Statement of James A. Kaitz

President and CEO

The Association for Financial Professionals

Before the House Financial Services Committee

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Rating the Rating Agencies: The State of Transparency and Competition

Wednesday, April 2, 2003

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Thank you Mr. Chairman. Chairman Baker, Ranking Member Kanjorski, and members of the Subcommittee, I am Jim Kaitz, President and CEO of the Association for Financial Professionals (AFP). Thank you for the invitation to testify before the Subcommittee today. In September 2002, we conducted a survey of our members to learn their views on the quality of the information provided by rating agencies and their regulation by the Securities and Exchange Commission (SEC), the results of which I am pleased to present to you today. (I have attached the entire survey results as Appendix A.)

INTRODUCTION

AFP represents 14,000 finance and treasury professionals from over 5,000 organizations. Organizations represented by our members are drawn generally from the Fortune 1000 and the largest of the middle-market companies in a wide variety of industries.

Our members are responsible for issuing short-term and long-term debt and investing corporate cash and pension funds for their organizations. They rely on the rating agencies when their company issues debt and when they make investment decisions. As such, their relationship with the rating agencies provides them with an opportunity to form opinions on both the strengths and weaknesses of the agencies.

In September 2002, we surveyed senior-level corporate practitioners such as CFOs, vice presidents of finance, and corporate treasurers regarding the accuracy and timeliness of credit ratings, the role the SEC should take in regulating the credit rating agencies, and the impact additional competition may have on the marketplace for ratings information. We released the results of the survey in November 2002. Following the release, we presented the results to the SEC during a hearing that was held to gather information for its study on the role and function of credit rating agencies in the operation of the securities markets. In summary, the survey found that many of our members believe that:

- the information provided by credit rating agencies is neither timely nor accurate;
- the rating agencies are primarily serving the interest of parties other than investors; and
- the SEC should increase its oversight of rating agencies and takes steps to foster greater competition in the market for credit rating information.

BACKGROUND

For nearly 100 years, rating agencies have been providing opinions on the creditworthiness of issuers of debt to assist investors. In 1975, the SEC recognized Moody's, Standard & Poor's, and Fitch, the three major rating agencies in existence at that time, as the first nationally recognized statistical rating organizations (NRSRO). The SEC and other regulators use the ratings from the NRSROs to determine whether certain regulated investment portfolios, including those of mutual funds, insurance companies and banks, meet established credit quality standards. As a result, companies that hope to have their debt purchased by these portfolios must have a rating from an NRSRO. Prior to this year, the SEC had recognized four other rating agencies, but each of these new entrants merged with Fitch.

SURVEY RESULTS

A) Performance of Rating Agencies

i) Accuracy of Ratings

A significant minority of survey respondents indicate that they have reservations about the accuracy of the information provided by rating agencies. Twenty-nine percent of corporate treasury and finance professionals who work for companies with rated debt indicated that their company's ratings are inaccurate. This is true for companies that had recently been downgraded, as well as for those that were recently upgraded.

Corporate investors also shared the concerns of debt issuers regarding the accuracy of credit ratings. Only 65 percent of corporate respondents that use credit ratings to make investment decisions believe that the ratings of the companies in which they invest are accurate.

While credit ratings are supposed to reflect a creditor's ability to service and repay debt, one third of treasury and finance professionals from companies with rated debt believe that their company's rating is more reflective of the industry in which it operates than the company's finances. Fewer than one of five respondents believes their company's ratings are more reflective of the company's finances, while more than two of five respondents believe that their company's ratings are reflective of a balance of the company's finances and the industry.

ii) Timeliness of Ratings

A majority of both debt issuers and investors also indicate that they believe ratings do not reflect changes in a company's finances in a timely manner. Only forty percent of companies with rated debt believe that their ratings have been changed in a timely manner. Nearly three of five respondents from companies that have seen their debt upgraded indicate that the change took place more than six months after the improvement in the company's financials. While more timely than upgrades, downgrades still took more than six months to reflect a deterioration in a company's financial condition according to twenty-seven percent of respondents. Many investors also question the timeliness of the information provided by credit ratings; less than 40 percent of respondents that use credit ratings for investment decisions agree that credit ratings are timely.

iii) Assisting Investors

Rating agencies exist to provide tools for the investing public. However, only twenty-two percent of respondents believe the ratings most favor the interests of investors in debt. Treasury and finance professionals instead believe the ratings favor other interests. Fifteen percent of respondents believe the ratings most favor issuers of debt, while another 15 percent of corporate practitioners believe rating agency ratings most favor either commercial or investment banks. Financial professionals from companies that do not issue rated debt are even more skeptical about who the rating agencies favor.

