhancements build on Moody's existing practices and processes through which we continually seek to ensure the integrity and credibility of our ratings. We also have been working to adapt, as needed, our policies, systems and organization to implement rules adopted by the Securities and Exchange Commission ("SEC") for nationally recognized statistical rating organizations ("NRSROs").

We welcome reform efforts that are likely to reinforce high quality ratings and improve market transparency without intruding on the independence of rating opinion content. We believe that some of the reform proposals – such as increasing transparency in the ratings process or reducing the use of credit ratings in regulation – likely will have a positive impact. We remain concerned, however, that other proposed measures, while well-intentioned, do not address the more fundamental vulnerabilities in credit markets and ultimately could, if implemented, reduce transparency and the availability of diverse, independent opinions. We also believe policymakers should review the weaknesses that exist in the structured finance market – in particular, the need for greater transparency and disclosure by issuers *to the investing public* of information about transaction structures and asset pools.

Moody's is committed to maintaining a productive dialogue with this Subcommittee, the entire Congress, the SEC and other regulators and market participants about the necessary steps to restore confidence in our industry and the U.S. financial system.

II. MOODY'S EFFORTS TO ADVANCE THE QUALITY, TRANSPARENCY AND INDEPENDENCE OF CREDIT RATINGS

The various contributors to the recent market crisis are by now well-chronicled, starting with the performance of U.S. sub-prime home mortgages and then of mortgage-backed and related securities originated primarily in 2006 and early 2007. Moreover, it is now clear that significant, latent vulnerabilities had been developing in the infrastructure of the global financial markets, and that once exposed, these weaknesses could, and

¹ See our update to *Strengthening Analytical Quality and Transparency*, which we began publishing in August 2008 and continue to update. It is available on moody.com.

would, have severe and reverberating consequences.²

Moody's has addressed in previous legislative and regulatory hearings the steps we took prior to and during the financial crisis to watch, warn and react.³ Like other market participants, however, we did not fully anticipate the magnitude and speed of the deterioration in mortgage quality or the suddenness of the transition to restrictive lending. We were far from alone in that regard, but we believe that we should be the leading edge for predictive opinions about future credit risks, and we have learned important lessons from that experience.

Efforts to Restore Confidence

The past two years have reminded all market participants how rapidly and dramatically markets can change. Throughout this period, Moody's has – in an effort to enhance accountability – reached out to market participants and policymakers globally for feedback regarding the utility of our ratings and ratings system. Based on the feedback we have received and our own deliberations, Moody's has adopted a wide range of measures to enhance the quality, independence and transparency of our credit ratings, including the following:

- 1) **Strengthening the analytical quality of our ratings:** including creating permanent, internal methodology review and model verification and validation processes; continuing the separation of personnel involved in initial rating assignments and surveillance; reinforcing the independence of the Credit Policy function; implementing methodological modifications; enhancing our existing professional training program; and formalizing model error discovery procedures.
- 2) **Enhancing consistency across rating groups:** including incorporating common macro-economic scenarios in rating committees; broadening cross-disciplinary rating committee participation; and improving surveillance coordination across rating groups.
- 3) **Reinforcing measures to avoid conflicts of interest:** including codifying the existing prohibition against analysts providing recommendations or advice on structuring securities; prohibiting fee discussions by ratings managers as well as analysts (who were already subject to such a prohibition); changing rating committee composition to enhance independence and objectivity; conducting “look-back” reviews when analysts leave to join organizations with potential conflicts; revising our Securities Trading Policy; retaining and reviewing complaints about analysts made by third parties; reinforcing independence and objectivity through analyst compensation policies; and adopting a stricter prohibition on Moody's analysts receiving gifts (to supplement our existing Moody's Corporation policy on this matter).

² Some of these weaknesses include exceptional leverage and business models that relied on secondary markets for liquidity of complex instruments in periods of stress; the interaction of asset valuation and capital; insufficient risk management practices; interlinked market participants; and limited transparency.

³ For example, see, April 15, 2009 Statement of Raymond W. McDaniel before the United States Securities and Exchange Commission, which is available on moodys.com.

