State of Connecticut

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ATTORNEY GENERAL

Hartford

May 31, 2008

The Honorable Barney Frank
Chairman, House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Re: Credit Rating Agency Reform

Dear Congressman Frank:

I write to strongly urge that your committee and Congress pass legislation to reform the credit rating industry and to make the credit rating system fair to states and municipalities that issue billions of dollars in public bonds every year.

As I testified before your committee on March 12th of this year, my office is actively pursuing an antitrust investigation of the three major credit rating agencies and their use of a biased dual rating system for bonds issued by states, municipalities and other public entities From public documents and information, as well as information uncovered in my investigation, we know that rating agencies frequently give states and municipalities substantially lower credit ratings as compared to corporations with the same or worse rates of default. This dual rating system costs cities, towns, and school districts in Connecticut and around the country millions of dollars in unnecessary interest and insurance costs every year. Given your committee's interest in the role of the credit rating agencies in our financial markets, I thought it would be helpful to tell you some of what my office has learned thus far I am writing similar letters to Senators Dodd and Shelby and to Chairman Cox at the Securities and Exchange Commission (SEC)

Our investigation has revealed that as far back as 1999, the ratings agencies have knowingly and systematically given state, municipal, and other public entities lower credit ratings than other forms of debt, such as corporate and structured securities, with similar or even worse rates of default. From 1999 through 2007, the three major credit rating agencies conducted numerous studies on the default rates of municipal bonds. Each of these studies confirmed the fact that state, municipal and other public bonds rarely default. Indeed, some classes of public debt essentially never default. Federal law indicates that a credit rating should reflect "a rating agencies' assessment with respect to the ability and willingness of an issuer to make timely payments on a debt instrument, such as a bond, over the life of that instrument." See *Report on the Credit Rating Agency Reform Act of 2006*, Senate Rpt. 109-326, at 2. The rating agencies' representations to the markets as to what their ratings mean largely track this definition. For example, Standard & Poor's public website plainly states that a credit rating "primarily indicates the likelihood of default." <u>See</u> *Standard & Poor's General Description of Corporate and Government Ratings Credit Rating Methodology*, June 26, 2007.

Despite these facts, rating agencies routinely give credit ratings to public bonds that are as much as 7-8 notches below corporate debt with similar or even greater risks of default. We know that this issue prompted much internal debate within the ratings agencies yet, despite the incongruence of these approaches, the practice continues to this day.

For example, Connecticut recently issued a $2 billion, 15-year general obligation bond backed by the full faith and credit of the State. Despite never having defaulted on any bond obligation, Connecticut's bond received an "Aa" rating. In light of the rating agencies' repeated studies of public bond default rates, it is very difficult to conclude that there is any factual or analytical basis for the proposition that the State of Connecticut is more likely to default on its bond obligations than any of the many corporations, bond insurers, or structured finance securities receiving higher "Aaa" ratings. It is simply not true, and the rating agencies know it.

This is no small matter to public bond issuers. For example, if Connecticut had received a more accurate "Aaa" rating and the $2 billion bond interest rate was decreased by just 25 basis points, the State would have saved Connecticut taxpayers $44 million in interest costs. Similarly, the small town of East Haddam, Connecticut recently issued $16.6 million in general obligation bonds to pay for construction of a new school. If East Haddam's bond issue had been rated on the same scale as corporate bonds, it would have received an "Aaa" rating and saved the taxpayers of East Haddam approximately $350,000 in interest costs over the life of the bond. These unnecessary interest costs are multiplied literally thousands of times across the country whenever a state, city, town, school district, or sewer district issues a bond to pay for a critical public project.

Additionally, because underrating places much municipal debt below SEC Rule 2a-7 thresholds, money market funds and other large institutional investors (like insurers) either cannot buy municipal bonds without the additional cost of bond insurance or are discouraged from doing so. Restricting the number of investors in the market increases the cost of issuing debt and decreases the amount of debt that will be issued. International investors are similarly discouraged from participating in the United States market because the different rating scale for US public debt prevents these investors from accurately comparing U.S. public debt risk to European credit risks and other U.S. non-public bonds.

To combat the costly effects of the dual rating system, I strongly urge your committee and the Congress to pass new legislation implementing the following specific reforms.

1. **Explicitly define in law that a credit rating is a rating agency's estimate of the likelihood that a bond will be paid back according to its terms.** The rating agencies do

not all use the same definition for their ratings and our investigation has seen clear evidence that investors are confused by or even completely unaware of what a given credit agency's rating actually means. Indeed, we have seen evidence that the raters themselves are sometimes confused as to the meaning of their own ratings. At least one credit rating agency has changed the definition of its municipal credit ratings, yet still uses the same letter symbols to express its ratings, both before and after the definition change.

