Testimony for 15 April 2009 Roundtable on Securities and Exchange Commission Oversight of Credit Rating Agencies

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Many thanks to Chairman Schapiro and the members of the Securities and Exchange Commission for this opportunity to express the views of ApgarPartners LLC – a startup that tests critical assumptions to identify hidden factors in bond valuation, risk management, and organizational performance.

In our view, government funding will not be necessary to create useful alternative credit ratings free from the challenges facing the major rating agencies. While many observers focus on the conflict of interest between issuers who pay for ratings and investors who use them, we suspect that rating opacity is a more serious problem. Unfortunately, most new rating alternatives share the opacity of major agency ratings or appear to require subsidies or other government interventions to reach an efficient scale. We nevertheless believe there is a viable alternative that avoids this dilemma.

The conflict between the interests of issuers who pay for major agency ratings and investors who use them is a tempting explanation of the agencies' reluctance to downgrade credits like Lehman until the days before it failed. But it is hard to trace direct influences on ratings. Far clearer is the fact that major agency ratings are opaque.

This is not just because of secrecy. It arises because the major agencies encourage analysts to use judgment and discretion for the sake of producing better ratings. The drawback of such discretion is that it is never clear whether misleading ratings stem from problems with the exercise of judgment or problems with the model that an analyst is using. Ratings that rely on discretion are in a certain sense incorrigible.

A number of new startups are challenging the major agencies by focusing on specific sectors and deploying what they believe is sharper analysis. It will be tough for any of these startups to reach anything like the scale enjoyed by the major rating agencies – tough but possible. Even if several of them do so, however, they won't be able to address the problem of opacity. Approaches based on the expertise of analysts generally need to protect and encourage the exercise of those analysts' discretion.

Other startups offer plenty of transparency in the form of fixed models for calculating the ratings they generate. This approach addresses opacity because users can see the precise relationship between the factors that drive them and the results they yield. Since they provide no new information once users have seen the underlying models, however, they may require some kind of subsidy to survive.

The subsidy need not be in the form of a government outlay. As Joe Grundfest has suggested, it should be enough for the government to divert a portion of the fees paid by issuers for major agency ratings to a fund for other rating companies. But that is still a significant intervention by the government and its effects are hard to predict.

Fortunately, these alternatives do not exhaust the possibilities. In particular, we believe it will be possible to build an alternative rating system that is perfectly transparent in that it ties its ratings to clearly defined models. The models, however, need not be fixed – structured properly, they can be tested and improved continuously. And these dynamic models can provide new information to the market in the form of the reasons behind the changes made in them.

The approach to credit ratings that ApgarPartners is currently pursuing suggests transparent and un-conflicted ratings are possible without government support.