- 4) **Improving the transparency of ratings and the ratings process:** including enhancing disclosures on incremental changes to methodologies; publishing detailed summaries of our methodologies for rating U.S. RMBS and CDOs; enhancing the review of loan originators in U.S. RMBS transactions and asking issuers for stronger representations and warranties relating to those transactions; providing additional information on structured finance ratings (V Scores, Parameter Sensitivity analysis, loss expectation and cash flow analysis, and key statistics and assumptions); enhancing disclosures regarding attributes and limitations of credit ratings in each rating announcement; pursuing efforts to discourage rating shopping; beginning to publish key statistics and default assumptions for all new structured finance ratings and for surveillance rating actions in major asset classes (including information relating to underlying pool losses); and creating a structured finance “Quick Check” Report which seeks to inform the market of our latest opinions, summaries of rating activities, methodology changes and ratings transition summaries and other key information.
- 5) **Increasing resources in key areas:** including strengthening the global leadership of the rating surveillance function; increasing the number of rating surveillance analysts; increasing the Credit Policy group’s staff; conducting a comprehensive review of our staffing model; and continuing to build out our Compliance function.

While we believe that we have made good progress with respect to augmenting the analytical framework and credibility of our ratings, we are committed to continuing to strive to enhance our policies and procedures even further.

III. PRELIMINARY COMMENTS ON DISCUSSION DRAFT OF HOUSE BILL “ACCOUNTABILITY AND TRANSPARENCY IN RATING AGENCIES ACT”

Moody’s supports reform proposals that can help restore the credibility of CRAs and help return confidence to structured finance markets. Policymakers, market participants, commentators and the CRAs themselves have offered a number of reform proposals that we believe could be constructive, if properly crafted and implemented.

In that regard, we are pleased to provide our preliminary views on the recently circulated discussion draft – “Accountability and Transparency in Rating Agencies Act” (the “**Discussion Draft**”). We will provide more detailed comments as we are able to more thoroughly analyze the Discussion Draft. We believe that it introduces a number of proposed changes in law and regulatory oversight of NRSROs that could further the objectives of accountability and transparency among CRAs. At the same time, however, we believe it also includes some areas that have the potential, if adopted in their current form, to undermine the very attributes of credit ratings that market participants and authorities value. While our remarks are preliminary, we hope that they will serve as a meaningful contribution to the discussion in Congress about the future regulation of the credit rating industry.

1. Enhanced Transparency

Moody's supports the efforts in the Discussion Draft to increase the transparency of our ratings performance and ratings methodologies and believes that such disclosures can benefit the credit markets. In our view, ratings quality can improve when market participants are able to compare the performance of ratings. As outlined above, in response to the credit crisis, we have increased the transparency of our methodologies and their risk characteristics. We support legislative efforts to continue such initiatives by requiring increased disclosures in the industry relating to information such as the assumptions used in ratings, the potential limitations of ratings, the information reviewed in the rating process and the potential volatility of the rating.

Further, we believe it may be appropriate to disclose some data, such as fees received from each rated entity, to regulatory entities. Disclosure of this data more broadly, however, may both undermine efforts to maintain analyst objectivity (Moody's currently prohibits analysts and managers from engaging in discussions regarding fees with issuers) and could also inadvertently raise antitrust issues.

2. Increased Regulatory Oversight

Moody's generally supports provisions in the Discussion Draft that would enhance oversight of all NRSROs. For example, Moody's supports language in the Discussion Draft that would establish an office within the SEC to oversee the credit rating industry. We believe that creating a dedicated office staffed by individuals with expertise in our industry will increase the focus of regulatory oversight and ensure that the interests of all market participants are well protected.

Moody's also supports language clarifying the ability of the SEC to apply fines or sanctions to NRSROs that fail to meet regulatory requirements - which we believe helps to promote accountability for CRAs.

We also welcome language requiring all NRSROs to establish governance procedures to appropriately manage conflicts of interest. While our Company already has such a policy in place, this requirement will help restore confidence in our industry by ensuring that all NRSROs are subject to enhanced regulatory oversight.

