

STATEMENT

of

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before the

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

PUBLIC HEARING OF THE RATING AGENCY (E) WORKING GROUP

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Washington National Harbor

Thank you for this opportunity to participate in the NAIC Public Hearing on Credit Rating Agencies. Realpoint is the most recent company to be designated by the Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (NRSRO). Realpoint is designated as an NRSRO for asset-backed securities or “structured finance” as it is often called. Our market specialty within structured finance is rating commercial mortgage-backed securities. (“CMBS”) Realpoint is one of the five companies designated by the Federal Reserve Board as an eligible rating agency for securities being issued under the Term Asset-Backed Securities Loan Facility (TALF).

By way of additional background, Realpoint has approximately 50 employees and is located in suburban Philadelphia. Realpoint operates as an independent, subscriber-premised business. This means that our revenues are derived primarily from investors, portfolio managers, analysts, broker/dealers and other market participants, which, incidentally, is how Moody’s, S&P and Fitch all operated for the first 75 years they were in business.

Our work product is based on post-sale data and consists of in-depth, monthly ratings reports on all current CMBS transactions (over 700), for which subscribers are assessed on a quarterly or other recurring basis. These reports, which are distributed to over 200 clients, include analytical performance summaries, “watch-list” alerts and other information about a rated security or the underlying collateral for that security such as the property-level reports for CMBS.

Your notice of hearing specified four principal areas of examination:

- The historical reliance of insurance regulators on ratings and the impact of this reliance;
- Issues concerning ratings, particularly related to structured securities and municipal bonds;
- Recent systemic remedies or procedural changes enacted by NRSROs; and,

- Recommendations and alternatives to NRSROs for prudential regulation.

The Role of Ratings in Insurance Regulation

With respect to the traditional usage of credit ratings by state insurance regulators and the institutions operating under their authority, the pattern has been largely similar to that of financial markets generally, namely independent credit ratings are an essential part of the regulatory process. This is why these ratings have to be both accurate and timely.

As has been universally recognized, however, the structured finance ratings of the major credit rating agencies have failed these tests. The Congressional Oversight Panel established as part of TARP found that the “major credit rating agencies played an important—and perhaps decisive—role in enabling (and validating) much of the behavior and decision making that now appears to have put the broader financial system at risk.”¹ A more specific examination of issuer-paid ratings by the SEC concluded that these ratings were not merely inaccurate, but that there were serious questions about the “integrity of the ratings process as a whole.”²

This should not come as a surprise when just three companies have come to dominate a market in which virtually all new offerings utilize two ratings. When private sector companies receive business without really having to compete in terms of either price or quality, there is very little incentive to rise above the bottom line.

Specifically with respect to insurance regulation, accurate ratings of CMBS and other assets are essential for state insurance regulators. Ratings that are too high or too low impair the established regulatory structure in two principal ways:

1 Special Report on Regulatory Reform of the Congressional Oversight Panel (January 29, 2009) at Page 40.

2 Summary Report of Issues Identified in the Commission Staff Examinations of Select Credit Rating Agencies by the Staff of the Securities and Exchange Commission (July, 2008).

- Evaluating Risk-Based Capital, which reflects the strength of insurers, calculated annually; and,
- Evaluating the Asset Valuation Reserve for life insurers.

In both instances, credit rating deficiencies impair the ability of even the most properly designed and administered system to differentiate between insurers that are well-capitalized and those that are potentially troubled.

As is the case under the federal system, there is also a process within the NAIC for individual credit rating agencies to be “recognized” as an Acceptable Rating Organization (ARO). Under one process, the Valuation of Securities Task Force (VOS/TF) may approve an application of a rating organization to be placed on the ARO List if the rating organization has been designated a NRSRO and it assigns and monitors ratings for at least ten percent (10%) of the dollar value of all assets owned by insurance companies. In addition to these general guidelines, there is also discretionary authority within the VOS/TF for adding a rating agency to the ARO list if it is determined that the ratings of that rating organization are necessary for the administration of any component of state-based financial solvency monitoring of insurance company investments. Realpoint is very pleased to have been included on the ARO list by vote of the VOS/TF this week, and we are confident that our ratings will contribute positively to advancing the NAIC’s goal of promoting greater accuracy in ratings performance.

Issues Related to Structured Securities and Municipal Bonds;

As noted, the performance of the major ratings agencies in structured finance has, simply stated, been terrible. The SEC recently published data showing that Moody’s has had to downgrade 94.2 percent of all the subprime residential mortgage backed securities it rated in 2006. This trend is being repeated in the CMBS market for all three of the major rating agencies.

For example, the three major rating agencies downgraded a total of 3,405 CMBS bond classes during the first half of the year and upgraded only 82, for the most lopsided upgrade-to-downgrade ratio in the history of the sector. Moody's Investors Service led the charge, downgrading a 2,212 bond classes while upgrading only 52.

