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Committee on Banking, Housing, and Urban Affairs
Assessing the Current Oversight and Operations of Credit Rating Agencies
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Thank you Chairman Shelby, Ranking Member Sarbanes, and members of this Committee for the opportunity to testify today. I am a law professor at the University of San Diego, where I have spent much of the past nine years studying the credit rating industry.

I. A Brief History

First, a bit of historical perspective. When I wrote my first academic article on credit rating agencies, in 1999, Moody's was not a public company and S&P was a relatively small line item at McGraw-Hill. I argued that the companies had an unfair oligopoly because of legal rules that required the use of NRSRO ratings. I also set forth evidence showing that credit ratings were "too little, too late," because they generate little information and lagged the market by months.

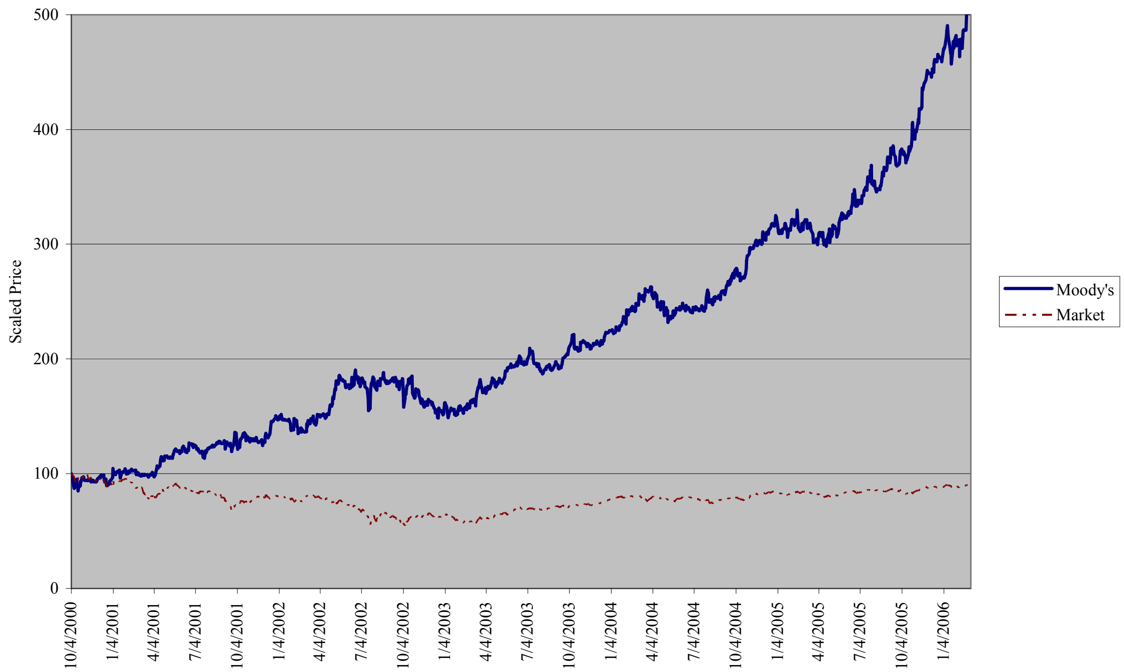
I didn't expect much of a response – academic articles rarely generate interest. But the NRSROs sent representatives to meet with me in San Diego and to dispute my findings at an academic conference. They also began a lobbying effort aimed at influencing opinion in the area. Moody's funded an academic research and advisory committee and even hired academics who had been examining NRSROs.

Not much changed until Enron collapsed in late 2001. As evidence emerged that NRSROs had played an important role, the U.S. Senate decided to examine the NRSRO process. When Senator Joseph Lieberman's staff invited me to testify before the Senate Committee on Governmental Affairs in January 2002, more than four years ago, Senators from both parties asked detailed questions about the serious problems and dangers in the credit rating industry.

Shortly thereafter, Moody's went public, with shares worth just about $4 billion, about one-seventh of the value of General Motors and less than half of the value of major financial firms such as Bear Stearns. Congress ultimately included as part of the Sarbanes-Oxley legislation a provision requiring that the SEC reexamine the NRSRO regime. I thank the members of this body, and particularly Ranking Member Sarbanes, for doing so.

Today, we have the results of that investigation, and the evidence against credit rating agencies is damning. The problems I addressed in 1999 have multiplied exponentially, Moody's and S&P are more profitable and powerful than ever, and the dangers presented by the NRSRO system are much greater than they were in 2002. Moody's shares are now worth about $20 billion, more than those of either General Motors or Bear Stearns. As the chart below shows, Moody's shares have increased in value by more than 500% since they were issued, during a period when the rest of the market was down. (Similar data is not available regarding the market value of S&P, which remains a subsidiary of McGraw-Hill.)

