AMERICANS FOR FINANCIAL REFORM
ACCOUNTABILITY ★ FAIRNESS ★ SECURITY

Americans for Financial Reform
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September 13, 2011

Via Email
Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: *Study on Assigned Credit Ratings,* File No. 4-629

Dear Ms. Murphy,

American for Financial Reform ("AFR") appreciates this opportunity to comment on Release No. 34-64456 (the "Release") regarding the study on assigned credit ratings for structured finance products mandated (the "Study") by section 939F of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). AFR is a coalition of more than 250 organizations who have come together to advocate for reform of financial sector regulation. Members of the AFR include consumer, civil rights, investor, retiree, labor, religious and business groups along with prominent economists and other experts.

Last month, AFR commented jointly with the Consumer Federation of America on the Commission's Release No. 34-64515, "Proposed Rules for Nationally Recognized Statistical Rating Organizations" (the "Proposed Oversight Rules"). There, we described and cited the abundant evidence that pervasive conflicts of interest had corrupted the methodologies and decisions of the nationally recognized statistical ratings organizations ("NRSROs") in analyzing structured finance products and thereby contributed significantly to the housing bubble and financial crisis. We also laid out reasons to believe that the supervisory approach outlined out by the Commission in the Proposed Oversight Rules – which essentially relied on self-regulation by the rating agencies – was highly unlikely to address these problems.

It is therefore vitally important that the Commission explore more sweeping reforms designed to directly address the conflicts of interest at the heart of the rating agency business model, as well as the deficiencies in professional standards that have emerged from the NRSROs incentives to gain business from the issuers who pay them. These problems are uniquely pressing in the area of structured finance products, where the complexity of the models used to price these instruments creates many more opportunities for the process to be corrupted than the relatively simpler world of institutional ratings. Indeed, the issues experienced with unreliable ratings during the financial crisis are already reappearing. To take just one example, numerous re-remics

or re-securitizations of RMBS rated as recently as 2008-2009 have been severely downgraded.[1] Some have gone from AAA to CC or even D (Default). These problems underline the importance of aiming for real systemic change in the NRSRO business model.
In considering the potential effects of institutional changes in the rating agency business model, we urge the Commission to carefully consider the complex and potentially counterproductive effects of market competition under the current issuer-pays model. The Release notes that approximately 94% of the outstanding credit ratings for structured finance products were determined by the three largest NRSROs. (Release, at 7). While there are doubtless negative effects of this ratings oligopoly, AFR does not believe that the simple emergence of more competitors within the current NRSRO business model will address the problems with ratings quality.

Competition only works to improve quality if firms are competing on the basis of quality. Empirical evidence suggests this is likely not the case when it comes to issuer-pay credit ratings. A 2010 study found that the growth in market share enjoyed by Fitch Ratings, which emerged shortly after 2000 as a credible competitor to Moody's and S&P, coincided with lower quality ratings, as measured by the correlation between ratings and market-implied yields.[2] This is sensible when one considers that private rating agencies compete not for better ratings quality in the abstract, but for higher revenues and more business from issuers of rated instruments. To the extent that issuers desire high ratings for the credits they are selling, relying on greater competition among NRSROs using an issuer-pay model may actually produce lower quality ratings.

The Release seeks comment on the potential conflicts of interest in the issuer-pay model in rating structured finance products. Characterizing these conflicts and their impacts as "potential" (see, e.g., Release at 10-11) implies that they have not actually distorted the ratings process. Nothing could be further from the truth, however. Numerous investigations, hearings and studies have produced substantial evidence regarding both the conflicts of interest in the issuer-pay model and the impact of those conflicts on the ratings of structured finance products. Highlights, which we discussed in more detail in our comment on the Proposed Reforms, include the following:

- The Report of the U.S. Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," which found that NRSRO conflicts of interest arising from the issuer-pay model were a "significant cause" of inaccurate credit ratings, which in turn were a "key cause" of the financial crisis.

- Testimony of former NRSRO managers with responsibility for rating structured finance products, such as former Moody's Managing Director Eric Kolchinsky, who described the negative effects of intense pressures to build market share and satisfy the demands of issuers and sponsors on ratings methodologies and decisions.

[1] Shenn, Jody, "S&P Incorrectly Analyzed Re-Remic Mortgage Bonds", Bloomberg Business Week, December 15, 2010.

[2] Becker, Bo and Milbourn, Todd T., How Did Increased Competition Affect Credit Ratings? (September 21, 2010). Harvard Business School Finance Working Paper No. 09-051.

- Academic studies finding widespread deviations by NRSROs from their own models when rating certain structured finance products; relatively inflated ratings for mortgage-backed securities sold by larger underwriters (as defined by annual market share); and declines in credit quality correlating with the period in which revenue opportunities from rating structured finance products were highest, blunting reputational risks from issuing poor quality ratings.[3]

With problems so evident and widespread in the NRSRO marketplace, the Commission must consider fundamental structural reforms that go beyond the essentially self-regulatory approach advanced in its Proposed Oversight Rules. Some of these reforms could be incorporated into a stricter oversight approach, but a truly fundamental reform needs to seriously consider changes to the issuer-pays model.

