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**Testimony of
Eric Baggesen, Senior Investment Officer
California Public Employees' Retirement System
before the
House Committee on Oversight and Government Reform
September 30, 2009**

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Senior Investment Officer, Global Equities, CalPERS
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Introduction

I would like to thank Committee Chairman Towns and Ranking Member Issa for the opportunity to testify before you on a subject of great concern in capital markets reform.

My name is Eric Baggesen, Senior Investment Officer at the California Public Employees' Retirement System, CalPERS. CalPERS is the largest state public pension fund in the United States, responsible for assets of nearly \$200 billion, which we invest on behalf of 1.6 million beneficiaries. We rely on the quality and integrity of market information to allocate capital on behalf of our beneficiaries. Credit ratings make a critical contribution to those decisions. We therefore welcome the opportunity to discuss with you:

- CalPERS experience of using credit ratings agencies (CRAs)¹;
- the impact of their failure on investors' portfolios ;
- and our recommendations for reform.

Credit ratings are embedded in financial markets via regulation, license and convention. They cannot be avoided, and in many instances their use is effectively a requirement, not a choice. They are integral to our investment policies, including risk management, oversight of manager performance and to the assessment of the quality of individual securities and products.

There is a public interest in ensuring that information disseminated to investors is reliable, that the providers of information are free from conflicts of interest and that there

¹ The term Credit Ratings Agency (CRA) is used interchangeably with the formal definition Nationally Recognized Statistical Rating Organization (NRSRO).

is accountability, transparency and proper oversight from provider to user. This is well understood in other areas of vital importance to the public, such as food and drug safety, but also in the provision of information and opinion by third parties who affect financial decisions. Take the example of financial information. Companies are simply not permitted to raise public funds unless they provide financial statements in line with accounting standards, which are subject to an opinion from auditors who are then liable for that opinion, and are subject to both regulation and oversight by the users (shareowners) who appoint them.

Likewise governance or non financial information provided by companies is subject to standards and regulation via the Securities and Exchange Commission (SEC), to ensure that information in prospectuses, announcements, listing reports and other statements is subject to rigorous legal and regulatory oversight.

By contrast, CRAs' standards of business conduct are opaque, there are no agreed guidelines, and their revenues are based on a fundamental conflict of interest. These organizations have privileged access to issuer information, and operate under license within a narrow oligopoly.

Global markets rely upon the quality and integrity of information. There are three vital elements to that information: financial, non financial and credit. Two of these are subject to high standards of regulation and oversight. One is not. If those three channels of information provide the three legged stool upon which global markets depend, then credit ratings are a source of instability: they are the weak leg on the stool.

2. CalPERS experience of using credit ratings agencies

CalPERS investment staff internally manages \$50 billion in fixed income securities in sectors that range from US Government, Corporate, Structured (Mortgages and Asset Backed Securitizations), and Foreign Sovereign. CalPERS is affected across its portfolio both directly and indirectly by credit ratings.

We make use of credit ratings in establishing our investment policies, which frame our risk appetite against the liabilities we need to meet. We also use credit ratings to specify in contracts with external money managers the investments they are allowed to include in our account. In addition, we use these tools to assess performance against benchmarks, both for our internal and external managers. Credit ratings are also embedded in certain market indices which are structured around particular grades given by the CRAs. Our fixed income portfolio includes a range of rated products, and CalPERS global equity portfolio includes a wide universe of issuers who are dependent upon credit ratings to access the capital markets.

To manage its internal portfolio, CalPERS has staffed its fixed income department with corporate credit and structured securities analysts in order to independently assess the credit quality of issuers and structures. In the Structured markets, CalPERS internal portfolio managers assess key inputs into the ratings of securitizations by performing granular analysis of loan characteristics and stress tests of structures. In addition, our portfolio managers assess securitization market trends including underwriting standards, loan to values, and home price appreciation assumptions.

CalPERS also retains external money managers that have been given delegated responsibility to manage assets. CalPERS incurred losses in some of these portfolios due to the rating agency deficiencies. As a result, CalPERS has initiated litigation against certain credit rating agencies;² is bringing more assets in house; and performs detailed credit analyses of managers' holdings.

Issuers can raise and get access to capital more cheaply with a higher rating. CalPERS has been negatively impacted due to mis-rating of risk for issuers and classes of securities. The mid to long term impact of this mis-rating is the misallocation of capital. As we have seen, the CRAs' mis-ratings can have systemic impacts on equity and bond holders, GDP and employment, when the market realizes the risks are greater than those represented by the rating that was given.

² Please note that this litigation is *sub judice* and therefore not the subject of this testimony.

CalPERS itself subscribes directly to the credit opinions of the three leading credit rating agencies, Moodys, S&P and Fitch. CalPERS analysts have access to these opinions as well as the ability to have conversations with the analysts at the firms. CalPERS subscribes to and receives these opinions because the ratings agencies are in the unique position of obtaining non-public information from the issuers and ostensibly have large resources to apply in assessing the credit quality of issuers. Ratings actions can and do cause market prices to move.

