Internet Appendix for “Who Prices Credit Rating Inflation?”

C. Excerpts from credit rating agency documents and government documents

All excerpts are _exact quotes_ from credit rating agency internal and industry documents, Securities and Exchange Commission documents, Congressional hearings, and DOJ press releases and settlement statements of facts.

1. Statements describing the role of credit rating agencies

- Rating agencies generally view their role as assessing the creditworthiness of issuers on an ongoing basis, and the likelihood that debt will be repaid in a timely manner.[1]

- Credit ratings are used by these institutions [mutual funds and broker dealers] both for informational and regulatory purposes. These firms typically have their own internal credit research departments staffed with analysts who use ratings issued by credit rating agencies as one of several valuable “inputs” to their independent credit analysis.[2]

- Issuer representatives indicated that they seek credit ratings because of the value placed on the ratings by investors, and the affect credit ratings have on their ability to access capital.[3]

- A credit rating is Standard & Poor’s opinion of the general creditworthiness of an obligor, or the creditworthiness of an obligor with respect to a particular debt security or other financial obligation, based on relevant risk factors.[4]

- Our role is to disseminate opinions about the relative creditworthiness of bonds and other debt instruments.[5]

2. Statements indicating that credit ratings are supposed to be an objective and high quality assessment of an issuer’s creditworthiness

- Critical to a credit rating agency’s ability to serve this key market role [help the market to effectively and efficiently evaluate and assess credit risk] is its meeting the highest standards of integrity, independence, objectivity, transparency, credibility and quality.[6]
- Moody’s 2005 Code set forth its general policies to promote Moody’s stated objectives of integrity, objectivity, and transparency of the credit rating process. Section III(2)(A) of

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[1] U.S. Securities and Exchange Commission: Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets (January 2003), page 21.
[2] *Ibid.*
[3] *Ibid.*
[4] Standard & Poor’s Corporate Ratings Criteria (2006), page 8.
[5] Credit Rating Agencies and the Financial Crisis: Hearing before the Committee on Oversight and Government Reform, page 117.
[6] Standard & Poor’s Rating Services. U.S. Securities and Exchange Commission Public Hearing – November 15, 2002. Role and Function of Credit Rating Agencies in the U.S. Securities Markets.

Moody's 2005 Code, titled "Independence and Management of Conflicts of Interest," stated:

> 2.2 Moody's and its Analysts will use care and professional judgment to maintain both the substance and appearance of independence and objectivity.
> 2.3 The determination of a Credit Rating will be influenced only by factors relevant to the credit assessment.
> 2.4 The Credit Rating Moody's assigns to an Issuer, debt or debt-like obligation will not be affected by the existence of, or potential for, a business relationship between Moody's (or its affiliates) and the Issuer (or its affiliates) or any other party, or the non-existence of any such relationship.[7]

- Moody's 2005 Code also contained a section captioned the "Quality of the Rating Process," which stated:

> 1.6 Moody's and its Analysts will take steps to avoid issuing any credit analyses, ratings or reports that knowingly contain misrepresentations or are otherwise misleading as to the general creditworthiness of an Issuer or obligation.[8]

3. Statements indicating that credit rating agencies are aware that rating changes affect issuers

- *Judicious rating process*: because of the potential importance of the rating to the issuer and investor, Moody's carefully and deliberately considers all information relevant to the issuer's rating that the issuer and its advisors present to us. Moody's understands that its ratings can potentially become self-fulfilling forecasts. In the case of upgrades, that can mean greater capital market access and interest cost savings for issuers, and improved securities prices for investors. In the case of downgrades, it can mean higher capital costs for issuers, and portfolio turnover and losses for investors; most dramatically, however, it can terminate an issuer's access to capital, possibly even leading to default. Especially in the case of downgrades, the potentially self-fulfilling nature of ratings requires that Moody's particularly endeavor to avoid "false" negative predictions.[9]

- Standard & Poor's will consider additional ways to more explicitly incorporate contingent liquidity concerns in its credit ratings. In some cases, the analytical challenges are formidable, especially with respect to rating triggers. For one thing, there is a certain circularity to lowering a rating because of the risk you might lower that rating! Furthermore, in some cases, lowering the rating to reflect the added risk would not be commenting on the credit risk, but determining it. Consider an extreme case to illustrate the point: a company currently rated 'BBB-' introduces a rating trigger into debt of a substantial amount, allowing it to be put back to the company if the credit rating falls one