The reason for these wholesale downgrades is that the ratings were artificially high when initiated due to lack of competition and, just as importantly, lack of adequate monitoring after sale because the current industry fee structure places too much emphasis on new issue ratings as opposed to ongoing surveillance. This is unacceptable when dealing with debt obligations of ten, twenty years or even longer maturities.

The market for municipal securities is not our area of particular expertise, but the trouble in this market is directly related to structured finance because state and local issuers have relied for credit enhancement on bond insurers such as MBIA, ACA, and FGIC whose status has been severely impaired by their ventures into the business of guaranteeing mortgage backed securities. In essence, these public entities are now confronted with problems emanating from the financial weakness of the very companies which were thought to be assisting the marketability of their securities. If nothing else, this phenomenon shows the inter-connectedness of our modern financial system.

By contrast, Realpoint's initial ratings and ongoing analyses have been consistently lower and more stable than those of our larger, issuer-paid rating agencies. Even during these unprecedented times, downgrades at Realpoint stand below the 30 percent level and have occurred six to 12 months sooner than the corresponding rating actions taken by Moody's, S&P and Fitch.

It may be helpful at this point to discuss why the ratings of the major companies have been so widely “off the mark.” Unlike corporate bonds, which may be rated using publicly-available financial information, an initial issuance of structured finance bonds is rated by a rating agency selected by the issuer using information disclosed by the issuer to the rating agency. For a new CMBS offering, for example, the issuer generally starts the process of selecting its issuer-paid rating agencies by providing data (property information and existing mortgage loan terms) to three selected NRSROs. These NRSROs then analyze the largest properties, and a sample of the other properties, to provide preliminary feedback regarding proposed tranches (i.e., the subordination level attachment points) for the securities to be backed by the pool.

Since higher ratings generally equate to lower borrowing costs, there is a strong inclination for the issuer to select the NRSROs that provide favorable preliminary feedback to rate the new issue. As a consequence, an NRSRO that provides less favorable preliminary feedback may not be hired by the issuer. This practice is most often referred to as “ratings shopping” and it clearly impedes independence, accountability and transparency with respect to the new-issue ratings.

Realpoint has been the major proponent in testimony before the Congress and the SEC in ending this practice of confining the flow of both presale and ongoing credit information only those NRSROs hired to rate the issuance. As we tried to put it in commonly understood language at a recent congressional hearing:

This is not a complex problem and, in fact, it is not that different from when we were all in high school and everyone sought out the teachers who were known as “easy-graders.” This is what drove the massive level of high-grade defaults during the last two years and it still driving the remainder of the pre-sale process today.³

³ Statement of Robert G. Dobilas, *Hearing on Approaches to Improving Credit Rating Agency Regulations*, 111th Cong. 1st Sess. (May 19, 2009).

At a Commission meeting held just last week, the SEC addressed this issue by adopting new rules requiring any issuer or other sponsor of a security seeking a credit rating from an NRSRO to disclose the same financial information given to its solicited NRSRO to all other NRSROs designated to offer ratings for that particular type of security.⁴ We deem this to be one of the most important reforms undertaken by the government in response to the credit crisis and would strongly urge the NAIC to consider a comparable approach with respect to its ratings agency procedures as it considers ways to improve competition in the highly concentrated credit ratings industry.

Recent Systemic Remedies and Changes Adopted by NRSROs

In response to the industry's performance shortcomings, the major credit ratings agencies have reshuffled management and announced a number of industry "best practices" to address the loss of credibility in the marketplace. Included among these measures are:

- Enhanced review of the due diligence process conducted by originators and underwriters;
- Enhancement of analytical methodologies;
- Providing more clarity about the credit characteristics of structured finance ratings;
- Promoting objective measurement of ratings performance;
- Enhancing investors' understanding of the attributes and limitations of credit ratings;
- Rotation of analysts; and,
- Establishment of Ombudsman to manage conflicts.

Certainly these are welcomed actions, but in terms of the trillions of dollars in losses incurred by investors and now taxpayers as a consequence of the federal government's corporate rescues and more general financial market support programs, they are totally inadequate. In the words of Representative Paul Kanjorski (D-PA), who chairs the House Financial Services Subcommittee with jurisdiction over ratings agencies: "We must consider radical reforms aimed

⁴ SEC Press Release 2009-200 (September 17, 2009).

at improving accountability, reliability, transparency, and independence....We therefore should no longer pursue only modest modifications in regulating this problematic industry." ⁵

The new Administration's Treasury Department has made the same point in testimony before the Congress:

"But flaws and conflicts revealed in the current crisis highlight the need for us to go further as more needs to be done. Our legislative proposal directly addresses three primary problems in the role of credit rating agencies: lack of transparency, ratings shopping, and conflicts of interest."⁶

Another way to view the need for significant regulatory intervention in this process is to consider the current status of the CMBS market. As the State Insurance Commissioners are well aware, the broad decline in real estate values continues and commercial mortgage loan delinquencies are projected to exceed historical averages over the next few years. Concurrently, billions of dollars of commercial mortgage loans are scheduled to mature over the next few years while the CMBS market remains essentially at a standstill. There have been very few new issuances since June 2008 even with TALF assistance in place. In our view, unassisted investors both here and especially abroad are not going to be satisfied with self-imposed industry improvements and they will not return to the market until confidence in ratings has been restored through meaningful remediation directed from both state and federal governmental authorities.

