

BOND RATING AGENCIES: EXAMINING THE “NATIONALLY RECOGNIZED” STATISTICAL RATING ORGANIZATIONS

HYBRID HEARING

BEFORE THE
SUBCOMMITTEE ON INVESTOR PROTECTION,
ENTREPRENEURSHIP, AND CAPITAL MARKETS
OF THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
ONE HUNDRED SEVENTEENTH CONGRESS
FIRST SESSION

JULY 21, 2021

Printed for the use of the Committee on Financial Services

Serial No. 117–42



U.S. GOVERNMENT PUBLISHING OFFICE

45–509 PDF

WASHINGTON : 2021

HOUSE COMMITTEE ON FINANCIAL SERVICES

MAXINE WATERS, California, *Chairwoman*

CAROLYN B. MALONEY, New York	PATRICK McHENRY, North Carolina,
NYDIA M. VELAZQUEZ, New York	<i>Ranking Member</i>
BRAD SHERMAN, California	FRANK D. LUCAS, Oklahoma
GREGORY W. MEEKS, New York	BILL POSEY, Florida
DAVID SCOTT, Georgia	BLAINE LUETKEMEYER, Missouri
AL GREEN, Texas	BILL HUIZENGA, Michigan
EMANUEL CLEAVER, Missouri	ANN WAGNER, Missouri
ED PERLMUTTER, Colorado	ANDY BARR, Kentucky
JIM A. HIMES, Connecticut	ROGER WILLIAMS, Texas
BILL FOSTER, Illinois	FRENCH HILL, Arkansas
JOYCE BEATTY, Ohio	TOM EMMER, Minnesota
JUAN VARGAS, California	LEE M. ZELDIN, New York
JOSH GOTTHEIMER, New Jersey	BARRY LOUDERMILK, Georgia
VICENTE GONZALEZ, Texas	ALEXANDER X. MOONEY, West Virginia
AL LAWSON, Florida	WARREN DAVIDSON, Ohio
MICHAEL SAN NICOLAS, Guam	TED BUDD, North Carolina
CINDY AXNE, Iowa	DAVID KUSTOFF, Tennessee
SEAN CASTEN, Illinois	TREY HOLLINGSWORTH, Indiana
AYANNA PRESSLEY, Massachusetts	ANTHONY GONZALEZ, Ohio
RITCHIE TORRES, New York	JOHN ROSE, Tennessee
STEPHEN F. LYNCH, Massachusetts	BRYAN STEIL, Wisconsin
ALMA ADAMS, North Carolina	LANCE GOODEN, Texas
RASHIDA TLAIB, Michigan	WILLIAM TIMMONS, South Carolina
MADELEINE DEAN, Pennsylvania	VAN TAYLOR, Texas
ALEXANDRIA OCASIO-CORTEZ, New York	PETE SESSIONS, Texas
JESÚS “CHUY” GARCIA, Illinois	
SYLVIA GARCIA, Texas	
NIKEMA WILLIAMS, Georgia	
JAKE AUCHINCLOSS, Massachusetts	

CHARLA OUERTATANI, *Staff Director*

SUBCOMMITTEE ON INVESTOR PROTECTION, ENTREPRENEURSHIP,
AND CAPITAL MARKETS

BRAD SHERMAN, California, *Chairman*

CAROLYN B. MALONEY, New York
DAVID SCOTT, Georgia
JIM A. HIMES, Connecticut
BILL FOSTER, Illinois
GREGORY W. MEEKS, New York
JUAN VARGAS, California
JOSH GOTTHEIMER, New Jersey
VICENTE GONZALEZ, Texas
MICHAEL SAN NICOLAS, Guam
CINDY AXNE, Iowa
SEAN CASTEN, Illinois
EMANUEL CLEAVER, Missouri

BILL HUIZENGA, Michigan, *Ranking
Member*
ANN WAGNER, Missouri
FRENCH HILL, Arkansas
TOM EMMER, Minnesota
ALEXANDER X. MOONEY, West Virginia
WARREN DAVIDSON, Ohio
TREY HOLLINGSWORTH, Indiana, *Vice
Ranking Member*
ANTHONY GONZALEZ, Ohio
BRYAN STEIL, Wisconsin
VAN TAYLOR, Texas