[7] DOJ's Settlement with Moody's – Statement of Facts, page 1.
[8] *Id.* at page 2.
[9] Moody's Investor Services Special Comment: Understanding Moody's Corporate Bond Ratings and Rating Process (May 2002), page 4.

notch, to non-investment grade. A downgrade would precipitate the very crisis that was the cause for concern.[10]

- Many companies go one step further and incorporate specific rating objectives as corporate goals. Indeed, possessing an 'A' rating, or at least an investment-grade rating, affords companies a measure of flexibility and may be worthwhile as part of an overall financial strategy.[11]

- As a general rule, the more creditworthy an issuer or an issue is, the lower the interest rate the issuer would typically have to pay to attract investors. The reverse is also true: an issuer with lower creditworthiness will typically pay a higher interest rate to offset the greater credit risk assumed by investors.[12]

- Credit rating adjustments may play a role in how the market perceives a particular issuer or individual debt issue. Sometimes, for example, a downgrade by a rating agency may change the market's perception of the credit risk of a debt security which, combined with other factors, may lead to a change in the price of that security.[13]

4. Statements indicating that credit rating agencies rate issuers independently of the effect on the issuer (includes rating triggers)

- *Effect of a rating action on an issuer:* Moody's will proceed with issuing or changing a rating, notwithstanding the effect of the rating action on the issuer, including the possible effect on the issuer's market access or conditional obligations. The level of rating that Moody's assigns to an issuer that might experience potential changes in market access or conditional obligations will reflect Moody's assessment of the issuer's creditworthiness, including such considerations.[14]

- S&P Global Ratings will take a Credit Rating Action regardless of the potential effect (economic, political, or otherwise) of that action on S&P Global Ratings, an affiliate, an Issuer, an investor, or any other market participant.[15]

- In the U.S., Standard & Poor's assigns and publishes its ratings irrespective of issuer request, if the financing is a public deal.[16]

- The rating committee evaluates the matter, arrives at a rating decision, and notifies the company—after which Standard & Poor's publishes the rating. The process is exactly the

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[10] RatingsDirect: Identifying Rating Triggers and Other Contingent Calls on Liquidity, page 1.
[11] Standard & Poor's Corporate Ratings Criteria (2006), page 11.
[12] Standard & Poor's Rating Services: Guide to Credit Rating Essentials, page 6.
[13] *Id*. at page 15.
[14] Moody's Investor Services Special Comment: Understanding Moody's Corporate Bond Ratings and Rating Process (May 2002), page 4.
[15] S&P Global Ratings Code of Conduct (2018), page 6.
[16] Standard & Poor's Corporate Ratings Criteria (2006), page 10.

same as the rating of a new issue. Reflecting this surveillance, the timing of rating changes depends neither on the sale of new debt issues nor on our internal schedule for reviews.[17]

- *Rating triggers*: Rating triggers — especially if near an existing rating and requiring significant remedies, such as repayments or posting of collateral — can severely restrict a company's available outcomes and create additional volatility in a company's creditworthiness. The use of ratings in triggers can make the rating a causal element of a company's creditworthiness. In managing the rating system, Moody's will treat rating triggers as we would other elements of "conditionality" such as stock-price triggers or material adverse-change clauses. To the extent that these elements of conditionality are consequential to a company's future creditworthiness (or even viability), Moody's acts as judiciously as possible in reaching a rating conclusion. We do not, however, forbear, or allow a company's use of our ratings, to delay rating actions.[18]

- On the other hand, Standard & Poor's has not shied away from changing a rating where that was deserved—even knowing full well that the rating action would trip ratings triggers. Standard & Poor's behaves responsibly and takes pains to communicate to the company well ahead of time its ratings vulnerability—and the need to anticipate liquidity contingency. But Standard & Poor's would not maintain a rating that was inconsistent with its credit judgment merely because the rated company would suffer the consequences.[19]

- Standard & Poor's has never encouraged companies to utilize ratings-related triggers or covenants. In fact, we regularly have told companies that doing so was troubling to us—if for no other reason than its potential for embroiling Standard & Poor's in a company crisis. Now Standard & Poor's is considering a more active posture, one that encourages companies that have triggers to remove them or perhaps face a downgrade![20]

