

**TESTIMONY OF DEVEN SHARMA
PRESIDENT
STANDARD & POOR'S**

BEFORE

**THE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
UNITED STATES HOUSE OF REPRESENTATIVES**

OCTOBER 22, 2008

Mr. Chairman, Mr. Ranking Member, Members of the Committee, good morning. My name is Deven Sharma. I am the president of Standard & Poor's ("S&P") and I am pleased to appear before you today. These are unprecedented times and I appreciate the opportunity to participate in the discussion today about the ongoing global credit situation as well as S&P's nearly century-long history of publishing ratings, the steps we are taking to improve our processes in light of recent events and our role in the financial markets. Hopefully, this and other important dialogues happening around the world will lead to actions that strengthen the effective functioning of the capital markets, which are so important to our economic growth.

We at S&P appreciate the seriousness of the current dislocation in the capital markets and the challenges it poses for the American and global economies. Let me state upfront that we recognize that many of the forecasts we used in our ratings analysis of certain structured finance securities have not been borne out. We have reflected on the significance of these events and are committed to doing our part to enhance transparency and confidence in the markets. We are making several changes in our business which I will discuss at greater length later in my testimony.

Most of the ratings that have been the subject of significant attention, including our ratings on securities backed by subprime mortgages, were issued prior to the second half of 2007. There have been a number of significant developments since then that bear on our rating process, including:

- The implementation of the *Credit Rating Agency Reform Act of 2006* (the “CRARA”), which went into effect in June 2007 and is the first comprehensive regulatory scheme related to issuance of credit ratings;
- A recent comprehensive examination of our processes by the staff of the SEC; and
- A number of initiatives we have undertaken this year to improve the quality of our ratings process and our transparency to the markets.

For many decades, S&P has effectively served the global capital markets with high quality, independent, and transparent credit ratings. Those ratings represent an opinion about the creditworthiness of issuers and their debt. They primarily speak to the expected likelihood of default, although they can include other factors such as recovery upon default. Credit ratings are useful to investors, but it is important to recognize and appreciate how they should be used. S&P’s ratings do not speak to the market value of a security or the volatility of its price, and, critically, ratings are not recommendations or commentary on the suitability of a particular investment. We have long strived to make these limitations clear, but, as discussed in more detail below, recent events, including the apparent use of credit ratings by market participants in ways for which they were not designed, suggest the need for us to be even more aggressive in communicating with the market.

S&P has a long tradition of — and a strong cultural commitment to — integrity and professionalism. Our core mission is to provide the markets with quality, independent analysis. Three of the more important measures we employ to promote independence and analytical rigor are:

- Ratings decisions are always made by committees, not individuals. Working by committee brings greater breadth of experience and judgment to our analysis;
- We have in place a team of quality officers whose function is to promote analytical rigor and who provide an important safeguard to our ratings process; and
- We make our criteria, analytics and methodologies, as well as our ratings history, available and open to market comment and scrutiny. This promotes openness, consistency and objectivity.

Market participants and regulators alike have observed that our ratings have historically performed remarkably well. We have been in this business for over one hundred years and studies on rating trends and performance, which are available on our Web sites www.sandp.com and www.ratingsdirect.com, have repeatedly confirmed that S&P's ratings — whether of corporate debt, municipal bonds, structured finance, or the like — have been highly effective in informing the markets about both deterioration and improvement in credit quality. That legacy — which is our most valuable asset — has been challenged by recent events.

S&P's Initiatives To Enhance the Ratings Process and Promote Confidence

It is by now clear that a number of the assumptions we used in preparing our ratings on mortgage-backed securities issued between the last quarter of 2005 and the middle of 2007 did not work. Those assumptions about the expected performance of assets in a future economic environment were the result of a robust analysis of the transactions themselves, our monitoring of the market, our experience in rating these types of securities, and historical data, including

market events going back as far as 75 years to the Great Depression. We used these assumptions to determine, for example, our expectations regarding potential and likely losses arising out of pools of mortgages, which were then incorporated into our ratings. While we endeavored in good faith to assess what we thought would occur in a variety of future economic conditions so that our ratings might withstand the stresses of economic cycles, events have demonstrated that the historical data we used and the assumptions we made significantly underestimated the severity of what has actually occurred. Just as our analysis has always been informed by past experience and our view of likely future developments, we are taking steps to improve our ratings processes and learn from the unanticipated events now occurring in the markets.