B) Role of the SEC

i) Recognition of NRSROs

AFP members believe that the SEC plays an important role in overseeing the rating agencies. The overwhelming majority of respondents indicate that the SEC should take additional steps in its oversight of the rating agencies. Through its recognition of the NRSROs, the SEC determines which rating agencies are acceptable for purposes of assessing credit risk in certain regulated portfolios. Fifty-seven percent of corporate practitioners believe that it is appropriate for the SEC to continue its role in determining which rating agencies are acceptable. Only 18 percent of respondents disagree with the SEC's role. More telling is that 91 percent of respondents believe that the SEC should take additional steps in its oversight of the rating agencies.

Currently, there is no clearly defined process for credit agencies to achieve Nationally Recognized Statistical Rating Organization (NRSRO) status. Without a clear process and the possibility that other agencies may be recognized, there is little motivation for recognized rating agencies to improve their performance. Sixty-five percent of corporate practitioners believe the SEC should clarify its procedures for rating agencies to be recognized as NRSROs.

Granting NRSRO status to other credit rating agencies would provide additional competition that could result in improved accuracy and timeliness of ratings. In our survey, twenty-three percent of treasury and finance professionals supported the immediate recognition of at least one rating agency that was conducting business without NRSRO status. They believe that the additional competition stimulated by the recognition of additional rating agencies would increase both the accuracy and timeliness of credit ratings and ultimately lead to greater certainty in the assessment of corporate credit risk. Nearly three of five respondents believe the recognition of additional rating agencies would improve the quality of ratings and reduce the time it typically takes the rating agencies to account for material financial changes in their ratings.

ii) Oversight of NRSROs

Once the SEC recognizes a rating agency as an NRSRO, there is currently no ongoing process to ensure the agency's methodologies and procedures continue to be appropriate. Survey respondents believe a periodic review of the rating agencies is necessary. Seventy-three percent of corporate practitioners believe that the SEC should periodically review the rating agencies it currently recognizes, for example, every five years.

CONCLUSION

AFP believes that our survey results clearly show that the time has come to re-examine the role, function and regulation of credit rating agencies. We are encouraged by the SEC's report that was delivered to Congress in January and the issues it identified for further examination. Many of those issues are consistent with the findings of our survey. We look forward to reviewing and commenting on the SEC's concept release when it is published.

We are also encouraged by the SEC's recognition of Dominion Bond Rating Service as a fourth Nationally Recognized Statistical Rating Organization (NRSRO). As I mentioned, our members expect additional competition to improve the accuracy and timeliness of the ratings. These improvements will provide greater certainty in assessing corporate credit risk.

Recent SEC actions are important first steps in addressing concerns about the accuracy and timeliness of the information provided by credit rating agencies. AFP believes that the credit rating agencies are vital to the efficient operation of capital markets and is pleased that you have taken the lead in examining these issues. We hope that this hearing will bring to light opportunities to increase competition in the market for credit ratings and improve the quality of the information provided by credit rating agencies for the benefit of issuers and investors in the securities markets.

Appendix A

RATING AGENCIES SURVEY:
Accuracy, Timeliness, and Regulation

RATING AGENCIES SURVEY:
Accuracy, Timeliness, and Regulation

Report of Survey Results

November 2002

Association for Financial Professionals

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Introduction

For nearly 100 years, rating agencies have been providing opinions on the creditworthiness of issuers of debt to assist investors. The Securities and Exchange Commission (SEC) and banking regulators also rely on ratings from rating agencies. In 1975, the SEC recognized Moody's, Standard & Poor's, and Fitch, the three major rating agencies in existence at that time, as the first nationally recognized statistical rating organizations (NRSRO). The SEC and other regulators use the ratings from the NRSROs to determine whether certain regulated investment portfolios, including those of mutual funds, insurance companies and banks, meet established credit quality standards. As a result, companies that hope to have their debt purchased by these portfolios must have a rating from an NRSRO. Since 1975, the SEC has recognized four other rating agencies, but each of these entrants has merged with Fitch leaving only the original three agencies. No new agencies have been recognized since 1992.