3. Removal of statutory references to credit ratings from regulation

Moody's has long been concerned about the regulatory use of ratings.⁴ In light of the rapid and dramatic market changes in the last two years, we have reevaluated and reinforced our belief on the use of such ratings. Specifically, we believe that the use of ratings as a regulatory tool for oversight of regulated entities can adversely affect the behavior of market participants, encourage both over-reliance on ratings and rating shopping and reduce incentives to compete based on the quality of ratings. We therefore

⁴ See, for example, Moody's Investors Service September 5, 2008 Comment Letter to the SEC re: References to Ratings of Nationally Recognized Statistical Rating Organizations – Files S7-17-08, S7-18-08 and S7-19-08; Moody's Investors Service July 28, 2003 Comment Letter to the SEC re: File No. S7-12-03, Concept Release: Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws; Moody's Investors Service March 2000 Response to the Consultative Paper Issued By the Basel Committee on Bank Supervision – “A New Capital Adequacy Framework”; June 1995 Speech by Moody's Former Executive Vice President Before a Forum of International Regulatory Authorities Entitled “Ratings in Regulation - A Petition to the Gorillas”.

strongly support the goal of the Discussion Draft to remove references to credit ratings in regulation. We also recognize, however, that in light of current market conditions, eliminating or reducing NRSRO ratings-based criteria should be pursued judiciously as financial markets continue to show signs of weakness. We are happy to work with Congress in developing a plan for the judicious and efficient removal of ratings.

4. Governance

Moody's supports the concept of oversight by an independent board of directors. Eight of the nine directors on Moody's Board are independent directors, as defined by the NYSE. We also support having the board provide oversight with respect to procedures and policies. From a governance point of view, we believe it can be healthy for boards to have such input and that our board members have the appropriate skill set to succeed at this type of oversight. We believe that a separate committee of independent directors within the board may be the best way to accomplish this goal. Audit Committees may serve as a good model for forming a committee charged with the oversight of rating policies and procedures.

Moody's does not believe, however, that it is appropriate for the Board to provide oversight with respect to the content of our methodologies. We are concerned with the prospect of replacing the judgment of a large body of full-time experts in credit analysis with, at best, a small body of part-time experts in credit analysis. We question how taking this mandate away from our Credit Policy Group and giving it to our Board would strengthen the quality of our ratings.

5. Liability

Moody's is opposed to provisions in the Discussion Draft that would impose a collective liability regime on all NRSROs.

As a general matter, Moody's would caution against the unintended consequences of introducing measures that could increase CRAs' exposure to litigation and liability. To begin with, there is simply no truth to the popular notion that CRAs are somehow "immune" from liability. No less than any other market participants, CRAs have potential liability, for example, if they knowingly make false statements, engage in fraudulent conduct, or issue opinions that they do not genuinely hold. Moody's and other NRSROs are in fact being sued as we speak in numerous cases in federal and state courts around the country. So, under the existing law, there is already substantial accountability.

Courts agree, however, that, given the specter of unlimited liability, and the public interest in having independent rating opinions, CRAs should not be subject to potential liability simply because some disagree with an assigned rating, or because of honest errors of judgment. Furthermore, measures that would attempt to create new standards of liability could have a negative impact on markets. It is a CRA's task to make unbiased and often unpopular observations, and it is in the nature of the business that our opinions about the future (which are not statements of fact) are often not welcomed – not by the issuers, underwriters, or current holders of the issuer's securities. At any time, therefore, some market participants are likely to be unhappy with, and eager to contest, what they perceive as the "rightness" of a particular rating.

Thus, any change in the legal regime that exposes CRAs to greater liability is likely to result in a significant increase in threatened and actual litigation, much of it driven by mere disagreement with rating opinions. (Historically, litigation pursued against CRAs has come from issuers. This indicates that pressure created by a new liability standard will likely come again from issuers who would threaten litigation in an attempt to coerce CRAs into issuing higher ratings or refrain from taking a negative rating action.) This could lead CRAs to avoid publishing controversial opinions, and issue ratings that tend to conform to market sentiment. This would clearly be an unintended and undesirable consequence of any reform recommendations as it would quash diversity of opinions and, in turn, negatively impact transparency in the markets. In addition, to the extent that CRAs would increasingly move in lock-step with the market, rating opinions would be more volatile and pro-cyclical. If ratings continue to be used in the U.S. regulatory framework, such pro-cyclical behavior could have an adverse impact on U.S. capital markets.