S&P is not alone in having been taken by surprise by the extreme decline in the housing and mortgage markets. Virtually no one — be they homeowners, financial institutions, rating agencies, regulators, or investors — anticipated what is occurring. Although we highlighted to investors looming issues we saw in the housing market as far back as early 2006, the reality remains that in publishing our initial ratings on many of these securities we never expected such severe, negative performance in the housing and mortgage markets. There is no doubt that had we anticipated the extraordinary events that have occurred — and we did not — we would have utilized different economic forecasts and would not have assigned many of the original ratings that we did.

In light of these developments, we have been focused on two key efforts: (i) making adjustments to our analysis so that our current ratings reflect our best opinion of credit risk based on all information learned to date; and (ii) identifying and implementing steps to improve our

processes and restore the market's confidence in S&P's rating opinions. Let me describe in some more detail what we have been doing.

At S&P, a core principle of our business, and a key driver of our long track-record of analytical quality, is a constant commitment to improvement. We have actively sought, listened to, and reflected on the many comments and concerns that have been expressed in the markets and here in Washington and elsewhere, and we have focused our efforts to enhance our ratings process, provide better and more information to investors, and promote confidence in our ratings. As a result, we announced a series of actions earlier this year which focus on raising transparency — providing the market with greater insight and understanding of the analytics and information supporting our ratings — as well as further enhancing Standard and Poor's rating practices and processes.

In total, we introduced 27 new initiatives, which are a result of both our internal reviews and our dialogue with market participants and global policymakers. The initiatives include: (i) new governance procedures and controls designed to enhance the integrity of our ratings process and to safeguard against factors that could challenge that process; (ii) analytical changes focusing on the substantive analysis we do in arriving at our ratings opinions; (iii) changes to the information we use in our analysis and the way we convey our opinions to, and share our assumptions with, the public; and (iv) new ways to communicate with, and explain to, the market about our ratings, their intended use, and their limitations.

An important goal of these 27 initiatives is increased transparency and quality. For example:

- We are implementing a number of additional safeguards against potential conflicts of interest. These include: periodic rotation of credit analysts and establishing an Office of the Ombudsman.
- We are increasing the amount and usefulness of the information we publish, including our underlying assumptions for various asset classes, stress tests for our ratings, and scenario analysis around the factors that could drive a ratings change;
- We are expanding our surveillance by obtaining updated underlying loan data in certain structured finance securities during the period we monitor our ratings, in addition to continuing to analyze detailed loan data in the initial ratings process;
- We are implementing procedures to review more information about the processes used by issuers and originators to assess the accuracy and integrity of their data and their fraud detection measures so that we can better understand their data quality capabilities;
- We are developing new criteria focusing on the stability of our ratings. Broadly speaking, ratings stability refers to the movement of ratings, up or down, from their original ratings over time, rather than the ultimate likelihood of default. Historically, we have not expressly incorporated considerations of ratings stability into our analysis. Our new initiative responds to the market's request for such information and arises out of the unprecedented ratings volatility we have recently witnessed.
- We continue to invest in our people. For example, we have increased our ratings surveillance staff for all asset classes in structured finance, and brought in a number

of new senior executives — including a new Chief Credit Officer — and we have established a Model Validation Group.

- We are strengthening our analytics by separating out our criteria development functions from our ongoing quality review functions as well as from our ratings analysts.
- And we are reaching out to all types of market participants to explain further and more clearly the nature of ratings, including their limitations, and the importance of using other types of investment research in their analysis.