Some market participants have argued that the NRSROs did not adequately warn investors of the impending failure of Enron, Worldcom, and other recently bankrupt companies. For example, in 2001, the rating agencies continued to rate the debt of Enron at "investment grade" levels days before the company filed for bankruptcy. An October 2002 Senate Governmental Affairs Committee report on financial oversight specifically criticizes the failure of the NRSROs to take action in the case of Enron. **{See Appendix B for background information.}**

Treasury and finance professionals rely on the NRSROs when their company issues debt and when they make investment decisions. Their relationship with the NRSROs provides them with an opportunity to form opinions on both the strengths and weaknesses of the agencies' practices. In September 2002, the Association for Financial Professionals surveyed senior level corporate practitioners and financial industry service providers on their views regarding the quality of the NRSROs' ratings, the role the SEC should take in regulating the agencies, and the impact additional competition may have on the marketplace for ratings information.

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Executive Summary

Treasury and finance professionals, concerned with the quality and timeliness of credit ratings, believe the SEC should take additional action to improve its oversight of ratings agencies and foster greater competition. Nearly a third of corporate practitioners believe their company's ratings are inaccurate. Further, most respondents identify several other major problems that adversely affect their trust in the ratings. For example, most respondents do not believe changes in their company's finances are promptly reflected in the ratings. Many respondents also believe that their company's ratings are more reflective of the industry in which their company operates rather than the company's financial condition. Finally, most treasury and finance professionals do not believe the ratings favor the interests of investors in debt.

A significant minority of treasury and finance professionals believe that their company's credit ratings are inaccurate.

- Twenty-nine percent of practitioners who work for companies with rated debt believe that their company's ratings are inaccurate. Sixty-five percent of respondents believe that their company's ratings are accurate.

Most respondents do not believe changes in their company's finances are promptly reflected in the ratings.

- Only 40 percent of practitioners who work for companies with rated debt believe that changes in their company's ratings are timely. Further, most respondents believe ratings upgrades take longer to occur compared to ratings downgrades.
- Thirty-seven percent of corporate practitioners who use credit ratings for investment decisions feel that changes in the ratings are timely, with 43 percent of financial industry service providers holding similar views.

Treasury and finance corporate practitioners are more likely to believe that their company's ratings are reflective of the industry in which their company operates rather than their company's financial performance.

- Twice as many respondents believe that their company's credit ratings are more reflective of the industry in which it operates rather than of their company's finances (33 percent versus 17 percent).
- Forty-three percent of respondents believe their company's ratings reflect a balance between their company's finances and the industry.

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Despite the fact that rating agencies are supposed to support the information needs of investors in debt, relatively few treasury and finance professionals believe the ratings favor the interests of investors.

- Only 22 percent of treasury and finance corporate practitioners believe the ratings favor the interests of investors in debt while 13 percent believe that the rating agencies balance the interests of all stakeholders, including debt issuers and commercial and investment banks. Rather, most respondents believe the ratings agencies serve other stakeholders—including 15 percent who believe ratings favor the interests of debt issuers—or are not sure whose interests the ratings represent.
- Only 11 percent of financial industry service providers believe ratings favor the interests of investors in debt, while 13 percent believe the ratings favor the interests of issuers of debt. Ten percent believe rating agencies balance the interests of all stakeholders. Nearly half of financial industry service providers are not sure whose interests the ratings favor.

A majority of treasury and finance professionals believe that it is appropriate for the Securities and Exchange Commission to identify "acceptable" rating agencies.

- Fifty-seven percent of treasury and finance corporate practitioners believe that it is appropriate for the SEC to identify acceptable rating agencies. Fifty-nine percent of financial industry service providers agree with the role the SEC plays in identifying acceptable rating agencies.

Ninety percent of treasury and finance professionals believe the SEC should take additional action to improve its oversight of the rating agencies and foster greater competition.

- More than seventy percent of treasury and finance professionals believe that the SEC should periodically review the rating agencies it currently recognizes.
- Treasury and finance professionals also support additional competition in the market for credit ratings.
- Three out of five treasury and finance professionals believe that the SEC should clarify the procedures for rating agencies to be recognized by the Commission to facilitate the entry of other rating agencies.
- More than 20 percent of treasury and finance professionals believe that the SEC should immediately recognize other rating agencies already in the business (e.g., Egan-Jones, Dominion).