5. Statements indicating that credit rating agencies acknowledge conflicts of interest arising from the "issuer fee-based" business model

- During the relevant time period it was generally understood that potential conflicts of interest existed in Moody's business model. Moody's acknowledged this in public statements, including for example, in a July 28, 2003 letter to the United States Securities and Exchange Commission, in which Moody's stated that "the rating agency model which has developed is an 'issuer fee-based' model. This model has two intrinsic conflicts of interest which must be effectively managed: a) issuers pay rating agencies for their credit opinions; and, b) issuers are one source of input in a rating agency's formation of its opinion. . . ."[21]

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[17] Standard & Poor's Corporate Ratings Criteria (2006), page 18.
[18] Moody's Investor Services Special Comment: Understanding Moody's Corporate Bond Ratings and Rating Process (May 2002), page 4.
[19] RatingsDirect: Identifying Rating Triggers and Other Contingent Calls on Liquidity.
[20] *Ibid*.
[21] DOJ's Settlement with Moody's – Statement of Facts, page 2.

- In a February 2006 "Report On Implementation of Standard & Poor's Rating Services Code of Conduct," also published on S&P's website, S&P stated, among other things: (a) "[S&P] recognizes its role in the global capital markets and is committed to providing ratings that are objective, independent and credible"; and (b) "It is a central tenet of [S&P] that its ratings decisions not be influenced by the fact that [S&P] receives fees from issuers.[22]

- The practice of issuers paying for their own ratings creates the potential for a conflict of interest. Arguably, the dependence of rating agencies on revenues from the companies they rate could induce them to rate issuers more liberally, and temper their diligence in probing for negative information.[23]

6. Statements indicating that credit rating agencies did not appropriately address conflicts of interest arising from the "issuer fee-based" business model and did not adhere to their own standards in the run-up to the financial crisis

- "On more than one occasion, the company's leadership ignored senior analysts who warned that the company had given top ratings to financial products that were failing to perform as advertised," said Attorney General Holder. "As S&P admits under this settlement, company executives complained that the company declined to downgrade underperforming assets because it was worried that doing so would hurt the company's business. While this strategy may have helped S&P avoid disappointing its clients, it did major harm to the larger economy, contributing to the worst financial crisis since the Great Depression."[24]

- "Our investigation revealed, and Moody's has now acknowledged, that Moody's used a more lenient standard than it had itself published," said Principal Deputy Assistant Attorney General Benjamin C. Mizer, head of the Justice Department's Civil Division. "Investors relied on Moody's credit ratings to be objective and independent, and they naturally expected Moody's to follow its own published methods."[25]

- "Moody's now admits that it deviated from its methodologies and failed to disclose those changes to the public…."[26]

- This tension [the conflict generated by the "issuer fee-based" model], in many cases, was passed on to the managing directors, who were given both market share and ratings quality targets and asked to manage any tension. One managing director, reflecting on his

[22] DOJ's Settlement with Standard & Poor's – Statement of Facts, page 1.
[23] U.S. Securities and Exchange Commission: Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets (January 2003), page 41.
[24] DOJ's press release. Justice Department and State Partners Secure $1.375 Billion Settlement with S&P for Defrauding Investors in the Lead Up to the Financial Crisis, February 3, 2015.
[25] DOJ's press release. Justice Department and State Partners Secure nearly $864 Million Settlement with Moody's arising from Conduct in the Lead up to the Financial Crisis, January 13, 2017.
[26] *Ibid*.

experience with rating corporate bonds, wrote in October 2007 that "on the one hand, we need to win business and maintain market share, or we cease to be relevant. On the other hand, our reputation depends on maintaining ratings quality. . . . For the most part, we hand the dilemma off to the team [managing directors] to solve."[27]

- The documents from Standard & Poor's paints a similar picture. In one document, an S&P employee in the structured finance division writes, ``it could be structured by cows, and we would rate it.''[28]

7. Statements indicating that credit rating agencies renewed their commitment to credit rating quality following the financial crisis

- "Moody's failed to adhere to its own credit rating standards and fell short on its pledge of transparency in the run-up to the Great Recession," said Principal Deputy Associate Attorney General Bill Baer. "Today's settlement contains not only a significant penalty and factual admissions of its conduct, but also a commitment by Moody's to new and continued compliance measures designed to ensure the integrity of credit ratings going forward."[29]