Other Developments

Additionally, earlier this year, we signed an agreement with the New York Attorney General. The agreement focuses on augmenting our fee structure and increasing disclosure to investors and reinforcing the need for data quality. The SEC has also recently issued proposed new rules — of which S&P is broadly supportive. In both instances, the overarching goal has been one we whole-heartedly share: to increase transparency about what we do and how we do it. We take the need for greater transparency and independence very seriously, as demonstrated by the steps we are taking. We believe all parties are better served by open and transparent communication about how we analyze creditworthiness.

As the Committee is aware, the CRARA represents the first comprehensive regulatory scheme for ratings agencies that choose to register as NRSROs. This regulatory regime was the product of several years of consideration and, in our view, reflects a judicious balance between oversight and analytical independence. The SEC's implementing rules took effect on June 26, 2007, approximately 16 months ago, and the first SEC examination of S&P under the new

regime started in late 2007. The scope of the examination was extensive and the SEC staff was extremely thorough and comprehensive in its work.

At the conclusion of the examination, the SEC made a series of recommendations. We are taking aggressive action as a newly regulated entity to implement these and other steps that we believe will benefit our ratings process. Some of these initiatives, which are in addition to those I reviewed above, include:

- Revising and enhancing our policies regarding the adoption and dissemination of ratings criteria;
- Developing written policies and procedures relating to the detection, remediation and disclosure of potential errors in our ratings and methodologies; and
- Strengthening our compliance department and the monitoring of adherence to S&P's policies and procedures,

As has been widely publicized, the SEC's report also included reference to certain emails that raise concern. Some of those emails are attributable to S&P, including some that were inappropriately worded. Let me be clear that the unfortunate and inappropriate language used in these emails does not reflect the core culture of the organization I am committed to leading. I also want to be clear that, despite how some may interpret the language in certain of these emails, there is no evidence of any misconduct by our analysts or that the fundamental integrity of our ratings process has been compromised. Indeed, the SEC itself concluded that it found no evidence during its examination that S&P had compromised its standards to please issuers. It is also worth repeating that no single analyst, including the authors of these emails, has the ability

to determine ratings on his or her own as all of our ratings are determined by committee. Still, the language used in some of the emails is disappointing and we are redoubling our efforts to make sure our people appreciate the importance of professional conduct to our reputation, our business, and the markets we serve.

Response To Certain Questions

I would also like to address briefly three questions that are sometimes raised about our ratings business:

- Does our “issuer pays” business model -- whereby issuers of securities pay our ratings fees -- present a threat to the independence of our process?
- Do we “structure” the transactions we rate?
- Do we provide consulting service to issuers that could compromise our independence?

The “Issuer Pays” Model

Critics have alleged that the fees paid by issuers and/or their representatives present a conflict of interest that compromises the independence and objectivity of our ratings. These skeptics question whether, in pursuit of fees, S&P may give higher ratings than would otherwise be warranted. This is not the case. Moreover, such criticism ignores the significant benefits the “issuer pays” model provides to the market.

The fact is that, as the SEC recently concluded, “there is no evidence that decisions about rating methodology or models were made based on attracting or losing market share”.¹ Indeed,

¹ United States Securities and Exchange Commission, *Summary Report of Issues Identified In The Commission Staff’s Examinations of Select Credit Rating Agencies*, July 2008, at 25.

the facts consistently attest to S&P's independence. A highly publicized example occurred not too long ago in Canada where significant amounts of asset-backed commercial paper became illiquid. The paper had not met S&P's ratings criteria and so we did not rate it. While this decision meant our foregoing fees, it was consistent with our commitment to independence and quality.