3. The impact of credit ratings agency failure on institutional investors.

Quantifying the market impact of credit ratings failure is not a simple task. Estimates vary but the scale is huge. McKinsey calculates that the total credit losses on US originated debt from mid-2007 through to end of 2010 will be in the range of \$2.5 – 3.00 trillion.³ Goldman Sachs puts the figure for the same at slightly less with \$2 trillion in losses, of which \$1 trillion are carried in the US banking system (50% mortgage losses and 50% other loan losses).⁴ The IMF puts worldwide ‘toxic loan’ and securities losses at just over \$4 trillion by the end of 2010.⁵ As one of the largest institutional global investors, CalPERS has suffered from the impact of systemic losses both directly from the credit crisis, and the economic downturn which this accelerated. At its peak, CalPERS portfolio was valued at approximately \$270 billion. This fell dramatically in the wake of the crisis to \$165 billion in early 2009. It has recently recovered about \$35 billion, but the effect of the dislocations in financial markets has been severe.

4. Proposed reforms to Credit Rating Agencies

CalPERS considers comprehensive reform of the credit ratings industry to be sorely needed in order to ensure transparency and accountability across the capital markets.

³ McKinsey Quarterly, 8th June 2009, ‘What’s Next for US Banks?’

⁴ International Monetary Fund, 21st April 2009, “Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risks.”

⁵ Tyler Durden 25th January 2009 “Goldman Sachs: Of ~6% Fed Funds Rate and \$9.3 trillion in troubled US assets”

CalPERS Board has formally endorsed the recommendations of the Investor Working Group⁶. We propose the following specific reforms to credit rating agencies:

a. Congress and the Administration should consider ways to encourage alternatives to the predominant issuer-pays business model.

There is a fundamental conflict of interest when the issuer pays the fees of the CRA. There should be a change in the business model. For example, the fees earned by the CRAs should vest over a period of time equal to the average duration of the bonds rated. Fees should vest based on the performance of the original ratings and changes to those ratings over time relative to the credit performance of those bonds.

In addition CalPERS staff consider that users of credit ratings should have oversight over the hiring, remuneration and firing of the agencies which provide these services. We consider this should be explored, via an existing governance forum, such as the issuer's Annual General Meeting, where users could exercise a proxy vote on the appointment and fees paid to CRAs, or alternatively via a new mechanism that would need to be established across the industry.

b. Congress and the Administration should bolster the SEC's position as a strong, independent overseer of CRAs.

The SEC's authority to regulate rating agency practices, disclosures and conflicts of interest should be expanded and strengthened. The SEC should also be empowered to co-ordinate the reduction of reliance on ratings. CalPERS staff supports the announcements by the SEC last week to remove CRAs from various rules. This is a welcome start to the process of removing the requirement for use.

⁶ Co-Chaired by William Donaldson and Arthur Levitt, 15th July 2009, sponsored by the Council of Institutional Investors and the CFA Institute Center for Financial Market Integrity. Note Joe Dear is co-chair of the CII.

We also recommend that the SEC establish a CRA User Advisory Board of investors, which can provide feedback on methodologies, admission requirements and regulatory proposals.

c. CRAs should be required to manage and disclose conflicts of interest.

Complete, prominent and consistent disclosure of conflicts is also needed.

As an immediate step, CRAs, should be required to create an executive-level compliance officer position.

d. CRAs should be held to a higher standard of accountability.

CRAs should bear responsibility for mis-representing credit-worthiness of issuances. Congress should eliminate the effective exemption from liability provided to credit rating agencies under Section 11 of the Securities Act of 1933 for ratings paid for by the issuer or the offering participants. CalPERS staff also recommend that CRAs should be required to abide by Regulation FD, and not retain their privileged position of exclusion which has exacerbated investors' reliance upon their information.

e. Credit rating agencies should not rate products for which they lack sufficient information and expertise to assess.

Credit rating agencies should only rate instruments for which they have adequate information and skill. They should be held legally responsible if they overstep their abilities. They should not be permitted to rate any product where they cannot disclose the specifics of the underlying assets. Credit ratings agencies should be restricted from taking the metrics and methodology for one class of investment to rate another class without compelling evidence of comparability.

In addition, CalPERS staff consider that there should be a requirement for full disclosure of the methodology employed by CRAs, including data, models and assumptions used to develop the ratings on a security, along with comment on all risks identified in the process of making a decision to rate or not to rate a security or product.

CalPERS staff recommend that transparency requirements should include a “ratings scorecard” to assess the practices, accuracy and effectiveness of the rating process via historical rating outcomes. This would be the first step towards developing industry standards which can be regulated and made subject to codes of professional ethics.

Thank you for this opportunity to share our views on this vitally important element of financial market regulatory reform. I look forward to answering your questions.