CONTENTS

	Page
Hearing held on:	
July 21, 2021	1
Appendix:	
July 21, 2021	37

WITNESSES

WEDNESDAY, JULY 21, 2021

Bright, Michael R., Chief Executive Officer, The Structured Finance Association (SFA)	11
Linnell, Ian, President, Fitch Ratings	6
McGarritty, Amy Copeland, Chief Investment Officer, Colorado Public Employees' Retirement Association (PERA)	5
Nadler, Jim, President and CEO, Kroll Bond Rating Agency (KBRA)	8
Rhee, Robert J., Professor, University of Florida Law School	10

APPENDIX

Prepared statements:	
Bright, Michael R.	38
Linnell, Ian	47
McGarritty, Amy Copeland	57
Nadler, Jim	70
Rhee, Robert J.	76

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

McHenry, Hon. Patrick:	
Written statement of the Loan Syndications & Trading Association (LSTA)	89
Written statement of the National Association of Corporate Treasurers (NACT)	93
Vargas, Hon. Juan:	
Written responses to questions for the record submitted to Ian Linnell	96

BOND RATING AGENCIES: EXAMINING THE “NATIONALLY RECOGNIZED” STATISTICAL RATING ORGANIZATIONS

Wednesday, July 21, 2021

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INVESTOR PROTECTION,
ENTREPRENEURSHIP, AND CAPITAL MARKETS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 3:25 p.m., in room 2128, Rayburn House Office Building, Hon. Brad Sherman [chairman of the subcommittee] presiding.

Members present: Representatives Sherman, Foster, Vargas, Gottheimer, Axne, Casten, Cleaver; Huizenga, Wagner, Hill, Mooney, Hollingsworth, and Taylor.

Ex officio present: Representative Waters.

Also present: Representatives Pressley and Adams.

Chairman SHERMAN. The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will come to order.

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time. Also, without objection, members of the full Financial Services Committee who are not members of the subcommittee are authorized to participate in today's hearing.

Today's hearing is entitled, “Bond Rating Agencies: Examining the ‘Nationally Recognized’ Statistical Rating Organizations.”

I want to thank the witnesses and Members for accommodating the votes on the Floor, and convening at a different time. And I want to mention that quite a number of bills and discussion drafts have been listed as being under consideration at today's hearing. I notice that some of those bills are Democratic, put forth by Democratic authors, and some are bipartisan, and I would encourage my Republican colleagues to submit bills to be considered at our various subcommittee hearings.

I will now recognize myself for 4 minutes for an opening statement.

Americans say the economy is the most important thing. In a free market system, the allocation of capital is the most important thing in the economy. That is why we call it capitalism.

The people think that the most important institutions at the national level are the President and Congress. I believe that they are the Federal Reserve, the Financial Accounting Standards Board (FASB), and the bond rating agencies. Notice I use the term, “bond rating agencies,” because I don't want to use the term, “credit rat-

ing agencies,” and confuse them with those who rate the credit-worthiness of individuals. And the term, “nationally recognized statistical rating organizations (NRSROs)” is a misnomer, since what they do is hardly just statistical, or as objective as a statistician.

The allocation of capital is of critical importance. About \$250 trillion in capital is allocated through our equity markets, which provides \$250 trillion to businesses to conduct business. Twenty times as much money flows through the debt instruments that are rated by the bond rating agencies: corporate bonds; commercial paper; asset-backed securities; and municipal bonds. Those ratings determine what gets funded, and at what interest rate. If the rating is too low, the bond will yield a high rate of interest, the project won’t pencil out, and the factory will not be built. If the bond rating for a package of mortgages is too low and the interest rate is too high, you will not qualify for the loan.

Bond rating agencies earn roughly \$14 billion from our society to do their work. Their ratings are confusing, except to the insiders. They should be clear to outsiders. From the largest agency, the fifth-best rating is A+. Why would ordinary people think that A+ is the fifth-best? And, of course, the fourth-best from the other agency is Aa3.

