Enhanced Accountability and Transparency in Rating Agencies Act

Response to the Discussion Draft

U.S. House of Representatives
Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises
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INTRODUCTION

I am Kurt Schacht and I am the Managing Director of the CFA Institute Centre for Financial Market Integrity. I would like to thank the Committee for inviting our organization to testify today about credit rating issues. For those of you not familiar with our organization, CFA Institute is a non-profit professional membership organization with a mission of leading the investment profession globally by setting the highest standards of ethics, education, and professional excellence. CFA Institute is most widely recognized as the organization that administers the CFA examination and awards the CFA designation, a designation held by nearly 88,000 investment professionals worldwide.

The CFA Institute Centre, which is part of CFA Institute, represents the views of investment professionals, including portfolio managers, investment analysts and advisors located in more than 130 countries worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end-users remains of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for our members and the global investment community at large through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct.*

Over the past two years, the CFA Institute Centre has responded to six domestic and international regulatory consultations, and conducted two surveys of our 100,000 members on various aspects of this debate. Our responses to these consultations have discussed, among other things, the role and responsibilities of the credit rating firms, the NRSRO process, and conflicts of interest inherent in the issuer-paid model.

Before I focus on specific areas, I would like to comment briefly on the September 25th House Discussion Draft. In general, we support many aspects of this Discussion Draft.

We certainly support calls to increase transparency, manage conflicts of interest inherent in the current issuer-pay model, and provide the SEC with strong oversight authority. The objectives this Bill seeks to achieve go far in aligning investor interests with the work of ratings agencies.

We are concerned, however, about the degree of detail presented in this Discussion Draft, finding many instances where there is an effort to legislate what is more typically (and we believe more appropriately, in this case) left to the regulatory agency to implement. For example, we question provisions to set the compensation structures for the Board and the nine subsections detailing duties of the compliance officer. Instead, we encourage a reworking of this Bill that identifies and sets objectives, and imbues the functional regulatory agency with authority to implement the details of those objectives.

Now, I would like to focus my testimony on three matters. First, I want to focus on changes that need to be made to the business models of credit rating agencies in order to better protect investor interests. Second, I will discuss the perceptions of our professional membership on the validity of, level of reliance on, and government reforms efforts to date, related to credit ratings and raters. And finally, I will touch on the problematic custom of investors' and investment firms' blind reliance on the ratings. Users have a responsibility, too.

COMMENTS

Protection of Investor Interests

Regarding the credit-rating process, users are most concerned about the conflicted nature of ratings. The CRAs did a poor job of handling the crisis and acknowledging that their role was significant in convincing many investors, who would not have otherwise invested, to buy into a mix of exotic and complex instruments that were rated triple-A. While much of this CRA activity is still under investigation, there is convincing information that firms did an inadequate job of performing their due diligence. This includes little investigation of underlying mortgage portfolios, weak testing of default risks in a booming housing market, their inability to objectively and knowledgably rate many of these brand new structured products, and that the lure of a high and sustained flow of fee income related to the manufacture, rating, and sale of mortgage paper impaired their judgment and process. In case after case, ratings were issued on collateralized and other structured instruments—ratings that were based on very limited performance data for the underlying collateral. Often there was little or no prior record of default experience or track record of performance for such instruments. All of these factors led to an extremely conflicted, low-quality product and service in the view of many. In an environment where government has required these ratings and/or certified the raters, this is unacceptable and should never be permitted to happen again.

Earlier this year, we, in cooperation with the Council of Institutional Investors, created the Investors Working Group which brought together an august panel of investors, investor advocates, and former regulators to consider these and other matters relating to financial market regulatory reform from the investor's perspective. Co-chaired by former

SEC chairmen Arthur Levitt and William Donaldson, this group considered the substantial role credit rating agencies played in the U.S. market turmoil and recommended changes for a more comprehensive and rigorous government regulatory model, complete with conflict protections and consequences for improper process and behavior. These include the following:

1. **Congress and the Administration should consider ways to encourage alternatives to the predominant issuer-pays NRSRO business model.**

The IWG suggested that the fees earned by the NRSROs should vest over a period of time equal to the average duration of the bonds. Fees should vest based on the performance of the original ratings and changes to those ratings over time relative to the credit performance of the bonds. Credit rating agencies that continue to operate under the issuer-paid model should be subject to the strictest regulation.

2. **Congress and the Administration should bolster the SEC's position as a strong, independent overseer of NRSROs.**

The SEC's authority to regulate rating agency practices, disclosures, and conflicts of interest should be expanded and strengthened. The SEC should also be empowered to coordinate the reduction of reliance on ratings.

3. **NRSROs should be required to manage and disclose conflicts of interest.**

As an immediate step, the IWG recommended that NRSROs should be required to create an executive-level compliance officer position. More complete, prominent, and consistent disclosures of conflicts of interest are also needed. And credit raters should disclose the name of any client that generates more than 10 percent of the firm's revenues.