The real question is not whether there are potential conflicts of interest in the "issuer pays" model, but whether they can be effectively managed. Mr. Erik Sirri, director of the SEC's Division of Market Regulations, last year testified at a congressional hearing that the conflicts raised by this long-standing business model are indeed manageable. As Mr. Sirri testified:

"Typically, [rating agencies] are paid by the underwriter or the issuer. That presents a conflict, but we believe that conflict is manageable. [Rating agencies] should have . . . policies and procedures in place and they should adhere to those policies and procedures when they evaluate deals."²

S&P maintains rigorous policies and procedures around the integrity of our analytical processes through a number of checks and balances. For example, S&P's professionals are not now, and have never been, compensated based upon the amount of revenue we receive from the issuers or issues they rate. Nor do credit analysts negotiate fees. We have also instituted periodic rotations for credit analysts as well as "look back" procedures when credit analysts leave our firm to work for an issuer. As stated earlier, we also have a quality function separate from our analytical ratings teams and, most importantly, ratings decisions are made by

² *Recent Events in the Credit and Mortgage Markets and Possible Implications for U.S. Consumers and the Global Economy: Hearing Before the House Comm. on Financial Services, 110th Congress, 31 (2007) (statement of Erik R. Sirri, Director, Division of Market Regulation, Securities and Exchange Commission).*

committee. Taken together, we believe these measures provide robust safeguards against the potential conflict of interest inherent in the “issuer pays” model.

The “issuer pays” model also benefits the market. S&P makes all of its public ratings, as well as other important information, available to the market free of charge in real time. When a rating is assigned or changed, the announcement is made on our Web sites — www.sandp.com and www.ratingsdirect.com — and a press release is provided to news media outlets. Today there are approximately nine million current and historical ratings available on RatingsDirect and over one million active ratings are available for free on www.sandp.com. The benefits to the market are obvious: any and all interested market participants can access the same information at the same time. This creates a level playing field and a common basis for analyzing risk. It also leads to higher quality ratings as our analysis is subject to market scrutiny and reaction every day from every corner of the capital markets.

By contrast, subscription models, such as those used by some of our competitors, do not provide the broad (and free) dissemination of ratings that increases transparency for investors. Access to ratings under such models is expensive and exclusive to subscribers. Not only does this result in less, not more, information in the market about those ratings, but it can also take away an important check on ratings quality — the constant scrutiny of a broad market. Given the breadth of our ratings coverage and the depth of our analysis, many investors, including the vast majority of individual investors, simply would not be able to afford access to ratings information, if the “issuer pays” business model were to disappear. The likely result would be that these investors would have no meaningful access to ratings information.

Finally, it is worth noting that “investor pays” models have the potential for conflicts as well, as investors would prefer lower ratings, everything else being equal. The key question for any approach, whether it be investor or issuer paid, is then whether the rating agency takes appropriate steps to preserve its independence. For S&P, that independence is a core principle of our business.

S&P’s Policies Prohibit “Structuring”

Similar misunderstandings have led some to question whether S&P participates in “structuring” transactions, thereby threatening ratings independence. First, let me state clearly that our policies prohibit our analysts from structuring transactions or advising issuers on the structuring of deals.

It is true that our analysts talk to issuers of structured finance transactions as part of the ratings process, as they have traditionally had discussions with corporate issuers with respect to rating their non-structured securities. This dialogue provides benefits to the marketplace. Critical to our ability to rate transactions is a robust understanding of those transactions. Reading documents and reviewing the results of relevant modeling are important, of course, but so is communication with the people responsible for the transaction itself. Through dialogue with issuers and their representatives our analysts gain greater insight into transactions to be rated, including any modifications to those transactions that may occur as the process goes forward. This dialogue promotes transparency into our ratings process, a virtue we believe in, and one that regulators have consistently espoused.

While this dialogue may take different forms in different situations, the key point is that S&P’s role is fundamentally reactive. Using our fixed, publicly available criteria, issuers

provide us with information and we respond with our considered view of the ratings implications. In the process, and as part of our commitment to transparency, we also may discuss with issuers the reasoning behind our analysis. This type of dialogue informs the ratings process at S&P, which otherwise could be a "black box." Without informed discussion, issuers would be proposing structure upon structure until they stumbled upon the structure that best matches with their ratings goals. That certainly would not make the markets more transparent and efficient.