Not only that, the ratings are not defined. What is the estimated risk of loss with an A+ rating? We don’t know. There is an unchecked conflict of interest. The issuer selects the credit rating agency and pays them, say, \$1 million to give them a grade. Trust me, if you pay me \$1 million, I will give you a good grade.

And we saw them give very high grades to first and second mortgages for people who couldn’t afford to make the payments, and that is why the Financial Crisis Inquiry Commission stated that the inflated ratings given to mortgage-backed securities were a primary cause of the greatest economic catastrophe I have lived through.

I call it an unchecked conflict of interest, because there is no liability. In every other field, a professional who conducts malpractice gets sued. In this case, there is no check on the desire to give a higher rating and make the issuer happy because of the protections from liability.

In the Dodd-Frank Act, we ruled that at least with regard to asset-backed securities (ABS), there would be liability. And the bond rating agencies went on strike. The SEC issued a no-action letter declaring that they wouldn’t enforce our law, and the bond rating agencies won, proving that they are, indeed, more powerful than Congress.

I now yield to the ranking member of the subcommittee, Mr. Huizenga, for 5 minutes for an opening statement.

Mr. HUIZENGA. Thank you, Chairman Sherman.

Well, I am afraid, respectfully, that this hearing is another example of dusting off outdated ideas in search of a problem. Everyone here today agrees that investors’ overreliance on credit ratings is one of the many factors that led to the 2008 financial crisis. And the Dodd-Frank Act significantly expanded the scope of regulation and accountability of rating agencies.

Since we last had this discussion a number of years ago, it is important that we separate a few facts from the fiction.

Fact: Credit rating agencies face potential conflicts of interest, regardless of whether issuers, investors, or governments pay for those ratings. This idea that there is a model that does not present a conflict of any sort is just false. As long as there is a party interested in the outcome of a rating, there is going to be a potential conflict, and the Federal Government can certainly be a conflicted interested party as well.

Fact: Nearly 10 years ago, the Democrat-led SEC studied many potential credit rating agency compensation models, as well as the feasibility and desirability of standardizing the credit rating industry as required by Dodd-Frank. After a thorough review, public comment, and a public roundtable, the SEC staff did not mandate any structural changes to the issuer pay model.

Fact: The SEC's more recent examinations indicate that rating agencies are managing potential conflicts and producing ratings that benefit investors and issuers. If credit rating agencies fail to do so, the SEC has the right tools to intervene when necessary, and, parenthetically I might add, that if someone is doing something purely because they are getting paid for it, there are some legal responsibilities and obligations that need to be pursued and there should be ramifications for that. So to imply that anyone can just get bought in this is a sad state of affairs and they need to be gone after.

Fact: During the pandemic, the rating agencies responded to evolving market and economic conditions promptly, and effectively performed their role as independent providers of forward-looking information.

Given these facts, you may be asking yourself, why are we here today? The answer, I am afraid, is somewhat to relitigate Dodd-Frank, a bill that they jammed through more than a decade ago, without so much as even acknowledging what has transpired over the past decade.

Former Democrat Commissioner Roel Campos said it best, "It is not the time for an untested government-engineered credit ratings market. The credit markets and resulting information to investors is too important for laboratory experiments."

I will echo yet another voice from the Progressive Policy Institute, which is fairly left wing and not one that I would normally cite, but the Progressive Policy Institute had this to say, "The credit ratings market based on the issuer pay model seems to have a way to consistently produce high-quality and more accurate ratings that give strong and useful signals to market participants. Nobody has been able to come up with an alternative compensation model that is clearly better."

I urge my colleagues to focus our efforts on modern problems, and not just rehash a fight that is over a decade old. I know there are some who are trying to say that there are a number of problems, that there are issues, that somehow having institutional investors do their own due diligence is indicative of their lack of trust in the ratings that are there. Well, credit ratings are designed to augment and to be a tool, not simply to replace separate analysis, and it would seem to me that as we go and tackle some of these issues, we all realize and understand there is no one singular

source that we can go to to get all of this crystal ball read in a manner that is perfect. We don't live in a perfect world.

The COVID situation is a great example of that, where people were guessing what the future was going to look like, and they were having to do their best estimates with what they were dealing with.

