

Opening Comments:
“The Collapse of MF Global: Part 2”

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On behalf of Rapid Ratings' employees, shareholders and subscribers, I would like to thank Chairman Neugebauer, Ranking Member Capuano and members of the Subcommittee for asking me to testify today. I'm James Gellert, Chairman and Chief Executive of Rapid Ratings.

As is clear by now, MF Global is a tragic story for Wall Street, Main Street, and the futures industry. Its bankruptcy follows in trend with other notable financial failures from the last twelve years in one way: Agencies that were paid to provide professional opinions on credit risk failed to give sufficient warning of the firm's risk. MF Global carried investment grade ratings from **Standard & Poor's**, from 2007 until Oct 31, 2011 and from **Moody's and Fitch**, from 2007 until Oct 24th, 2011.

In contrast, Rapid Ratings provided two years of warning that MF Global was a High Risk, sub-investment grade entity.

We are a user-paid, not issuer-paid, firm. We use only financial statements, no market inputs, no qualitative analysts, and we have no contact in the rating process with management, bankers, investors, or advisors. We utilize our proprietary, software-based system to rate the financial health of thousands of public and private companies **quarterly**. Our ratings have an impressive record of far outperforming the Big Three.

Our FHR, Financial Health Rating, System evaluates 62 ratios from companies' income statements and balance sheets. Our 0-100 score is the product of a highly complex modeling process that measures variations in the financial health of any company, effectively benchmarking how well it is able to withstand internal or external shocks. We're consistent, and we're accurate: Over the past 20 years, approximately 90% of defaults have occurred at 40 and below on our scale.

At bankruptcy, we had MF Global rated a 23. Prior to their last quarterly release, they were rated a 29. Both ratings are in our High Risk category and well below investment grade, where we've had them for over two years. These ratings are the rough equivalent of a CCC-/CCC on the traditional Alpha scale, or 8-10 ratings notches below where they sat for the Big Three.

The FHR system is agnostic to qualitative judgments like management star power, unless their actions affect a company's financial health. To our system, MF Global is the simple story of a firm's declining in performance since 2007 in various measures, including revenue performance, profitability, debt service management. From 2007 through 2011, MF Global revenue declined by 63%, from \$6.1b to \$2.2b. Its net profit declined by 142%, from \$190m to negative \$79m. In the last 16 quarters, MF Global had 10 quarters with

recorded losses, and the last 4 quarters saw losses grow by 68% over the prior 12 months. Its most recent quarterly report showed a record loss of \$191.6 million.

Without even factoring in risky trading in Euro sovereign debt, poor risk controls, etc., MF Global was unmistakably in declining health. Yet Moody's, S&P and Fitch barely moved over this period. Why?

1. The **issuer-paid business model** is inherently conflicted, making objectivity difficult to administer consistently. Management of rated companies will try hard to get, and keep, the best ratings possible. If they are convincing, their ratings are better than not. If rating analysts don't properly question what they're "sold," a rating can be compromised.
2. The **Big Three strive for stable ratings and to "look through the cycle,"** thus ignoring the short-to-medium term performance volatility that can capture a firm's underlying fundamentals and determine long-term success or failure.
3. **Barriers to competition** are still great. Despite reform efforts, NRSRO ratings are still firmly embedded all over the financial system.
4. And finally, the **Big Three hold little to no accountability** when things go wrong.

The MF Global story inevitably turns to the question of timing of rating changes. Traditional agencies say they need to be careful when downgrading a company because they can affect market behavior. They also rightly assert that many investors want ratings stability.

These are indeed real concerns, but they pale in comparison to the damage done when ratings are downgraded too late or not at all. We do not advocate ratings volatility; we support a better ratings industry.

Congressman Fitzpatrick's recent draft bill responds directly to these points. It would require NRSROs to be accountable and stand by their ratings on a quarterly basis. The market has no way of knowing when the Big Three are proactive, behind schedule or simply inattentive to maintenance of an existing rating.

While we regularly outperform the Big Three, we don't believe that the Rapid Ratings' system is simply "better" than others, nor that traditional ratings are always flawed. We believe in open competition in the ratings business so institutional investors, risk professionals and regulators can choose among options that suit their needs best.

Certainly those who had our early warnings on MF Global were far better served than those who relied exclusively on the Big Three, whose ratings provided none. It is time to require more timely ratings, more accurate ratings, and more competition. We cannot simply rely on traditional agencies that promise much, only to deliver and defend much less.

Thank you.