Such confusion as to the basic meaning of a credit rating undermines the credit rating's very purpose, which is to provide the investor with an accurate, general estimate of risk. Having a uniform definition of what a rating means would improve market transparency by making it clear to all investors precisely what question a credit rating is intended to answer (and not answer). This is particularly important in the municipal bond market where as much as 50% of bond buyers are small, individual investors who do not have the expertise or resources to do their own credit analysis or track subtle yet important differences in ratings definitions. The more investors understand what a rating represents, the more accurately they will be able to judge the risk of a given investment. Of course, the procedures and methodology by which rating agencies arrive at their credit ratings should be left up to the rating agencies.

2. **Require ratings to be comparable across asset classes.** Investors frequently purchase different types of debt securities to diversify their portfolios and spread their risk. If credit ratings are not comparable across differing asset classes, investors cannot accurately assess the risk of different kinds of investments. Ratings comparability creates a more efficient market in which investors can more freely move their money among various investments depending on their assessment of the risk. In sum, bonds with the same probability of default should have the same credit rating.

3 **Require that state, municipal and other public bonds be rated on the same scale as corporate bonds.** It is simply unfair for Wall Street effectively to impose a secret tax on Main Street by giving publicly backed debt lower credits ratings. This unfair dual rating system forces cities and towns to either purchase bond insurance to achieve the "Aaa" credit rating they frequently already deserve, or pay the increased interest costs associated with a lower credit rating. Indeed, because bond insurers are rated on the more lenient corporate scale, many municipalities (who are rated on the more stringent municipal scale) are actually a better credit risk than the bond insurers from who they are purchasing insurance. At a time when the need for investment in our public infrastructure is more and more apparent, such additional hidden costs on the issuance of public debt is intolerable.

4. **Prohibit rating agencies from skewing their credit opinions based on issuer or investor preferences.** Our investigation has seen clear evidence that credit rating agencies modify their ratings based on client or investor preferences. For example, in the structured finance area, raters are far more likely to modify the assumptions they use in order to reach a higher rating when dealing with an investment bank. Investment banks are frequent and high paying customers of the credit raters. In particular, at the height of the structured securities

market in 2005-2006, investment banks were seeking ratings on newly issued securities nearly every day. By contrast, when dealing with a municipality or school district (which issue debt only once every few years) the rating agencies are far less accommodating. Moreover, the rating agencies claim they need to rate municipal and other public debt on a more stringent scale so that investors can see fine distinctions between the generally excellent credit quality of municipal issuers. Such a dual rating system misleads investors by exaggerating the risk of municipal debt as compared to other debt, such as corporate and structured securities. Rating agencies should be required to give their honest credit opinion, regardless of whether that means all the debt in a given sector receives a high rating. There is no basis for a class of issuers being effectively penalized for being a uniformly good credit risk.

5. **Provide the SEC with the authority to revoke rating agency registrations for consistently wrong ratings.** The Credit Rating Agency Reform Act of 2006 gives the SEC authority to revoke a credit rating agency's registration under the Act only if the rating agency fails to follow its own procedures. The Act does not give the SEC power to revoke an agency's registration if its ratings are consistently wrong. The SEC should have this authority. As Professor Adolf Berle of Columbia University Law School testified before your committee on April 22, 2008, there are few, if any, penalties to a rating agency for getting it wrong. The credit rating market is highly concentrated and most issuers require two ratings from a Nationally Recognized Statistical Rating Organization (NRSRO) to make their bond marketable under SEC rules. Thus, the rating agencies know that most issuers will be required to continue purchasing ratings regardless of their accuracy. Given the impact that inaccurate ratings have had on our national economy in recent months, this must change. If a rating agency consistently produces incorrect ratings, its registration as a NRSRO should be revoked.

Finally, I think it is worth pointing out that the above reforms can be implemented without a protracted legal battle over the rating agencies' claimed First Amendment rights. As you know, the major credit rating agencies claim their ratings are entitled to First Amendment protection as mere opinions and thus should be immune from federal regulation. Leaving aside the validity of this argument, it is clear that Congress does have the authority to regulate the brokers and dealers who are necessary to issuing municipal bonds to the market. Congress should use this authority to require the SEC to promulgate rules that prohibit brokers and dealers from handling securities that do not carry credit ratings in compliance with the reforms outlined above. Congress used this same strategy to overcome the so-called Tower Amendment limiting Congress' power to directly regulate how municipalities issue bonds. By regulating what types of bonds brokers and dealers can issue to the market, municipalities were effectively forced to provide greater disclosure of their finances. The same technique can be used here to encourage the credit raters to reform their business practices.

I would be happy to meet with you or your committee to further discuss these issues and provide additional information uncovered through my ongoing investigation.

Yours truly,

RICHARD BLUMENTHAL

c: The Honorable Spencer Bachus
Ranking Member