

Statement Before The NAIC Working Group on Rating Agencies

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Jerome S. Fons
NERA Economic Consulting and Fons Risk Solutions

I am pleased to be invited to share my views on the NAIC's use of ratings as part of its oversight of the insurance industry. By way of background, I am an economist with 17 years experience at Moody's Investors Service. My career there brought me in contact with nearly every aspect of the ratings business. When I left the firm in 2007, I was Managing Director, Credit Policy. I currently consult on rating agency issues.

This particular panel is titled "Rating Agencies – What Happened?" and seeks answers to a number of important questions. I will try to address some of these in my comments that follow.

The reputations of the major rating firms were built on a solid track record – at least up until the mid 1990s – of rating corporations. Bond defaults by highly rated corporate issuers were few and far between. During that time, the ratings business grew in importance and became increasingly profitable. Although a number of missteps in the early part of this decade triggered alarm bells and spawned investigations, the influence of ratings continued to expand.

In more recent years, the major rating firms served as catalysts for the spread of complex and opaque securities, many of which were exempt from securities registration requirements. These structured securities were highly profitable for the major raters. However, it was extremely difficult to independently verify the quality of the ratings analysis, as there was little public access to the underlying details of a transaction. Market participants relied on ratings as a substitute for proper disclosure and took comfort from the notion that rating firms would not risk their reputations.

Unfortunately, the major rating firms willingly traded their reputations for short-term profits. They allowed themselves to be played off of one another in an effort to maintain (or perhaps increase) market share. Assumptions underlying many rated structured products were not challenged or updated. Even as the housing market began to lose steam, the major raters did not incorporate this development into their models.

The result has been the destruction of wealth and the destruction of reputations. I am doubtful that the major rating firms will ever regain the public's trust. Denial, blame shifting and a refusal to address the causes of the crisis leave little room for sympathy. To this day, they have not acknowledged the fact that many structured products are inherently un-ratable.

The role of a rating agency is to provide a fair, unbiased assessment of value in order to improve the efficiency of credit markets. But powerful interests prefer inefficient

markets so that they can extract returns from the less informed. It takes heroic discipline to stand up to these interests, and in my view, for-profit rating firms are not up to the task. The stakes are too high and to be successful, an honest rater will make many people angry. It is very difficult to run a business when your customers hate you. And they will hate you when you cost them money.

The challenge is to devise a plan that moves us away from the current system, with its dependence on the integrity of a select number of conflicted players. For one thing, I would like to see greater emphasis on defining and measuring rating quality. The NAIC is in a position to get us there.

Acceptable rating organizations should provide a full history of their ratings to a central depository. This data would be used to calculate and compare the historical accuracy of rating organizations across asset type. Accuracy measures indicate the ability of a rating system to separate, *ex ante*, those issuers and obligations that subsequently default from those that do not default. These measures should be prepared by an independent body, rather than by the rating firms themselves. And only the performance measures, not the underlying rating histories, would be disclosed publicly.

I also believe that rating firms should rate only fully registered securities, and that these securities should meet very high disclosure standards. Current proposals requiring originators to share new-issue data among rating firms do not instill public confidence, nor do they provide the ability to verify independently whether a rating is reasonable. As long as ratings serve as a substitute for adequate disclosure, investors and others will not be able to perform their own analysis.

Finally, although we are perhaps too far down this road, regulators and lawmakers must reduce their reliance on credit ratings as tools of public policy. Until a viable alternative emerges, progress in this area is likely to be spotty. But I believe something will emerge to fill the void.

With that, I am happy to answer any questions. Thank you.