Consumer Federation of America

August 13, 2014

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File Number S7-18-11
Nationally Recognized Statistical Rating Organizations and Universal Rating Symbols

Dear Secretary Murphy,

We[1] understand questions have been raised within the Commission about whether requiring Nationally Recognized Statistical Rating Organizations (NRSROs) to apply rating symbols consistently across asset classes—and holding NRSROs accountable if they do not—would constitute impermissible regulation of the substance of credit ratings or the procedures and methodologies by which NRSROs determine credit ratings, in violation of section 15E(c)(2) of the Exchange Act. As explained below, our proposed regulatory fixes would not run afoul of section 15E(c)(2), and they should be adopted.

As our March 2014 comment[2] detailed, credit rating symbols have been applied inconsistently across asset classes, both historically and most concretely in the run-up to the 2007-2008 financial crisis. As a result of credit rating symbols' being applied inconsistently, different asset classes have experienced significant divergences in ratings performance. For example, AAA-rated municipal securities have exhibited very different risk characteristics, such as severe downgrade and default statistics, from AAA-rated structured products.

Section 938(a) of the Dodd-Frank Act requires the Commission to issue rules that in turn require NRSROs to establish, maintain, and enforce written policies and procedures that:

1) **assess the probability** that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument;

1 CFA is a non-profit association of nearly 300 national, state, and local pro-consumer organizations. It was formed in 1967 to represent the consumer interest through research, advocacy and education.
2 *See* CFA Request for Re-Proposal Relating to Nationally Recognized Statistical Rating Organizations, Filed March 3, 2014, https://www.sec.gov/comments/s7-18-11/s71811-78.pdf

2) **clearly define and disclose** the meaning of any symbol used by the NRSRO to denote a credit rating; and
3) **apply any symbol** described in item (2) in a manner that is consistent for all types of securities and money market instruments for which the symbol is used.

If an NRSRO is unwilling or unable to apply a rating symbol consistently, under Section 938(b) an NRSRO can use distinct sets of symbols to denote credit ratings for different types of securities or money market instruments.

Requiring credit ratings to have substance is not the same thing as regulating what that substance is

Under Section 938(a), an NRSRO can use whatever criteria it wishes to assess the probability that an issuer will repay its investors. An NRSRO's criteria can be based on whatever factors the NRSRO deems relevant. What matters is: 1) that an assessment is made, disclosed, and followed; and 2) that it offers some distinct and concrete predictive value that is capable of being reviewed and evaluated as to whether or not the assessment was reasonably accurate. This is a necessary accountability mechanism that provides investors, NRSROs themselves, and the Commission a concrete standard to measure against. And, if actual performance falls out of line with the assessed probabilities, it allows for opportunities to repair the deficiencies.

Similarly, under Section 938(a), an NRSRO can use whatever symbols it chooses to denote credit ratings, so long as those symbols are clearly defined and disclosed. Again, what matters is that any symbol that denotes an assessment of the probability that an issuer will repay its investors is sufficiently defined so that it offers some distinct and concrete predictive value that is capable of being reviewed and evaluated as to whether or not the symbol—and assessment—were reasonably accurate. This is the only way investors, NRSROs themselves, and the Commission will be able to gauge, for example, what distinguishes a AAA-rated security from a AA-rated security.

Currently, NRSROs' credit assessments and accompanying rating symbols are so vague that they fail to provide any distinct and concrete predictive value. As a result, it is impossible to review and evaluate them as to whether or not they are reasonably accurate. S&P's "Understanding Standard and Poor's Rating Definitions"[3] document, which was originally published in 2009 and which the company has repeatedly cited to since, most recently on March 21, 2014, provides a prime example of how NRSROs issue credit ratings that mean everything and nothing at the same time. According to S&P:

> "Creditworthiness is a multi-faceted phenomenon. Although there is no 'formula' for combining the various facets, our credit ratings attempt to condense their combined effects into rating symbols along a simple, one-dimensional scale."
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> …
>
> "Still, we do not attach specific probabilities to particular types of potential economic environments. Therefore, we do not ascribe a specific 'default probability' to each rating category."

[3] Mark Adelson, et al., Understanding Standard & Poor's Rating Definitions, Standard & Poor's article, June 3, 2009, http://www.standardandpoors.com/spf/upload/Ratings_EMEA/GeneralCriteriaUnderstandingSandPsRatingDefinitionsJune32009.pdf

> …
> "As noted earlier, the key objective of Standard and Poor's ratings is rank ordering the relative creditworthiness of issuers and obligations…That is, when our ratings perform as intended, securities with higher ratings should display lower observed default frequencies than securities with lower ratings during a given test period."
> …
> "However, as noted above, economic cycles do not produce the same degree of stress in all geographic regions and in all market segments at any point in time. Accordingly, although we strive for comparability in our ratings, we expect to observe less consistency in rank ordering of observed default frequencies among regions and market segments."

S&P goes on to "define" its rating symbols but those "definitions" lack any reasonable degree of clarity that would allow anyone to review and evaluate them for accuracy. For example, S&P states that a AAA-rated obligor has an "extremely strong capacity to meet its financial commitments," whereas a AA-rated obligor has a "very strong capacity to meet its financial commitments." What distinguishes "extremely strong" from "very strong" is not explained. The real world impact is rating agencies are free to issue ratings and rating updates without any substance, and without any mechanism for investors, the ratings agencies themselves, or the Commission to hold them accountable.