Finally, measures that would attempt to create new standards of liability for CRAs could lead to a greater risk of over-reliance on ratings by investors. This stems from the fact that investors may be tempted to hold the view that if a CRA is subject to heightened standards of liability and publishes an opinion in such an environment, a CRA would be expected to have considered all elements of risk for an investor, leaving the investor with a misguided comfort that a CRA's opinion on credit risk addresses all the risk elements (e.g., foreign exchange risk and currency devaluations) relevant to that investor, not just the creditworthiness about which our ratings are designed to provide an opinion.

With respect to the First Amendment issues raised by the liability provisions, I have asked our First Amendment counsel, who include Professor Laurence Tribe and Tom Goldstein, to prepare a Whitepaper that we would be happy to share with the Subcommittee.

6. Issuer Disclosure of Preliminary Ratings

Rating shopping, in structured finance as well as other credit markets, is a harmful practice engaged in by some issuers and/or subscribers. The problem exists regardless of whether issuers or subscribers pay for ratings and stems from issuers' control of the information needed to analyze an obligation and assign a rating. It occurs in situations where those paying for credit ratings do not feel constrained to seek the best quality rating by, among other things, market disciplinary forces. Opaque markets can facilitate rating shopping by limiting the ability of CRAs, other analysts and investors to: (1) assess independently the creditworthiness of issuers; and/or (2) express opinions to compete with issuer-paid or subscriber-paid ratings.

We do not believe, however, that the disclosure of preliminary ratings will in any meaningful manner deter rating shopping. As issuers become aware that preliminary ratings will be required to be disclosed, issuers will simply "shop" one stage earlier in the process. Issuers could (i) present "what if" scenarios to CRAs, thereby avoiding any trigger for disclosure; or (ii) completely bypass CRAs that are perceived to have a more conservative methodological approach. This will result in an environment where the more conservative CRAs are not provided with an opportunity to provide their credit

opinion to the market, thus leaving the market worse-off in considering only favorable preliminary and final credit ratings.

The answer to rating shopping, we believe, lies more in the solution we propose under Section IV below – that is, encouraging issuers to make more detailed information as well as ongoing performance data available to the general public at issuance.

IV. IMPROVING DISCLOSURE IN THE STRUCTURED FINANCE MARKET – A CRITICAL ELEMENT MISSING FROM THE CURRENT PROPOSALS

Similar to the analysis of corporate securities, analyzing and monitoring structured finance products is a data-intensive process. Consequently, we believe that one of the most significant steps that can be taken to restore confidence in the structured finance market is to improve the availability and quantity of underlying information for structured securities within the regulatory framework. For the reasons set out below, we hope that regulators and policymakers will adopt a more forceful, legislative approach in encouraging issuers to address the information quality problems in the structured finance market.

Unlike in the corporate market, where investors and other market participants can reasonably develop their own informed opinions based on publicly available information, in the structured finance market, there is insufficient public information to do so. Disclosure requirements for publicly offered securities do not require the public dissemination of sufficient information about the structure or underlying assets of a securitization to make reliable analysis possible. Indeed, under this limited information disclosure model, CRAs must ask for additional information to analyze and rate securities.

In the absence of sufficient data, investors are unable to conduct their own analysis and develop their own independent views about potential or existing investments. Furthermore, CRAs are practically unable to offer unsolicited ratings and research, which has the effect of restricting information available to investors and increasing the potential for rating shopping by issuers. Finally, since they are not subject to a similar degree of public scrutiny as corporate issuers, structured finance issuers may feel less responsibility for the quality of information related to their securitized products.

To address these problems in the structured finance market, Moody's believes that a legislative amendment to the Securities Act of 1933 and the Securities Exchange Act of 1934 (collectively, the "**Securities Legislation**") mandating that the SEC update the structured finance disclosure regime for all offers and sales of asset-backed securities ("**ABS**") by, as appropriate, amending existing rules and regulations (*e.g.*, Regulation AB and Rule 144A) or adopting new rules and regulations, is necessary.⁵ We recommend that the legislation outline the main categories of information that the issuer, sponsor or