One obvious alternative to the issuer-pays model is a subscriber-pay model. Appropriately, the Commission seeks comment on the possible conflicts of interest arising from a subscriber-pay system. In our view, a subscriber-pay model is not fully free from conflicts of interest. Investors may not want to see a downgrade in the rating of a security they already hold, for example, and thus might not wish to pay for robust ratings surveillance. Moreover, ratings in a subscriber-pay system are not generally available to the public. To the extent ratings are communicated to non-paying investors, an NRSRO using a subscriber-pay model is not compensated fully for the value it creates. That fact may make it difficult for firms to thrive under a subscriber-pay model. (Indeed, many commentators have attributed the switch from a subscriber-pay to issuer-pay model in the 1970s to costs from free riding. (See Joseph Grundfest & Evgeniya Hochenberg, "Investor Owned and Controlled Rating Agencies: A Summary Introduction," at 4 working paper 2009, available at www.ssrn.com).

On balance, we believe the Commission should endorse a system that would separate issuer payment for ratings on structured finance products from issuer selection of an NRSRO. By eliminating ratings shopping, such a system would ease the market share pressures that led NRSROs to yield to issuer demands. In our view, an approach in which the neutral party is required to assign a rating will properly align incentives. We are concerned that an approach which requires investor cooperation, such as the investor-owned NRSRO model, may not be realistic given the competition among many institutional investors and the apparent reluctance of many investors to pay for research services.

Beyond addressing issuer-pay incentives, a major benefit of a 15E(w) system is that the body assigning the ratings could also create incentives for higher ratings quality through maintaining quality standards for the pool of NRSROs eligible to receive an assignment. (Note that this assigning body could be a non-profit self-regulatory organization and not necessarily a government agency). These quality incentives could relate to the measured accuracy of ratings outcome. However, AFR believes that ratings outcomes alone are problematic as a measure of quality, as many types of structured instruments (notably mortgage-backed securities) may take many years to show flaws in the initial underwriting standards. During the years prior to the

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[3] For an excellent summary of this research, see John C. Coffee, Jr., "Ratings Reform: the Good, the Bad and the Ugly," Harvard Business Law Review, Vol. 1, pp. 231-278, at 255 (2011))

rating failure, the mis-rated instruments can proliferate and spread through the financial system. This is exactly what occurred with mortgage backed securities prior to the financial crisis.

Any approach intended to improve quality must therefore also be attentive to the ratings inputs – such as methodologies, analysis, and analyst training. While the Commission's Proposed Oversight Rules purported to address these areas, as we discussed in our comment that proposal relied on the ratings agencies to essentially police themselves, and was unlikely to improve the situation while fundamental profit incentives created such intense pressure for lower quality. A ratings assignment body, whether it was a government agency or an independent, non-profit professional organization, could be a powerful force for maintenance of strict methodological and analytical standards for NRSROs. This would bring the credit analysis profession closer to other professions who maintain standards through licensing and professional self-regulation, such as accountants and actuaries.

In designing and running the kind of assignment system envisioned in 939F, the Commission or the relevant self-regulatory body must also remain alert for manipulation of the system. For example, it might be possible for issuers to simply withdraw their proposed securities issue if they 'draw' a rating agency known to maintain objective rating standards that may lead to a low rating. After slightly rearranging the pool of loans, they could then try again with a new issue. It would be important to vigilantly oversee the assignment process to prevent this type of gaming of the system.

Finally, in our experience, it is often much easier to quantify the costs of a new regulatory scheme than the benefits. We have no doubt that NRSROs and others with an interest in perpetuating the current system will set forth in great detail the costs and difficulties of transitioning to a new model for rating structured finance products. The benefits, though less easily toted up, are potentially enormous. The utter failure of the NRSROs to rate structured finance products accurately was a key factor in promoting a massive misallocation of capital in the U.S. markets, whose consequences were and continue to be disastrous for the economy as well as many of AFR's members. Meaningful credit rating agency reform will significantly reduce the likelihood that these events will recur, a substantial benefit to all participants in the capital markets.

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We appreciate the opportunity to share our views with the Commission on these important issues. If you have any questions, or need additional information, please do not hesitate to contact Marcus Stanley, AFR's Policy Director, at marcus@ourfinancialsecurity.org.

Sincerely,

Americans for Financial Reform

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AARP
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans for Fairness in Lending
- Americans United for Change
- Calvert Asset Management Company, Inc.
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company

- Home Actions
- Housing Counseling Services
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center

- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

Partial list of State and Local Signers

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA

- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG

- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG