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TO: The Commercial Mortgage Securities Association

FROM: Scott Sinder
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RE: House Financial Services Committee Mark-Up of H.R. 3355

This morning, the Senate Banking Committee held a hearing on “The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets.” The hearing included discussion of the potential for legislation amending the Credit Reporting Agency Reporting Act of 2006 (“CRARA”). Links to the written testimony of all panelists are listed at the conclusion of this memorandum.

There was very little partisanship in the hearing. In their verbal statements, Senators from both sides of the aisle were critical of the role that Credit Rating Agencies (“CRA”) have played in the greater subprime credit issue. At the heart of the matter was the apparent conflict-of-interest that is endemic to the current “issue-to-pay” system whereby the CRAs are paid for the ratings that they issue. Several Senators suggested moving to a system of investor funded CRAs to potentially eliminate this conflict-of-interest. The only disagreement among members of the committee was on whether newer, more extensive legislation should be passed to supplement CRARA which was enacted less than a year ago. Many Republicans tended to believe that any real judgments on CRARA are premature, while many Democrats believed that CRARA had not done enough to avert the crisis.

Senator Jack Reed (D-IA) chaired the hearing. The Senators in attendance were Sen. Richard Shelby (R-AL, ranking member), Sen. Chuck Schumer (D-NY), Sen. John Sununu (R-NH), Sen. Bob Casey (D-PA), Sen. Chuck Hagel, Sen. Sherrod Brown (D-OH), Sen. Evan Bayh (D-IN), Sen. Robert Menendez (D-NJ), Sen. Wayne Allard, and Sen. Mel Martinez (R-FL). All Senators issued oral statements with the exception of Sen. Hagel (R-NE).

The sole witness on the first panel was SEC Chairman Christopher Cox. Chairman Cox's testimony noted that even under CRARA, the SEC does not have the authority to review the substance of the credit ratings issued, or the procedures and methodologies used in determining those ratings. Upon questioning by the Committee, Cox acknowledged that he does not want the SEC to have that authority because he believes that: (1) doing so will put a "collar on innovation;" (2) the market will punish CRAs that are consistently wrong; and (3) CRARA already provides a sufficient middle ground.

According to Cox, under CRARA, the SEC has approved seven (7) new nationally recognized statistically reporting organizations ("NRSRO") in the last six months. The SEC is currently non-publicly probing whether NRSROs were under "undue influence from issuers and underwriters" and whether procedures for handling conflicts-of-interest were properly followed.

The second panel was comprised of John Coffee (Professor of Law, Columbia University), Dr. Lawrence White (Professor of Economics, NYU), Michael Kaneff (Moody Financial Services), and Vickie Tillman (Standard and Poor's). Prof. Coffee noted in his testimony that he believes that the market provides very little punishment for inaccuracy on the part of the CRAs and that they downgrade only under "great pain of penalty." To remedy this, he suggests that: (1) the SEC should compute default rates using their own criteria and publish them electronically on a real-time basis; (2) NRSRO status should be forfeitable for extreme inaccuracy; and (3) new competitors should be protected by mandating fair disclosure for all NRSROs.

Prof. White echoed many of Prof. Coffee's sentiments with one notable exception. He believes that an insufficient amount of time has lapsed since CRARA's passage and more time

should be given to properly understand its effectiveness. He was adamant, however, in noting his belief that the NRSRO structure prior to CRARA was inadequate.

Mr. Kanef and Ms. Tillman both made the same essential point: the CRAs are not to blame for the current crisis in the subprime lending market. Kanef cited fraud in the mortgage origination process, deterioration in underwriting standards, and increasingly restrictive lending standards as prime contributors to the crisis. Upon questioning, both generally agreed that the conflicts-of-interest inherent to the current issue-to-pay model are manageable as is. Furthermore, they believe that the procedures and methodologies used in issuing ratings are adequately transparent as well.

Chairman Cox's Written Testimony

Professor Coffee's Written Testimony

Professor White's Written Testimony

Mr. Michael Kanef's Written Testimony

Ms. Gail Tillman's Written Testimony

We hope this is helpful.