⁵ The SEC is moving in the right direction and has announced that it will adopt a final rule that will require an NRSRO – that is paid by an arranger to rate a structured finance product – to disclose to other NRSROs that it is in the process of determining such a credit rating. The rule will also require the NRSRO to obtain a representation from the arranger that the arranger will provide the same information to other NRSROs seeking to rate the product. We believe that this rule should be a first step in amending the structured finance disclosure regime so that all investors have access to this information.

underwriter should disclose to investors eligible to invest in the securities in question and make available to the public. We also recommend that the Securities Legislation be amended to direct the SEC to develop requirements for issuers of ABS to disclose:

- in periodic and annual reports, updates to and material changes in the information required to have been disclosed at the time of the ABS' offer and sale;
- information about events that may take place after issuance of the securities and that are relevant to an assessment of the risks associated with buying or holding such securities, such as information regarding the performance of the underlying assets, breaches of material agreements relating to the securities and fulfilled repurchase requests; and
- any other type of information that the SEC determines, after consultation with the market, is needed to maintain a transparent structured finance market and provide investors with sufficient information to conduct a thorough analysis of the principal investment risks of the securities.

In the U.S., a significant secondary market where privately placed securities are traded among qualified purchasers (such as institutional investors) has developed for some types of structured finance securities. In addition, some types of structured finance securities that are issued under private placements are often tailored to meet the needs of specific investors and originators involved in the transaction. This tailoring process can contribute to a structured finance security's complexity. As a result, secondary market purchasers of privately placed structured finance securities can find it challenging to obtain sufficient information to make informed investment decisions. In such circumstances, they might be inclined to over-rely on credit ratings to assess risks other than credit risks. For these reasons, we recommend that information about ABS should continue to be made available generally to the market for so long as the ABS may be traded, offered, sold, purchased or otherwise transferred.

While Moody's is committed to implementing various initiatives to address shortcomings in this sector, we also believe that confidence in structured finance markets will not be restored unless the mandatory disclosure regime for structured finance products is enhanced and updated. In our view, updating the disclosure regime will yield three principal benefits:

- **Giving investors access to more information would reduce the risk of over-reliance on credit ratings.** Such access also would have the effect of enhancing investors' ability to meaningfully assess the work of CRAs.
- **Embedding enhanced information requirements in offering and ongoing performance documents intended for investors likely will improve the information about structures and assets.** This approach, which is analogous to the approach taken in corporate debt markets, aligns responsibility for information quality with the party who: (i) has the greatest control over the information in the first place; and (ii) will gain the benefit from access to the securities markets.
- **Making more information available to investors will broaden the range of opinions and analysis available, including from all CRAs.** If sufficient information is made available to investors, then it necessarily is available to those

CRAs not selected to rate a securitization. As a result, CRAs (as well as a host of other market commentators) would be in a position to offer ratings and research, which would broaden the range of information available to investors.

V. CRA BUSINESS MODEL

Some market observers remain skeptical that meaningful rating quality improvements can be achieved within the context of the issuer-pays model and some current reform proposals seek for this topic to be researched in greater depth over the next few years with a report due to policymakers on a preferred model for rating agency compensation. They maintain that the potential conflict of interest inherent in the issuer-pays model is fundamentally unmanageable. In fact, all CRA business models (investor-pays, government pays and issuer pays) have embedded conflicts that need to be properly managed. Furthermore, the greater analytical resources and the free public availability of ratings under the issuer pays model have demonstrable benefits in terms of rating quality.

During its history, Moody's has operated both under an issuer-pays model and, before that, under an investor pays model. Historical performance recorded under both models does not support the assertion that the potential conflict of interest in the issuer-pays model is unmanageable.

In fact Moody's research shows (as detailed more fully in Appendix A) that with respect to ratings on companies the issuer-pays model which Moody's has used since the early 1970s is actually associated with higher accuracy ratios,⁶ lower investment-grade loss rates, and higher downgrade rates⁷ than the investor-pays model it used prior to that time. All together, the data suggests that Moody's ratings on companies have become more accurate and less "issuer-friendly" over time. Moreover, these findings are consistent with academic studies and our own research, which have observed that our corporate rating criteria, as measured by standard credit-related accounting ratios, appear to have become more "conservative" over time.⁸

Potential Conflicts of Interest in the Investor-Pays Model

Some market participants have suggested that an investor-pays business model would have fewer potential conflicts than an issuer-pays model. We believe this presumption ignores the sources and drivers of potential conflicts of interest in the ratings business as well as the significant public policy benefits associated with the issuer-pays model.