More treasury and finance professionals expect benefits from the recognition of additional rating agencies than expect additional costs.

- Fifty-six percent of treasury and finance corporate practitioners believe that the recognition of additional rating agencies would improve the quality of the ratings. Sixty-three percent of financial industry service providers share similar beliefs.
- Fifty-eight percent of corporate practitioners, along with 59 percent of finance industry service providers, expect improved timeliness of rating changes as a result of additional competition among rating agencies.

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- Forty-eight percent of corporate practitioners believe the recognition of additional rating agencies would increase certainty in the assessment of corporate credit risk. Sixty percent of financial industry service providers share similar beliefs.
- Less than half of corporate practitioners believe that additional competition would lead to increased expense for debt issuers while only a third of respondents believe expenses will increase for investors in debt.

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Survey Findings

Importance of the NRSROs

Credit ratings affect nearly all businesses—regardless of whether a company issues debt. Just under half of the respondents to the survey work for a company that has rated debt, while the vast majority work for a company that uses ratings from an NRSRO to make investment decisions.

Issuers of Debt

While many companies are able to issue debt without a rating from an NRSRO, non-rated debt is typically subject to higher interest rates and fees. As a result, many companies are reluctant or unable to issue debt without an NRSRO rating. Only 21 percent of survey respondents indicate that their company would be able to issue public debt without a rating from one of the "Big Three" agencies.

Despite being able to access analysis from all three NRSROs, most companies with rated debt tend to seek out ratings from only two of the three NRSROs. **Among the three NRSROs, most businesses that issue short-term debt receive a rating from both Moody's and Standard & Poor's (at least 90 percent each), while Fitch is less prevalent (40 percent). At least 90 percent of companies issuing long-term debt are rated by Moody's and Standard & Poor's, while only 36 percent receive ratings from Fitch.**

Market Penetration of Rating Agencies Among Companies with Rated Debt
(Percentage of Respondents)

Debt	Short-term Debt	Long-term
Standard & Poor's	92%	92%
Moody's	90	90
Fitch	40	36

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Rating Triggers

Credit and debt agreements held by companies may contain clauses called "rating triggers." These triggers may require an issuer to repay debt at an accelerated pace or reduce or eliminate the amount of credit available to a borrower if their ratings drop below a level specified in their agreement. **Over a quarter of respondents from companies with rated debt indicate that their company is subject to ratings triggers.**

Investors in Debt

Companies may rely on a number of resources to assess credit risk, including the analyses provided by NRSROs, when making investment decisions. Two of the three NRSROs dominate the market for information used for investment decisions. **More than 80 percent of survey respondents report that their company considers ratings from Moody's and Standard & Poor's to be acceptable sources of credit risk information per their company's investment policy. More than a third of respondents list analysis from Fitch as an acceptable source for credit risk information.**

Use of NRSROs for Investment Decisions
(Percentage of Respondents)

	Corporate Practitioners	Financial Industry Service Providers
Standard & Poor's	88%	86%
Moody's	87	85
Fitch	34	35
None	4	2

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Accuracy & Timeliness

Accuracy

Debt Issuers

Twenty-nine percent of corporate practitioners believe the ratings on their company's short-term and long-term debt are inaccurate. Sixty-five percent of respondents believe the ratings of their company's short-term and long-term debt are accurate.

Not all of the respondents who believe their company's ratings are inaccurate are from companies that recently received a ratings downgrade. Among those working for companies that recently experienced a downgrade, 37 percent of respondents believe their company's ratings inaccurately reflect their company's financial situation. Twenty-six percent of practitioners from companies that recently experienced a ratings upgrade also believe their company's ratings are inaccurate.