- In conclusion, we [Moody's] believe in this process, but continually strive to do better. For example, as described more fully in my written statement, we're refining our rating methodologies, increasing the transparency of our analysis and adopting new measures to reinforce and enhance existing processes and policies that address potential conflicts of interest.[30]

- Since 2008, we [Standard & Poor's] have undertaken a number of initiatives aimed at promoting four broad objectives: (i) ensuring the integrity and independence of the ratings process; (ii) enhancing analytical quality; (iii) providing greater transparency to the market by disseminating more information about ratings, as well as information to help investors form their own views of the soundness of rating analysis; and (iv) more effectively training our analysts and educating the marketplace about ratings.[31]

- Standard & Poor's is committed to taking action to help restore confidence in ratings. As one example, over the past year, we have launched a number of initiatives designed to foster greater transparency in our analytics and processes. These initiatives have included publishing "what-if" scenario analyses discussing factors that could cause ratings to change, more explicit discussions of the assumptions we used in forming our opinions, and

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[27] DOJ's Settlement with Moody's – Statement of Facts, page 3.

[28] Credit Rating Agencies and the Financial Crisis: Hearing Before the Committee on Oversight and Government Reform, page 3.

[29] DOJ's press release. Justice Department and State Partners Secure nearly $864 Million Settlement with Moody's arising from Conduct in the Lead up to the Financial Crisis, January 13, 2017.

[30] Credit Rating Agencies and the Financial Crisis: Hearing Before the Committee on Oversight and Government Reform, page 117.

[31] Testimony of Deven Sharma, President, Standard & Poor's. Before the United States House of Representatives Committee on Financial Services Subcommittee on Oversight and Investigations – July 27, 2011, page 3.

changes we have made to our rating criteria for several asset classes resulting from macroeconomic developments and ongoing performance data.[32]

8. Statements indicating that credit rating agencies do not audit the information provided by issuers

- Standard & Poor’s does not perform an audit of the rated company or otherwise undertake to verify information provided by the company; nor does Standard & Poor's audit or rate the work of the company's auditors or repeat the auditors' accounting review. Standard & Poor's relies on the integrity and quality of the company's publicly available financial reports and financial statements and expressly relies on the rated company to provide current and timely information - both at the time of the initial rating and on an ongoing basis for the proper conduct of surveillance of the company's creditworthiness.[33]

- Analysts should keep in mind, as we make clear in our rating publications, that MIS is not obligated to perform, and does not perform, audits or due diligence with respect to verifying the accuracy of information received or obtained in connection with the Credit Rating process; accountants, underwriters, Issuers and others serve these functions in the market.[34]

9. Statements discussing the barriers to entry and consequent oligopoly in the U.S. securities market

- The recent growth in the number of firms operating as credit rating agencies suggests a growing appetite among market participants for advice about credit quality, and that new entrants are able to develop a following for their credit judgments. At the same time, few would dispute that new entrants generally have been unable to evolve into a substantial presence in the ratings industry. Many believe this is due primarily to the longstanding dominance of the credit rating business by a few firms – essentially the NRSROs – as well as the fact that the marketplace may not demand ratings from more than two or three rating agencies.[35]

- As to the regulatory impact on rating agency competition, a wide range of observers has criticized the regulatory use of the NRSRO concept – particularly the “national recognition” requirement – as creating a substantial barrier to entry. In essence, these critics contend that important users of securities ratings have a regulatory incentive to obtain ratings issued by NRSROs, and that without NRSRO status new entrants encounter great difficulties achieving the “national recognition” necessary to acquire the NRSRO

[32] RatingsDirect: Understanding Standard & Poor’s Rating Definitions – June 3, 2009, page 2.
[33] Standard & Poor’s Rating Services. U.S. Securities and Exchange Commission Public Hearing – November 15, 2002. Role and Function of Credit Rating Agencies in the U.S. Securities Markets.
[34] Moody’s Investor Service Best Practices Guidance for the Credit Rating Process – October 29, 2010, page 9.
[35] U.S. Securities and Exchange Commission: Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets (January 2003), page 37.

designation. In other words, new entrants are faced with something akin to a “chicken and egg” problem in achieving NRSRO status, which they view as necessary or, at a minimum, very important for becoming a substantial presence in the credit rating industry.[36]

[36] *Ibid.*