⁶ See, "Measuring the Performance of Corporate Bond Ratings," April 2003. Accuracy ratios measure the ability of ratings to differentiate between issuers that default and those that do not default. The accuracy ratio lies between minus one and positive one, similar to a correlation statistic, and can be converted to a percentage. If all defaulters were initially assigned the lowest rating category, the accuracy ratio would approach one. If all defaulters were distributed randomly throughout the population without regard to ratings, the accuracy ratio would be zero. And, if all defaulters were initially assigned the highest rating category, the accuracy ratio would approach minus one.

⁷ *Ibid.*, discusses these benchmarks of ratings performance.

⁸ See, for example, Blume, M.E., F. Lim & A.C. MacKinlay (1998), "The Declining Credit Quality of U.S. Corporate Debt: Myth or Reality?" *Journal of Finance* 53.4, and "Maintaining Consistent Corporate Ratings Over Time," *Moody's Special Comment*, August 2008.

- ***First, investors can be just as motivated as issuers to influence ratings.*** In practice, the term “investors” is a short-hand description for any subscriber to a rating service and describes a variety of parties with vested interests in the credit ratings of securities including:
 - Short sellers: (for example, hedge funds that take a significant short position on a particular company): as subscribers under an investor-pays model, they may be highly motivated to encourage a negative rating action.
 - Long investors: similar to their short counterparts, long investors understandably are interested in the outcome of rating actions. Before they purchase a security, they may prefer to have ratings maintained or raised rather than lowered to avoid, for example, valuation markdowns or forced sales.
 - Governments: governments, often faced with competing financial market and social policy objectives, may seek to have ratings “protect” nationally, systemically or politically important issuers such as large industrial employers, banks or governments themselves. This is particularly an issue in instances where governments have stepped in to provide systemic support to such institutions, i.e., when the prudential regulator also becomes an investor.
- ***Second, there is often no clear distinction between investors and issuers.*** Investors frequently are entities that are also issuers, such as banks, insurance companies and governments.
- ***Third, shifting “who pays” will not prevent issuers from using other financial means to try to influence ratings.*** Entities seeking to influence rating actions can and have attempted to do so by challenging CRAs through commercial mechanisms unrelated to fees, such as litigation to coerce higher ratings.

Put simply, numerous parties – including investors and issuers – may want ratings assigned and maintained in a manner that is most beneficial to their interests, and those interests often may conflict with the goal of a CRA to issue an objective rating.

Given that the investor-pays business model also embeds potential conflicts, a secondary question arises. Does one business model offer superior, offsetting public policy benefits over the other? The principal benefit in the issuer-pays model is that it allows all rating actions to be released to the general public simultaneously and at no cost to investors. Larger, wealthier parties do not have an advantage over smaller rivals. The investor-pays model, however, does not allow for the public and broad disclosure of ratings. Rather, the model involves selective disclosure of information via subscription. The basis of the model, therefore, is to charge fees in return for selective access to information for those who can afford the subscription fees.

A Deal-Pays Model May Eliminate Competition

An alternative business model has been discussed in the public debate, variously referred to as a “deal-pays” or “bond surcharge” model. The principal perceived attraction of such a model is that it would automate the fee payment process by imposing some sort of surcharge on debt issuance that is thereafter allocated among CRAs. The

deal-pay model appears to “fix” the two shortcomings of the investor-pay model, in that (like the issuer-pay model) it delivers a public rating available to all for free; and, it can generate fees that can be calibrated to fund higher quality analysis.

Leaving aside the complexities of the mechanism by which the model could be made operational,⁹ the meaningful distinctions between the deal-pays model and the issuer-pays or subscriber-pays models are: a) who picks the rating agency – the government, institutional investors, or issuers; b) by what criteria is the rating agency chosen; and c) at what price is the rating agency paid? Whatever the mechanism for selecting the rating agencies, the nature of competition is changed. Rather than each rating agency competing for investors and issuers on a one-by-one basis, each CRA will seek to convince a single agent (whether a board of investors, the government, or a board of issuers) to pick the CRA for the next transaction or set of transactions. This power will lead to a similar conflict of interest as that which already exists in the other models. In fact, it may result in “lobbying” activities and greater risk of error, because it is substituting the decision of one entity (the sole decision-maker), for the decisions of many (the market).