Agreement on Whether Company's Ratings Are Accurate
(Percentage Distribution)

	All Corporate Practitioners	Corporate Practitioners-Recent Downgrade	Corporate Practitioners-Recent Upgrade
Strongly agree	21%	10%	20%
Somewhat agree	44	45	50
Neither	6	8	4
Somewhat disagree	21	29	18
Strongly disagree	8	8	8

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While most treasury and financial professionals working for companies with rated debt have confidence in the rating agencies' knowledge of their company and their industry, one out of five respondents disagree with each of these statements. **Only 62 percent of respondents agree with the statement "the rating agencies understand my company." Further, 66 percent of respondents believe the rating agencies understand the industry in which their company operates. Finally, two-thirds of respondents are pleased with the frequency with which the rating agencies' staff meet with their company's staff.**

Evaluation of Rating Agencies' Understanding of Companies and Industries
(Percentage Distribution)

	Agencies Understand Company	Agencies Understand Industry	Agencies Meet with Company Staff Frequently
Strongly agree	19%	25%	27%
Somewhat agree	43	41	39
Neither	14	12	15
Somewhat disagree	19	17	11
Strongly disagree	5	5	8

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Accuracy

Investors

Treasury and finance professionals who use rating agency analysis for investment decisions share the opinions of those who work for companies with rated debt. While a majority of respondents believe the ratings are accurate, many others either believe the credit ratings of the companies in which they invest are inaccurate or are unsure of their accuracy.

Among corporate practitioners from companies that use ratings for investment decisions, only 65 percent believe the ratings of companies in which their company invests are accurate. AFP members who work for financial industry service providers—such as banks—hold a similar, if somewhat more positive, viewpoint. Three-quarters of respondents from financial industry service providers believe the ratings of the companies in which their company invest are accurate.

Agreement by Investors that Credit Ratings are Accurate
(Percentage Distribution)

	Corporate Practitioners	Financial Industry Service Providers
Strongly agree	7%	9%
Somewhat agree	58	66
Neither	21	21
Somewhat disagree	12	4
Strongly disagree	2	*

*Less than one percent

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Timeliness

Debt Issuers and Investors

Most respondents—whether they work for a company with rated debt or use ratings for investment decisions—do not believe that ratings reflect changes in a company's finances in a timely fashion. **Only 40 percent of corporate practitioners from companies with rated debt believe that changes in their company's ratings have been timely. Further, only 37 percent of corporate practitioners who use ratings for investment decisions believe changes in the ratings are timely.**

Agreement on Whether Company's Ratings Are Timely
(Percentage Distribution)

	Corporate Practitioners from Companies w/ Rated Debt	Corporate Practitioners from Companies that Use Ratings for Investment Decisions	Financial Industry Service Providers
Strongly agree	11%	4%	8%
Somewhat agree	29	33	35
Neither	22	25	29
Somewhat disagree	28	28	25
Strongly disagree	10	10	3

Corporate practitioners indicate that it can take months or even a year or more for a change in their company's financial condition to be reflected in the ratings. Slightly more than half of practitioners from companies that have experienced a ratings downgrade report that it took the ratings agencies between one and six months for a deterioration in their company's financials to be reflected in their ratings. **Twenty-seven percent of respondents said the downgrade took place more than six months after the deterioration in the company's financials.**

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Rating upgrades can take even longer. **Fifty-seven percent of respondents who represent companies that have experienced a ratings upgrade report that the upgrade took place more than six months after the improvement in the company's financials.**

Length of Time for Ratings Changes—Companies that Have Experienced a Change
(Percentage Distribution)

	Downgrades	Upgrades
Less than a month	22%	14%
One to six months	51	29
Six months to a year	19	22
More than a year	8	35

Determinants of Ratings

Credit ratings are supposed to reflect a creditor's ability to service and ultimately repay debt. **Yet, 33 percent of corporate practitioners believe their company's ratings are more reflective of the industry in which it operates than the company's finances.** Only 17 percent of respondents believe their company's ratings are more reflective of the company's finances. Forty-three of respondents believe their company's ratings reflect a balance between their company's finances and the industry.

Opinions on Whether Ratings Are More Reflective of Company's Finances or the Industry in Which it Operates
(Percentage Distribution)

Company finances	17%
Industry in which company operates	33
Balanced between both	43
Don't know	7

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Assisting Investors

Rating agencies have been providing opinions on the creditworthiness of issuers of debt to assist investors for over 100 years. However, relatively few treasury and finance professionals believe the ratings favor the interests of investors. **Only 22 percent of corporate practitioners believe the ratings most favor the interests of investors in debt.**

Treasury and finance professionals instead believe the ratings favor other interests. Fifteen percent of respondents believe the ratings most favor issuers of debt, while another 15 percent of corporate practitioners believe rating agency ratings most favor either commercial or investment banks. Commercial and investment banks may play different roles in relation to a company that issues debt or borrows. First, both commercial and investment banks may invest in debt and therefore may have the same interests as investors. Banks can also profit by lending to a company and by providing services to the debt issuer.