Moody's and Fitch are equally vague in describing just what meaning their rating symbols convey. On its Ratings Definitions page, for example, Moody's states: "Obligations carrying the same rating are not claimed to be of absolutely equal credit quality. In a broad sense, they are alike in position, but since there are a limited number of rating classes used in grading thousands of bonds, the symbols cannot reflect the same shadings of risk which actually exist."[4] Similarly, in its Special Report on Ratings Comparability,[5] Fitch states: "The widely recognized 'AAA' to '0' credit scale, first designed by John Fitch in 1924, is a universally recognized indicator of credit risk. However, in reality, credit risk crosses multiple dimensions – default, loss, liquidity, and others." Fitch does not specify what those "others" are. Despite the fact that Fitch says credit risk crosses "multiple dimensions," it continues to assert: "A rating scale should pick one dimension if it is to give the clearest message." It is troubling that Fitch believes boiling down complex and nuanced analysis, based on multiple dimensions that are not fully transparent, into overly simplistic symbols that apply across asset classes, conveys the clearest message.

Further, Fitch apparently doesn't even strive to achieve comparability across asset classes with the use of its symbols. It says, "[W]hile loss given default (LGO) is also a seemingly desirable component to have imbedded in a long-term rating, Fitch recognizes that differences among sectors and structures make it impractical to aspire to achieve comparability on this element within all its long-term ratings." Nonetheless, Fitch continues to use the same "universally recognized indicator of credit risk" across asset classes.

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[4] Ratings Definitions, Moody's, https://www.moodys.com/Pages/amr002002.aspx

[5] John S. Olert, et al., Ratings Comparability, Special Report, Fitch Ratings, http://www.sec.gov/comments/4-622/4622-16.pdf

When investors rely on credit ratings to make their investment decisions, they have two overarching concerns: first, whether a security will be paid according to its contractual terms (i.e., whether timely payments of principal and interest will be made as they come due), and second, in the event that there is a default, what the expected loss will be. Any suggestion by credit rating agencies that creditworthiness is so much more multi-faceted and nuanced is belied by credit rating agencies' persistent and eager use of rating symbols that follow an overly simplistic, one-dimensional scale.

To hold rating agencies accountable for their rating decisions, NRSROs must be required to issue symbols that correspond to an acceptable range of publicly disclosed and easily accessible default probabilities and accompanying loss expectations. Rating agencies would be free to set the performance criteria for their ratings. Thus, AAA could mean anything a rating agency wants it to mean. For example, it could mean between 0 and 1 percent default probability, or it could mean between 0 and 10 percent default probability. Because rating agencies would be free to set their own parameters and build in any buffer or margin of error they deem appropriate, there is no legitimate argument that this approach would constitute impermissible regulation of the substance of credit ratings or the procedures and methodologies by which NRSROs determine credit ratings.

Once an NRSRO issues symbols that correspond to acceptable ranges of publicly disclosed and easily accessible default probabilities and accompanying loss expectations, those symbols must be applied consistently. Since, here too, an NRSRO would still have a choice about the application of rating symbols, this would not constitute any impermissible regulation of the substance of credit ratings or the procedures and methodologies by which NRSROs determine credit ratings. An NRSRO can either define symbols so that they can be applied consistently across asset classes, such that a AAA-rated municipal security reflects the same degree of risk as a AAA-rated structured product. Alternatively, under Section 938(b), an NRSRO can create a completely different rating regime for certain asset classes, so that a particular asset class fits within the predicted range that the NRSRO chooses.

Even if the Commission does not go our preferred route of requiring NRSROs to issue symbols that correspond to acceptable numerical ranges of publicly disclosed and easily accessible default probabilities and accompanying loss expectations, the Commission can still hold NRSROs accountable for inconsistently applying rating symbols across asset classes. If an NRSRO uses any rating scale that provides a reasonable investor to believe that the ratings provide relative rankings among issuers and obligations of overall creditworthiness (e.g., AAA is more likely to meet its financial obligations than AA, etc.), and those rating scales are applied across asset classes, then they must be applied consistently across asset classes. To ensure that this occurs, the Commission should monitor how the symbols are being applied. If, for example, a BBB-rated municipal bond demonstrates over time a higher likelihood of being repaid than a AAA-rated structured product, the Commission should require the NRSRO to either correct its approach or adopt distinct ratings symbols for different asset classes. For continued failures, the Commission should impose on an NRSRO appropriate sanctions, including fines and disgorgement of profits and, ultimately, loss of NRSRO status with regard to the relevant asset classes.

NRSROs are legally sanctioned monopolies that, under the current regulatory approach, are allowed to issue with impunity ratings that lack substance and bear no rational relationship to actual performance. Dodd-Frank offers the Commission the tools it needs to correct this problem. The Commission must adopt regulations that make effective use of those tools or risk perpetuating a broken system that causes investors to be harmed and the market to be exposed to excessive risk.

Respectfully submitted,

Micah Hauptman
Financial Services Counsel

Barbara Roper
Director of Investor Protection

cc: The Honorable Mary Jo White, Chair
The Honorable Luis Aguilar, Commissioner
The Honorable Daniel Gallagher, Commissioner
The Honorable Michael Piwowar, Commissioner
The Honorable Kara Stein, Commissioner