Consequently, the deal-pays model is unique only if it ultimately allocates fees differently than the other two models, that is by determination of interested parties – whether issuers, investors or governments. To achieve that would require some form of non-judgment-based fee allocation (for example, rotational, pro rata or lottery system), with the consequence, and perhaps the goal, of eliminating competition – under a theory that if “competition” could be eliminated, so too could “conflict”. However, the elimination of competition would also likely eliminate the incentive for ratings agencies to strive to produce better quality ratings. Perhaps the negative influences of competition would be redressed, but if fees are guaranteed (or, conversely, not achievable) regardless of the quality of a CRA’s opinions, the incentive for CRAs to innovate, update and adapt methodologies to changing market conditions – i.e., to enhance ratings performance – is removed.

Moody’s has always believed that healthy competition in the CRA industry is crucial. It is the mechanism through which each participating CRA is motivated to improve. The answer is not as simple as “more competition is good and less competition is bad”; the opposite may also be true depending on circumstances. The critical question is what form of competition is being encouraged? Are rules and regulations (or the market) structurally encouraging competition for the most flattering ratings? Are they encouraging competition based on the most predictive ratings? Or are they encouraging something else entirely?

⁹ This approach introduces intriguing complexities. How will the fees be apportioned? Will fees be equally divided between all CRAs? Will CRAs be paid and therefore authorized to assign ratings on a rotation basis? Will distribution of fees be based on an arbitrary lottery system? In addition, who will be responsible for distribution of the fees? It is conceivable that whoever is authorized to distribute the fees will be similarly conflicted as those entities discussed in the models above, which would negate the underlying purpose of instituting a surcharge model. More importantly still, which CRAs will be eligible to receive such fees? Obviously, if divided only among registered CRAs, or a sub-set of registered CRAs, such a system would leave others at an extreme competitive disadvantage and create significant regulatory barriers.

We believe that the public interest is served by trying to answer the question of “how can the system encourage high quality ratings” not simply “who should pay for ratings?”

VI. CONCLUSION

Moody’s has always believed that critical examination of the CRA industry and its role in the broader market is a healthy process that can encourage best practices, support the integrity of our products and services, and allow our industry to adapt to the evolving expectations of market participants. Many necessary actions can and have been taken by Moody’s and at the industry level, and policymakers at the domestic and international levels have proposed a host of constructive reform measures for our industry and credit markets generally. Moody’s wholeheartedly supports constructive reform measures and we are firmly committed to meeting the highest standards of integrity in our rating practices, quality in our rating methodologies and analysis, and transparency in our rating actions and rating performance metrics.

I am happy to respond to any questions.

APPENDIX A

The Evolution of the Issuer-Pays Model

For over fifty years, Moody's operated under the investor-pays model before shifting to the issuer-pays model in the early 1970s. The change was made in response to several market trends, including increasing interest by investors for more in-depth and timely analysis. This more rigorous and more costly analysis could not be sustained by the fees charged to subscribers. As investors were seeking this higher quality analysis, advances in reproduction and distribution technologies were simultaneously increasing the "free rider" problem among users of ratings. This made it even more difficult to raise the required revenue from subscribers.

Moody's therefore adopted a new business model – shifting from one supported by investor fees to one based on fees from issuers – which had the impact of allowing Moody's to increase the depth and quality of its analysis. In so doing, Moody's made its ratings available to the entire public, rather than just paying subscribers. The resulting increase in revenue allowed individual rating analysts to focus on fewer credits in greater depth. At the same time, analysts were able to increase the frequency of informational meetings with both issuers and investors, allowing for a more measured approach to ratings transition as new information was incorporated into the rating on a more timely basis.

Comparing Performance: Issuer-Pays Period vs. the Investor-Pays Period Shows Higher Accuracy During the Issuer-Pays Period

This change in our business model in the early 1970s provides insight as to whether ratings quality likely would benefit from a shift away from the issuer-pays model today. In particular, we have looked into whether, after a change in our business model, our ratings performance deteriorated and whether there was any statistical evidence to suggest that Moody's analysts began to cater more directly to the interests of issuers at the expense of investors.