4. **NRSROs should be held to a higher standard of accountability.**

The IWG recommended that Congress eliminate the effective exemption from liability provided to credit rating agencies under Section 11 of the Securities Act of 1933 for ratings paid for by the issuer or offering participants. This change would make rating agencies more diligent about the ratings process and, ultimately, more accountable for sloppy performance.

The IWG also believes that NRSROs should not rate products for which they lack sufficient information and expertise to assess. Credit rating agencies should only rate instruments for which they have adequate information and should be legally vulnerable if they do otherwise. This would effectively limit their ability to offer ratings for certain products. For example, rating agencies should be restricted from rating any product that has a structure dependent on market pricing.

Finally, the IWG said NRSROs should not be permitted to rate any product where they cannot disclose the specifics of the underlying assets. The IWG also recommended that credit rating agencies be restricted from taking the metrics and methodology for one class of investment to rate another class without compelling evidence of comparability.

5. Reliance on NRSRO ratings should be greatly reduced by statutory and regulatory amendments. Market participants should reduce their dependence on ratings in making investment decisions.

Many statutes and rules that require certain investors to hold only securities with specific ratings encouraged some investors to rely too heavily on credit ratings. Eliminating these requirements over time, or clarifying that reliance on the rating does not satisfy due diligence obligations, would force investors to seek additional and alternative assessments of credit risk.

The IWG report also calls for more and better oversight from the SEC, increased and substantive disclosures about conflicts of interests, a higher standard of accountability, and finally a reduced reliance on credit ratings in statutes and regulations.

I will submit a copy of this report for the record. As you will note, these recommendations support in detail or in tone a number of the provisions in the House September 29th Discussion Draft.

Perspective of the CFA Institute Membership

As a global organization, we also have been called upon to consider credit rating reform from a number of other perspectives over the past year. To help inform our positions, we have surveyed our global membership on two occasions, most recently in April of this year. In response to the questions asked in that survey, our members conveyed a lack of trust in these firms. More than 60% of the 1,182 respondents concluded that the ratings issued by credit rating agencies are not valid. A nearly identical 60% stated that they don't find that such opinions are useful in their investment decision-making processes. When asked about government regulation of CRAs, more than 70% said that additional oversight was needed. On the other hand, 51% disagreed with steps by the U.S. government to deemphasize reliance on credit ratings for investors and issuers, alike.

These results point to a number of cross-currents in this CRA debate. We are currently caught in a world that is between full government regulation of ratings and a laissez faire model of these firms being an independent service provider to issuers. Our survey results and the seeming contradictions in their responses reflect this confused picture. As it currently stands, there is a very high distrust of the credit rating process. At the same time, a significant majority say more government oversight is needed, while a slim majority disagrees with steps to remove reference to CRAs and to deemphasize their role in providing rating services regulation.

We do not intend to defend members of the CRA industry, but realize they are clearly not the only ones to blame, only the easiest. The CRAs were in the unfortunate spot of being an early and visible target in this credit mess. The complexity and interconnectedness of

this crisis are still being sorted out, but most stakeholders were fairly clear on the role played by the CRAs and how various "credits" and instruments, held out to be the triple-A gold standard rating, were now imploding.

There are a few things to consider in this regard. While the government on the one hand was criticizing CRAs and the accuracy of their ratings, the ratings on firms associated with credit rescue programs such as the mono-line insurers and others, remained unchanged despite well-known problems. It was, and continues to be, a very mixed message and one that needs to be clarified. We must not have a situation where two sets of ratings apply—one for private companies and another for when government bailout funding is involved.

Responsibility of Users

Finally, users have an important responsibility to consider in this debate. It is clear that the credit ratings themselves, accurate or not, were being absolutely misused by many investors. Users have some responsibility to understand the basis for these ratings, and to do their own analyses of the credit and other risks to match their own investment circumstances. Blind reliance on the rating as the one and only due-diligence step happened with such frequency and ease that it had become the accepted industry practice. In this sense, it was the government's endorsement and designation of NRSRO status that had the effect of a seal of approval. The fact that this unprofessional and careless practice became, in many cases, industry custom seems clear, but it must never again be acceptable practice for investment managers holding themselves out as experts. There has been much discussion about investors, in both conventional and structured products, "circling" (or purchasing) large multi-million dollar quantities, solely on the basis of a rating and without review of official investment documentation. The practice began with conventional corporate debt and carried over into the structured product market with ease. Our profession of investors and users of investment ratings must do better.

CONCLUSION

The CFA Institute Centre appreciates the opportunity to participate in these CRA hearings. We strongly believe that this area is in need of immediate reform and support Congressional action to strengthen SEC oversight, as well as to bolster efforts to improve the internal structure of credit rating agencies themselves. To that end, CFA Institute supports measures outlined in the Discussion Draft that give the SEC direct authority to review ratings and underlying methodologies, that address the management of conflicts of interest inherent in the issuer-paid business model, and that contemplate significant measures to increase transparency. CFA Institute is committed to providing our assistance to these efforts.