The Interests Credit Ratings Favor
(Percentage Distribution)

	Corporate Practitioners	Financial Industry Service Providers
Investors in debt	22%	11%
Issuers of debt	15	13
Investment banks	10	11
Commercial banks	5	5
Interests are balanced	13	10
Don't know	35	50

Treasury and finance professionals from companies that do not issue rated debt, including those from banks, are even more skeptical about who the rating agencies most favor. Only nine percent of corporate practitioners who work for a company that does not issue rated debt, along with 11 percent of financial industry service providers, believe the ratings favor the interests of investors in debt. This compares with 38 percent of corporate practitioners from companies with rated debt. A possible reason for the difference in opinion is that staff from companies with rated debt must interact with personnel from the rating agencies and, therefore, may have a better appreciation of how the agencies develop ratings.

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Alternative Sources of Information

When making investment decisions, many companies tap other resources for credit risk information to supplement the analysis provided by the three NRSROs. **Eighty-three percent of corporate practitioner respondents indicate that their company turns to information sources beyond the NRSROs when making investment decisions.** These resources, however, are not adequate by themselves for most companies' investment policies.

The three alternative external resources most cited by corporate practitioners are Dun & Bradstreet (48 percent), investment banker research (36 percent), and A.M. Best Company (26 percent). In addition, 42 percent of practitioners report that their company has developed proprietary research.

Respondents from financial industry service providers use alternative information resources in a similar fashion. Seventy-eight percent of respondents report using Dun & Bradstreet while 22 percent indicate that their company uses A.M. Best Company. Sixty-eight percent of respondents use information developed from internal proprietary research while 17 percent turn to research prepared by investment bankers.

Other Resources Used to Make Investment Decisions
(Percentage of Respondents)

	Corporate Practitioners	Financial Industry Service Providers
A.M. Best Company	26%	22%
Dominion Bond Rating Service	4	4
Dun & Bradstreet	48	78
Egan-Jones Rating Company	1	3
KMV	1	13
Lace Financial	3	4
Other rating agencies	1	3
Internal research	42	68
Research from investment bankers	36	17
Other	7	6
Company does not consult other resources	17	3

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The Role of the SEC

Since 1975, the SEC has been responsible for recognizing rating agencies as NRSROs. Treasury and finance professionals believe that the SEC should continue its oversight of the NRSROs. In addition, survey respondents believe the SEC should take additional action to improve its oversight of the rating agencies and foster greater competition.

Fifty-seven percent of corporate practitioners believe that it is appropriate for the SEC to determine which rating agencies are acceptable for purposes of assessing credit risk in regulated portfolios. Only 18 percent of respondents disagree with the SEC's role. Fifty-nine percent of financial industry service providers also support the SEC's role, with only 11 percent dissenting.

Appropriateness of SEC's Role in Recognizing Rating Agencies
(Percentage Distribution)

	Corporate Practitioners	Financial Industry Service Providers
SEC's role is appropriate	57%	59%
SEC's role is not appropriate	18	11
Do not know	25	30

Expanded Role for the SEC

Most treasury and finance professionals support proposals for the SEC to expand its oversight of the rating agencies beyond simple recognition of NRSROs. **More than ninety percent of survey respondents believe the SEC should take additional steps in its oversight of the rating agencies.** A majority of respondents agree that these additional steps should include periodic review of NRSROs and clarifying the procedures for the recognition of additional agencies. Even respondents who believe the SEC should not be recognizing rating agencies support an expanded role for the SEC should the Commission's role continue.

Currently, the SEC does not periodically review the methodologies and performance of NRSROs. Once the SEC recognizes a rating agency as an NRSRO, there is no ongoing process to ensure the agency's methodologies and procedures remain valid.