Performance of Corporate Finance Ratings

With respect to ratings on companies, as is shown in the table below, Moody's research demonstrates that the issuer-pays era is actually associated with higher accuracy ratios,¹⁰ lower investment-grade loss rates, and higher downgrade rates.¹¹ All together, the data suggests that Moody's ratings have become more accurate and less "issuer-friendly" over time.¹² Moreover, these findings are consistent with academic studies and

¹⁰ See, "Measuring the Performance of Corporate Bond Ratings," April 2003. Accuracy ratios measure the ability of ratings to differentiate between issuers that default and those that do not default. The accuracy ratio lies between minus one and positive one, similar to a correlation statistic, and can be converted to a percentage. If all defaulters were initially assigned the lowest rating category, the accuracy ratio would approach one. If all defaulters were distributed randomly throughout the population without regard to ratings, the accuracy ratio would be zero. And, if all defaulters were initially assigned the highest rating category, the accuracy ratio would approach minus one.

¹¹ *Ibid.*, discusses these benchmarks of ratings performance.

¹² Moody's has conducted similar research for structured finance dating from 1993-2008 (as far back as we maintain default and loss data on securitizations), but with two important limitations. First, securitization did not exist during the 1920-1970 period, so the issuer-pays vs. investor-pays comparison available for corporate ratings is not

our own research, which have observed that our corporate rating criteria, as measured by standard credit-related accounting ratios, appear to have become more “conservative” over time.¹³

While this “before and after” comparison is by no means a definitive test, it indicates that a move from an investor-pays model to an issuer-pays model does not necessarily lead to deterioration in credit standards and rating inflation as some have suggested. Indeed, it suggests that the issuer-pays model is coincident with, and may lead to higher overall ratings quality.

Comparing Corporate Rating Performance Over Time

	Investor-Pays ERA 1920-1970	Issuer Pays ERA 1971-2008	Difference
Simple averages across monthly cohorts			
1-Year Accuracy Ratio	67%	83%	16%
5-Year Accuracy Ratio	63%	68%	6%
1-Year Investment Grade Loss Rate	0.13%	0.03%	-0.1%
5-Year Investment Grade Loss Rate	1.35%	0.11%	-1.24%
Broad Rating Downgrade Rate (12 month)	5.6%	6.3%	0.7%
Weighted average, by number of issuers			
1-Year Accuracy Ratio	62%	83%	21%
5-Year Accuracy Ratio	54%	71%	17%
1-Year Investment Grade Loss Rate	0.17%	0.04%	-0.13%
5-Year Investment Grade Loss Rate	2.08%	0.13%	-1.95%
Broad Rating Downgrade Rate (12 month)	7.8%	6.6%	-1.2%

One reason that overall ratings quality may have improved is that the quality of the analysis, itself, may have improved. With the advent of the issuer-pay model, the number of credits followed by individual rating analysts declined, the frequency of informational meetings with issuers and investors increased, investments in better technological tools increased, and the frequency of rating changes all rose over time. A second reason behind the improvement in our ratings performance during this time period may be the considerable increase in both the quantity and quality of corporate issuer-disclosure and reporting.

available for structured finance. Second, the current measurement period for structured finance through mid-2008 does not capture the full impact of the current downturn on expected losses for outstanding structured finance securities. Nonetheless, for completeness we include the following table:

Structured Finance Performance Statistics (1993– 2008H1)		
	Simple averages across monthly cohorts	Weighted average, by number of issuers
1-Year Accuracy Ratio	90%	76%
5-Year Accuracy Ratio	88%	84%
1-Year Investment Grade Loss Rate	0.18%	0.42%
5-Year Investment Grade Loss Rate	0.54%	0.73%
Broad Rating Downgrade Rate (12 month)	1.9%	3.4%

¹³ See, for example, Blume, M.E., F. Lim & A.C. MacKinlay (1998), "The Declining Credit Quality of U.S. Corporate Debt: Myth or Reality?" *Journal of Finance* 53.4, and "Maintaining Consistent Corporate Ratings Over Time," *Moody's Special Comment*, August 2008.