Nor should anyone view as suspicious the fact that some issuers structure transactions in an effort to obtain a specific rating result. Indeed, a variety of potential structures could merit a particular result consistent with our ratings criteria. Our role is to come to a view as to the structures presented, but not to choose among them.

Ratings Services Does Not Engage In Consulting

Similarly, S&P's credit ratings business does not provide consulting services to the issuers we rate. We do not advise issuers about how to conduct their business, whether to seek financing, or how and when to approach the capital markets. Additionally, our ratings analysts are strictly segregated from other S&P activities and those of our parent company, The McGraw-Hill Companies, Inc.

Some have questioned whether our "Ratings Evaluation Service" ("RES") amounts to consulting and so I would like to spend a minute addressing that. RES provides our assessment to entities contemplating potential transactions – an acquisition, for example – of the likely ratings impact of those transactions. S&P does not suggest strategic alternatives to the issuer or provide advice about what the issuer should or should not do. Nor does S&P commit to the

rating assessment it provides; instead, S&P makes clear that if and when the entity takes the contemplated action, any actual ratings decision will be subject to our committee process and will be evaluated both on its final terms and in light of market conditions applicable at the time of the action. S&P's receipt, in connection with RES, of information about the proposed transaction beforehand (and our ability to conduct an informed analysis of it) not only provides valuable information to the issuer, but it also puts us in a better position to publish a rating when the deal is actually announced. This enables us to provide the market with a more timely analysis of the transaction, and allows the market to factor that analysis in more quickly.

I should also note that as a matter of policy we do not offer RES for structured finance securities.

A Systemic Challenge

We believe the capital markets will continue to look for quality, independent ratings as they move out of the current financial and economic turmoil and look to expand and grow. Ratings have been, and we believe will continue to be, an important tool for investors looking for a common and transparent language for evaluating and comparing creditworthiness across all sectors in both mature and developing global markets.

Restoring confidence in the credit markets will require a systemic effort, however. At S&P, we are one part of the equation and we are ready and willing to do our share, but other market participants need to take action as well. For example, while we can take, and have implemented, steps to try to improve the quality of the data we use and the quality of opinions we publish, it is critical for all market participants — including issuers, investors, regulators, and

others — to come together with meaningful solutions that will strengthen our financial system at its core to help prevent a recurrence of the present situation.

Similarly, while we are increasing our communications efforts regarding the nature of ratings, we do not control whether others ultimately use our ratings appropriately or not. Reports suggest that some market participants have used ratings in ways for which they were not designed. As noted, ratings are not investment advice or recommendations to buy, sell, or hold a security. Instead, our ratings are opinions on the relative future credit risk of an entity or a debt obligation, primarily the risk that an entity may not meet its contractual and financial obligations as they come due. Some investors and other market participants have incorrectly assumed that our ratings speak to other investment considerations such as liquidity and/or the market value of debt securities: they do not.

We understand that some financial institutions have cited recent S&P downgrades of our ratings on them as a reason for their difficulties. While we are not privy to all of the facts, these difficulties would appear to have resulted from many factors influencing the market, rather than from the ratings themselves. Such a situation is unfortunate and has had regrettable consequences for the markets, but we do not believe it would have been appropriate or consistent with our independent role in the markets for us to have refrained from taking action we otherwise believed warranted out of deference to particular issuers. Our ratings are not driven by market sentiment. Rather, our role is to act as independent observers offering our views of creditworthiness.

Conclusion

I thank you for the opportunity to participate in this hearing. Since our founding over a century ago, S&P's consistent approach has been to learn from experience and to evolve our analytics, criteria, and review processes when appropriate. You can expect that same approach going forward. Let me also assure you again of our commitment to analytical excellence and our desire to continue to work with Congress and governments, legislatures and policy-makers worldwide as they explore the recent troubling developments and strive to develop solutions to restore stability in the global capital markets. I would be happy to answer any questions you may have.