So with that, I would like to yield back the rest of my time.

Chairman SHERMAN. I now recognize the Chair of the full Financial Services Committee, the gentlewoman from California, Chairwoman Waters, for 1 minute.

Chairwoman WATERS. Thank you, Mr. Chairman.

In the lead-up to the 2008 financial crisis, the bond rating agencies assigned AAA ratings to worthless mortgage-backed securities and complex products created by Wall Street, all the while knowing that retirees, cities and towns, and investors around the world relied on their ratings to make investment decisions. Their ratings brought our financial system to its knees. Millions of people lost their jobs, their homes, and their life savings, not to mention costing the economy trillions of dollars.

Eleven years later, many of the Dodd-Frank reforms for rating agencies remain unfinished, including addressing a central conflict of interest wherein the same companies selling securities continue to shop around for their preferred ratings. With the financial risk that climate change and the pandemic now pose, investors need objective and reliable ratings more than ever.

So, I look forward to this discussion. I want to thank Mr. Sherman for putting the time and attention on this issue that is certainly needed. And I am looking forward to seeing how we can improve this critical part of our capital market.

I yield back.

Chairman SHERMAN. Thank you.

Before introducing our witnesses, let me introduce the two witnesses who refused to be here: Douglas Peterson, president and CEO of S&P Global; and Rob Fauber, president and CEO of Moody's Corporation. Even when they realized they didn't even have to use any commute time to be here, they refused our request.

That is why I am appreciative of the witnesses who are here: Amy Copeland McGarrity, chief investment officer of the Colorado Public Employees' Retirement Association; Ian Linnell, president of Fitch Ratings, the third-largest agency, who is showing a respect for Congress by being here that I really appreciate; Jim Nadler, president and CEO of Kroll Bond Rating Agency; Robert J. Rhee, a professor with the University of Florida Law School; and Michael Bright, chief executive officer of The Structured Finance Association.

Witnesses are reminded that their oral testimony will be limited to 5 minutes. You should be able to see a timer on the desk in front of you or indicated on your screen that will indicate how much time you have left. When you have 1 minute remaining, a yellow light should appear. I would ask that you be mindful of the timer, and when the red light appears, wrap up very quickly, so that we can be respectful of everyone's time.

And without objection, your written statements will be made a part of the record.

Ms. McGarrity, you are now recognized for 5 minutes.

STATEMENT OF AMY COPELAND MCGARRITY, CHIEF INVESTMENT OFFICER, COLORADO PUBLIC EMPLOYEES' RETIREMENT ASSOCIATION (PERA)

Ms. MCGARRITY. Chairman Sherman, Ranking Member Huizenga, and members of the subcommittee, thank you for the opportunity to speak with you today.

My name is Amy McGarrity, and I serve as the chief investment officer for the Colorado Public Employees' Retirement Association, which we call PERA. I am going to summarize my written remarks, and I ask for them to be included in the hearing record.

PERA is a public pension plan serving more than 620,000 current and former public employees and their beneficiaries, with over \$60 billion in assets. Unlike many other pensions, we manage over 60 percent of our assets in-house, so we are allocating to asset classes while also selecting specific securities. In fact, our more than \$12 billion in fixed income assets are managed entirely in-house by our investment professionals.

PERA's investors typically look well beyond the credit ratings and other assessments of securities provided by the rating agencies. Thus, while a particular credit rating may be a component of our investment decision-making process, our team also conducts proprietary fundamental and relative value analysis in order to derive our investment decisions.

Put simply, we try to look beyond the ratings because we don't always have confidence in them, and we typically have the ability and resources to do so. Credit ratings also impact our investments indirectly, such as being used as a screen for inclusion or exclusion due to a particular portfolio benchmark index.

Lastly, our portfolios have internal guidelines which may refer to credit ratings and allowed securities.

But let's remember the purpose of credit ratings. Credit ratings are intended to provide investors and other market participants with accurate assessments of the risk of defaults. That credit risk could arise from any reason, ranging from traditional business risks, a global pandemic, or simply having trouble filling orders because of microchip or worker shortages.