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Most survey respondents believe a periodic review of the rating agencies is necessary. **Seventy-three percent of corporate practitioners, along with 71 percent of respondents from financial industry service providers, believe that the SEC should periodically review the rating agencies it currently recognizes, for example, every five years.**

Some observers, including some rating agencies that have attempted to be recognized as an NRSRO, argue that there is no defined process for credit agencies to achieve NRSRO status. Without additional rating agencies—or at least the threat of entry by other agencies—some observers believe the three major agencies have little motivation to improve their performance. Most treasury and finance professionals agree the SEC should take steps to clarify the process for agencies to achieve NRSRO status. **Sixty-five percent of corporate practitioners and 60 percent of respondents from financial service providers believe the SEC should clarify its procedures for rating agencies to be recognized as NRSROs.**

Recently, several rating agencies, including Egan-Jones and Dominion, sought NRSRO status and were rejected. Some observers believe that granting NRSRO status to at least one of these companies would provide additional competition that could result in improved accuracy and timeliness of ratings. **Twenty-three percent of corporate practitioners, along with 22 percent of respondents from financial industry service providers, support the immediate recognition of at least one rating agency currently conducting business without NRSRO status.**

Additional Actions that the SEC Should Take in its Oversight of Rating Agencies

	Corporate Practitioners	Financial Industry Service Providers
Periodically review rating agencies	73%	71%
Clarify procedures for rating agency recognition	65	60
Immediately recognize other rating agencies	23	22
Other	5	4

(Percentage of Respondents)

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The Impact of Entry

Treasury and finance professionals support the entry of competitors to Moody's, Standard & Poor's, and Fitch in the marketplace for ratings information. They believe additional competition would increase both the accuracy and timeliness of credit ratings and ultimately lead to greater certainty in the assessment of corporate credit risk. Further, they are more likely to believe that there will be benefits from additional competition than they are to believe there will be increased costs.

Most respondents indicate that the following beneficial outcomes would result from the recognition of additional rating agencies:

- **Fifty-six percent of treasury and finance corporate practitioners, along with 63 percent of finance industry service providers, believe the recognition of additional rating agencies would improve the quality of ratings.**
- **Fifty-eight percent of corporate practitioners, plus 76 percent of financial industry service providers, believe entry of other rating agencies would reduce the time it typically takes the rating agencies to account for material financial changes in their ratings.**
- **Forty-eight percent of corporate practitioners, along with 60 percent of financial industry service providers, believe that additional choices for rating agencies would increase certainty when assessing corporate credit risk.**

More treasury and finance professionals expect benefits from the recognition of additional rating agencies than expect additional costs. Forty-six percent of corporate practitioners, along with 43 percent of financial industry service providers, believe expenses would rise for issuers of debt. A third of corporate practitioners, along with 36 percent of financial industry service providers, believe expenses would rise for investors in debt.

Impact of Recognizing Additional Rating Agencies

(Percentage of Respondents Choosing "Strongly Agree" or "Somewhat Agree")

	Corporate Practitioners	Financial Industry Service Providers
Improved ratings quality	56%	63%
Improved timeliness	58	76
Greater certainty when assessing credit risk	48	60
Increased expense for debt issuers	46	43
Increased expense for investors	33	36

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Appendices

Appendix A: Methodology
Appendix B: Background

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Appendix A: Methodology

In September 2002, the Association for Financial Professionals e-mailed a 17-question survey to more than 2,700 practitioner members of AFP holding senior level job titles[1]. 327 surveys were returned. AFP also sent the same survey to prospective practitioner members of AFP, producing an additional 207 completed surveys. At the same time, AFP sent a nine-question survey to financial industry service providers who indicated their employer is a bank, generating a response of 181 surveys. At a 95 percent confidence level, the responses from practitioners are accurate within a four-percentage point interval. For responses from finance industry service providers, the 95 percent confidence interval is seven percentage points.

The respondents to this survey are similar to the demographic profile of AFP's membership. Among corporate practitioners, the typical respondent works for a company with annual revenues slightly less than $1 billion. As a comparison, the typical AFP corporate practitioner member works for a company with revenues slightly greater than $1 billion. More than half of the respondents from financial industry service providers work for banks with assets greater than $20 billion.

The survey questionnaires are available on the Research page of AFP's Web site at www.AFPonline.org.

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[1] Senior job titles include CEO, CFO, president, vice president, assistant vice president, director, treasurer, and assistant treasurer.

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Appendix B: Background

For nearly 100 years, rating agencies have been providing opinions on the creditworthiness of issuers of debt to assist investors. In 1909, Moody's published the first bond ratings in the U.S. for railroad bonds. Poor's began issuing ratings in 1916, with Standard Statistics and Fitch Publishing following in 1922 and 1924, respectively. In 1941, Standard Statistics and Poor's merged into Standard & Poor's. These ratings were intended as tools for the investing public, which provided revenue to the rating agencies by purchasing their published reports.