Recommendations and Alternatives to NRSROs for Prudential Regulation

No recommendations in the credit rating industry will ultimately succeed unless the current situation -- where two companies control 80 percent of the market and third company

⁵ Opening Statement , *Hearing on Approaches to Improving Credit Rating Agency Regulations*, *supra* n. 3

⁶ Statement of Michael Barr, Assistant Secretary for Financial Institutions, *Examining Proposals to Enhance the Regulation of Credit Rating Agencies*. 111th Cong. 1st Sess. (Aug. 5, 2009).

holds the next 15 percent of the market share -- is both reformed and opened to more competition. Fortunately, a number of independent companies like Realpoint have emerged in recent years using the subscriber-based business model where the incentives between the investing public and the rating agency are properly aligned. At Realpoint, if we do not produce accurate and timely ratings, we would lose our subscribers. Under the currently dominant issuer-paid model, the record shows that there are no adverse consequences for being wrong. Almost ten years ago, for example, the major rating agencies were assessing the debt of Enron, WorldCom, and Global Crossing at investment grade practically to the point at which these companies filed for bankruptcy. Yet, in the ensuing years, the profits of these same rating agencies rose and their market share remained unchanged.

The public benefits of having six or seven independent and qualified credit ratings, rather than just the two selected and paid by the parties selling the securities, are obvious, immediate and manifest. For this reason, we respectfully urge the NAIC to continue to review its ARO procedures and promptly take whatever steps are deemed prudent to allow other qualified NRSROs participate.

Specialized assets also require specialized expertise, analytical models and supervision by management experienced with Mortgage-Backed Securities (MBS), including CMBS. Insurance companies, themselves, understand the importance of accurate, up-to-date, impartial supervised ratings for MBS, which is one of major reasons why the leading investing insurers retain Realpoint as an independent rating agency to assist in rating and monitoring the securities they hold. Particularly for complex assets, many insurance companies believe that prudence mandates that independent third-parties evaluate the assets they hold, over and above the analyses they perform internally.

Operating under the subscriber-paid business model, Realpoint made its reputation as an independent provider of CMBS ratings and analysis through ongoing surveillance of the underlying real estate collateral. This requires access to the trustee, servicer and special servicer reports, as well as all property-level due diligence information and reports (such as operating statements, appraisals, re-appraisals and inspection reports) provided by third-party vendors to the issuers. Thus it is critical that actions taken to prevent ratings-shopping cover not just presale activity, but all ongoing reports and information through legal documentation which would memorialize this requirement.

Another proposal which should be considered is one suggested recently by Senator Charles Schumer (D-NY) which would require every 10th credit rating issued by an NRSRO to carry another rating from a separate independently designated agency. As he described it, the purpose of these “randomized” ratings is to “receive a second, independent rating from a different credit rating agency than the one initially hired by the issuer.”⁷ The effect of this proposal would likewise be to broaden market opportunities for independent companies.

I would also like to comment in opposition to a “reform” initiative gaining momentum in some quarters that is focused on the judicial aspects of the ratings industry. This is the First Amendment or “freedom of speech” defense which has traditionally been invoked to defeat civil claims for rating failures. Resorting to the courts for effective remedy resolution is not what we need in the business community. Credit ratings are opinions regarding the likelihood of payment of a financial obligation in accordance with the stated terms of the debt agreement; we are not and cannot be financial guarantors either directly or indirectly.

⁷ Press Release: *Schumer Proposes New Backup Rating System to Keep Conflict-Riddled Credit Rating Firms Honest* (August 5, 2009).

By way of example, at Realpoint, we have issued outstanding ratings on approximately \$780 billion of CMBS. The idea that our modest company could be confronted with potential liabilities on this scale does not align with our business model. Even if we could afford it, no company would or should commit to that level of errors and omissions insurance. Whether or not the larger companies could manage that risk is for them to determine, but, in our view, the removal of our liability protections would have the opposite effect of promoting competition.

Conclusion

AAA investors abandoned the MBS market and they are not coming back until the system is changed. The SEC has taken an important step in this direction in mandating that the issuers' pre-sale and ongoing information be made available to all qualified rating agencies. However, this is only a first step. Competition can be further enhanced by having securities which are held by insurance companies and other regulated financial institutions rated co-equally by subscriber-based rating agencies. As it has often done in the past, the NAIC can help establish these higher levels of regulatory and fiduciary standards and we strongly encourage you do so.

Thank you for the opportunity to appear at this hearing and I look forward to responding to any questions you may have.