Moody's vs. the Market



II. Key Problems

Moody's and S&P say they are merely publishing companies and that they distribute their ratings to the public for free. But if that is right, why have they become so much more profitable?

Even a simple financial analysis shows that the NRSROs are not in the publishing business. For example, Moody's shares are worth more than the combined value of Dow Jones (publisher of the Wall Street Journal), the New York Times, the Washington Post, and Knight-Ridder, which owns dozens of publications. But Moody's has only a fraction of those firms' employees, and provides far less information.

And credit ratings certainly are not free. The costs of ratings are passed to investors who buy rated securities, which are more expensive than they otherwise would be – by billions of dollars – because issuers are effectively required to pay for ratings.

The NRSRO's increasing oligopoly profits are a dangerous sign, a symptom of an infection spreading through the financial markets. Because regulations make NRSRO ratings so important, investors have incentives to engage in dysfunctional behavior to obtain high ratings. And they pay very high fees to do so. The rating agencies are conflicted, not only because issuers pay for ratings – they also provide consulting services and threaten unsolicited ratings. The multi-trillion dollar credit derivatives industry, which is driven by NRSRO ratings and generates a large share of NRSRO profits, is opaque, volatile, and downright frightening.

Overall, the NRSRO regime poses a serious threat to the financial system. It is no coincidence that NRSRO ratings played a central role in the bankruptcy of Orange County, the collapse of Enron, and numerous other scandals.

III. <u>Potential Reforms</u>

In my view, the ideal solution would be to replace the entire NRSRO regime with one based on market measures. Every day, every hour, or even every second, the markets provide information about the risks of particular securities. Indeed, the NRSROs use these measures (albeit not very well) in determining ratings. Congress might simply replace NRSRO ratings with reasonable market-based ranges. Alternatively, any reform, including the one set forth in H.R. 2990, would benefit from including market-based measures.

H.R. 2990 is a fair compromise. It would increase competition and create incentives for rating companies that use market-based measures and/or receive fees from investors, rather than issuers. Pressure from competition will vastly improve quality control in the credit rating industry. To the extent there are market-based constraints, they should eliminate any "race to the bottom." I have seen no evidence that opening the markets to competition would be disruptive or lead to rate shopping. Instead, it is the conflicts of interest and perverse incentives associated with the current NRSRO system that pose the greatest concerns. It is possible that S&P and Moody's will continue to dominate the industry after reform, but if they do so it will be because they offer higher quality ratings in the face of competition, not because of a regulatory oligopoly.

Let me conclude by briefly mentioning three issues related to NRSRO accountability, which I believe should be part of the discussion of reform. First, federal law currently exempts NRSROs from liability for federal securities fraud. It should not. Whatever one's view of securities fraud liability in general, there is no good reason to give NRSROs special treatment.

Second, Moody's and S&P have claimed that their ratings are merely "opinions' that are protected as free speech. In my view, Congress should welcome S&P's threat to challenge the constitutionality of NRSRO legislation. If S&P did so, the federal courts finally would be able to resolve this important issue, in a careful way with appropriate context. Credit ratings are not merely opinions, any more than fairness opinions of investment banks, audit opinions of accounting firms, legal opinions of attorneys, buy/sell ratings of securities analysts, or even the certifications of financial statements made by CEOs and CFOs are mere opinions. H.R. 2990 is not unconstitutional – if it were, then much of the federal securities law system would be subject to challenges based on the First Amendment.

Third, the NRSROs have argued that they can take care of any industry problems on a voluntary basis, perhaps with the help of the SEC. But both the NRSROs and the SEC have demonstrated during the past three decades that they cannot be trusted to reform the credit rating business. The SEC created the regulatory oligopoly and the NRSROs have exploited it. The SEC did not even attempt to define "NRSRO" until recently, thirty years after it first used the term. Documents such as S&P's "code of conduct" are self-serving and toothless. NRSROs will not police their own conduct without a credible enforcement mechanism.

Our financial markets are the strongest in the world, in large part because Congress has intervened at critical moments to reshape the financial landscape. When the stock market crashed in 1929, Congress responded with important legislation, not just once but several times over a period of years. In 2002, Congress offered its first response to a wave of corporate scandals with the Sarbanes-Oxley legislation. Now is the right time for Congress to continue that response by acting to reform the crucially important credit ratings industry. Thank you again for the opportunity to give you my thoughts.

I have attached to this testimony my testimony on H.R. 2990, and three academic articles I have written on the NRSRO system. I hope this information is helpful to the Committee.