Since their beginning, the importance of credit ratings to investors, issuers, and other participants in the securities markets has increased significantly. This is in part due to the dramatic increase in the number of debt issuers and issues. Perhaps more importantly, the complexity of many financial products, such as asset-backed and derivative securities, has made it more difficult for investors to assess credit risk on their own. The role of credit ratings has also expanded to other countries as a result of the globalization of financial markets.

Regulatory requirements have also contributed to the increased importance of credit rating agencies. Many regulators, responsible for ensuring the safety and soundness of banks, brokers, insurers, mutual funds and pension funds, found the process of assessing risk in these portfolios to be costly and inaccurate. Rather than continue to conduct this analysis on their own, regulators recognized that the private market was already rating bonds at no cost to the government. Regulators began to rely on the information provided by these ratings to fulfill their regulatory obligations and required regulated entities to report the ratings of the bonds in which they invested. Starting around 1970, Moody's and Standard & Poor's began to charge issuers for bond ratings rather than relying on publication revenue from investors and other market participants as their primary source of income.

Because of its increased reliance on credit ratings, the SEC in 1975 recognized Moody's, Standard & Poor's, and Fitch, the three major rating agencies in existence at that time, as the first nationally recognized statistical rating organizations (NRSRO). The SEC originally recognized these three firms for the purpose of determining capital charges on debt securities for broker-dealers. Over time, the NRSRO concept was also incorporated into new regulations related to the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. Other regulators have followed suit and adopted the NRSRO designation in their regulations. Only ratings from an NRSRO are recognized in many of these regulations. As a result, companies that hope to have their debt purchased by large institutional investors, including banks, mutual funds, and insurers, must have a rating from an NRSRO.

The SEC considers many criteria for NRSRO recognition. According to testimony by SEC Commissioner Isaac C. Hunt, Jr. before the Senate Committee on Governmental Affairs in March 2002, the single most important criterion that the SEC considers when determining whether a

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rating agency may be considered a nationally recognized statistical rating organization "is that the rating agency is nationally recognized." Hunt also said that this "means the rating organization is widely accepted in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings." The SEC also reviews the operational capability and reliability of each rating organization, including their rating procedures, organizational structure, financial resources, staffing, independence from the companies it rates, and internal controls.

Since 1975, the SEC has recognized only four new rating agencies: Duff and Phelps, McCarthy Crisanti and Maffei, IBCA, and Thomson BankWatch. Each of these entrants has subsequently merged with Fitch, leaving only the original three agencies. No new agencies have been recognized since 1992. Several rating agencies, including LACE Financial, Dominion Bond Rating Service, and Egan-Jones Ratings, have sought the NRSRO designation in recent years with little success. In 1998, the U.S. Department of Justice's Antitrust Division submitted comments to the SEC stating its belief that the requirements to become an NRSRO create an anti-competitive barrier to entry for new credit rating agencies.

Credit ratings are important to companies for many reasons. Whether a company has a credit rating from one or more of the NRSROs and the level of its ratings have a significant impact on the company's ability to issue debt and the terms, including pricing, under which the company may do so. Changes in credit ratings can also impact existing credit and debt agreements. Over one quarter of respondents to this survey indicate that there are ratings triggers in their company's credit or debt agreements that would reduce the amount of credit available to them or would require them to repay debt at an accelerated pace as a result of a ratings downgrade. Many companies also rely heavily on ratings from NRSROs when making investment decisions.

Some market participants have criticized the rating agencies, who are given enhanced access to corporate executives and financial information, for failing to warn investors of problems at Enron, WorldCom and other companies that later declared bankruptcy. Congress joined the debate and mandated action by regulators.

The Sarbanes-Oxley Act of 2002 will have significant effects on corporate governance, financial accounting, and SEC reporting. Because of the importance of rating agencies to regulatory agencies and the securities markets, the Act also requires that the SEC conduct a study of the role and function of credit rating agencies in the operation of the securities market. That study must be completed by January 26, 2003.

On October 7, 2002, the Senate Governmental Affairs Committee issued a report, "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs." That report criticized the three major credit rating agencies for failing to warn the public with respect to Enron and recommended additional regulation and training for rating agencies.

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