April 23, 2007

Ms. Nancy M. Morris
Secretary, Securities and Exchange Commission
100 F Street, NE
Washington DC 20549-1090

Sent by electronic mail

Re: File No. S7-04-07 (SEC Proposed Rules Implementing Provisions of the Credit Rating Agency Reform Act of 2006

Dear Ms. Morris:

I am currently the Willis H. Booth Professor of Banking and Finance at the Haas School of Business, University of California, Berkeley, and a Co-Chair of the Fisher Center for Real Estate and Urban Economics. I am also a member of the Fitch Academic Advisory Board. The views expressed here are my own and independent of my position on the Fitch Advisory Board.

With the passage of the Credit Rating Agency Reform Act of 2006, a major goal of Congress was to encourage competition and entry into the bond rating business, specifically with regard to "Nationally Recognized Statistical Rating Organizations" (NRSROs). The proposed Rule 17g-6—Prohibited Unfair, Coercive, or Abusive Practices (on pp. 94-105) is critical to meeting this goal. The Commission has requested "comment on all aspects of proposed Rule 17g-6, particularly on whether the proposed rule's requirements that prohibit certain acts and practices could be more narrowly tailored and still meet the stated goals." It is to this request that I am responding.

I am responding, in particular, to the practice noted as "notching" which occurs in rating a structured product, which for simplicity I will refer to as a collateralized debt obligation (CDO). The rated risk for CDOs and similar structured products is created by the underlying bonds or similar debt instruments issued by separate entities. The credit rating for the CDO will, of course, depend in significant part on the ratings of the underlying bonds. It will obviously facilitate the rating process for the CDO if the underlying bonds have already been rated by one or more NRSROs.

The practice of notching arises when a NRSRO sets two conditions for its rating of a CDO or similar structured product:

i) That at least a minimum percent of the underlying bonds be rated by *that NRSRO*. The current proposal suggests that the minimum be set at 85 percent.

ii) For those bonds only rated by *another NRSRO*, that there be a discount (the notching) applied to the rating provided by that other NRSRO, or the bonds need to be shadow-rated or a credit fee be assessed.

The anti-competitive potential of notching is clear: It creates a strong economic incentive for bond issuers to have their bonds rated by the same NRSRO that may be asked to rate CDOs and other structured products for which their bonds represent the underlying collateral. If the bond issuers fail to do this, they face the risk that the CDO may not be rated at all or that the original ratings of their bonds will be discounted when computing the overall CDO rating. Either of these consequences could impose major economic costs on the bond issuer. The commission "has preliminarily determined that these practices would be unfair, coercive, or abusive". I strongly endorse this preliminary finding.

The NRSROs that practice notching argue that "rating shopping" is a prevalent practice, thereby suggesting that ratings assigned by other NRSROs are somehow inaccurate or unreliable. "Rating shopping" refers to the practice by which a bond issuer may seek preliminary ratings from several NRSROs and then purchase a public rating from the NRSRO with the highest preliminary rating. It is in the best interests of bond issuers to shop for ratings if:

i) They believe they will achieve a higher rating for their bond by shopping;

ii) They believe that this higher rating will be credible with market investors.

If Moody's and S&P's arguments concerning rating shopping were valid, we should see distinctly different ratings on bonds that have been rated by more than one NRSRO. In fact, we do not see this. The comparability studies published by Moody's and Fitch invariably show that for dual-rated bonds, more than 90% of ratings are the same or within one notch of each other.[1] This is not surprising, since market investors would immediately disregard the ratings of any NRSRO which was revealed to be susceptible to shopping.

In addition to being anti-competitive, notching may lead to misleading credit ratings. Categorically reducing ratings assigned to securities held by CDOs and similar structured products without analytic support for such reductions may result in lower ratings for the securities of the CDOs and structured products than is otherwise deserved.

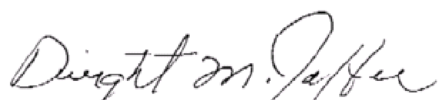
A correspondence to you on March 30, 2007, from Charles Calomiris etal., argues the opposite position, namely that notching is a benign activity. The core of their argument is that "there is a natural market remedy," namely, that the victim of notching should "over time garner a larger share of the CDO rating business….". This assumes the market for credit rating services is fully competitive, and that no firms have market power. However, in passing the Credit Rating Agency Reform Act of 2006, Congress reflected the concern that the competitive status of the credit rating business was in jeopardy. Indeed, there is no denying the dominant market position of just two firms, and once this is recognized, a "natural market remedy" becomes a wish, which, unfortunately, is currently just the opposite of the reality.

I also wish to comment on the revision of Rule 17g-6 which has been proposed by Fitch Ratings. In its letter of April 11, 2007, Fitch suggested that the threshold for which a NRSRO could decline to rate a CDO or similar structured product be reduced to 66% as long as at least 2

[1] Fitch Credit Market Research Report, "U.S. Structured Finance Rating Comparability Survey" (Mar. 24, 2006); Fitch Credit Market Research Report, "International Structured Finance Rating Comparability Survey" (May 16, 2006); Moody's Special Report, "Comparing Ratings on Jointly-Rated U.S. Structured Finance Securities" (May 25, 2006); Moody's Special Report, "Comparing Ratings on Jointly-Rated U.S. Structured Finance Securities: 2007 Update" (March 30, 2007).

NRSROs had rated the particular underlying bond, while allowing the NRSRO to choose which of the two (or more) ratings it choose to use in creating its CDO rating. I believe this is a very strong pro-competitive proposal which the SEC should include in its final ruling. It allows a NRSRO not to rate any CDO or similar structured product in which it, or at least 2 other NRSROs, have not rated at least two-thirds of all the underlying bonds. On the other hand, it requires that when the two-thirds threshold is met, that the NRSRO adopt at least one of the two or more NRSRO ratings that have been provided for the underlying bonds.

Sincerely,



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