Further, to the extent that credit ratings provided by NRSROs may be inaccurate, that may lead some investors to mispricing their risks and inefficiently allocating their capital. This will impact different investors differently.

Make no mistake, large sophisticated market participants with the resources and expertise needed to make accurate credit risk assessments may benefit from the mispricing of assets by those who may be more dependent upon ratings for their pricing determinations.

By now, we all know that tens of thousands of asset-backed securities were rated AAA in the run-up to the GSEs, and thousands of them would be relatively quickly downgraded to junk status and huge percentages of them actually defaulted. Clearly, something was wrong.

Several government investigations and enforcement actions, numerous civil lawsuits, and widespread press reports essentially all

confirmed what many of us now accept: The ratings weren't reliable. Bipartisan efforts to reform the industry and improve ratings' accuracy were floated, and ultimately a school of reforms was included in the Dodd-Frank Act. However, significant questions regarding rating agency independence remain, and the ratings marketplace remains highly concentrated.

While much work has been done, the SEC never adopted a ratings assignment system, nor did it propose changes to the issuer pay model. I have spent much time in the last few years exploring these problems.

In addition to my role at PERA, I have had the honor of being appointed by then-SEC Chairman Clayton to serve on the SEC's Fixed Income Market Structure Advisory Committee (FIMSAC), and was asked to Chair its Credit Ratings Subcommittee. In our subcommittee, we explored the issuer pay business model and ways to address that clear conflict of interest, as well as other ways to improve credit ratings quality. As part of that process, the Credit Ratings Subcommittee released a draft discussion document that would have created an assignment process to reduce the issuer pay conflict of interest.

While we ultimately could not get consensus on that issue amongst the members of the FIMSAC, we nevertheless were able to get consensus on other recommendations, including increasing rating agency disclosures regarding models and deviations, enhancing issuer disclosures for how they select ratings firms to assess both corporate securities and securitized products, and establishing a mechanism for bondholders to vote on the issuer-selected ratings firms.

These are valuable proposed reforms, but in my opinion, are not nearly enough. The core of the issue with credit ratings remains the conflicts of interest associated with issuers both choosing and paying for their own ratings. The SEC should consider establishing a ratings assignment process that would offer enhanced opportunities for smaller rating agencies and reduce incentive for rating inflation. And there should also be greater efforts to ensure rating agency accountability.

I appreciate that this subcommittee and the SEC are again exploring ways to improve the accuracy of ratings to better protect investors, but also to drive more fair, orderly, and efficient markets. Less-conflicted and higher-quality credit ratings would benefit PERA and the markets overall.

Thank you for the opportunity to speak with you today, and I look forward to answering your questions.

[The prepared statement of Ms. McGarrity can be found on page 57 of the appendix.]

Chairman SHERMAN. Thank you. And thank you for your brevity. We will now hear from Mr. Linnell.

STATEMENT OF IAN LINNELL, PRESIDENT, FITCH RATINGS

Mr. LINNELL. Thank you.

Chairman Sherman, Ranking Member Huizenga, and distinguished members of the subcommittee, my name is Ian Linnell, and I am the president of Fitch Ratings. I appreciate the invitation to appear before you to talk about Fitch Ratings and the role of

credit rating agencies in the capital markets. Credit ratings provide a forward-looking and relative opinion on credit risk, namely, how likely it is that investors will be repaid in full and on time. Credit risk is an important factor when considering whether to buy a bond. Unfortunately, for a variety of reasons, some investors do not adequately assess credit risk.

Fitch helps to make sense of credit risk with ratings based on a simple letter scale. “AAA” is the highest rating, indicating the least credit risk, and “D” is the lowest rating. We have over 2,000 employees working in over 30 countries, including over 1,250 analysts. Fitch, which is part of the Fitch Group, and a wholly-owned subsidiary of Hearst Corporation, is dedicated to providing the financial markets with timely, independent, and objective credit ratings.

In the wake of the 2007 financial crisis, Congress passed the Dodd-Frank Act in 2010. Congress designed many of the provisions of Dodd-Frank to address concerns about the credit rating process that regulators believed contributed to the financial crisis.

Even before Dodd-Frank’s requirements went into effect, Fitch implemented a variety of changes to its business design to address many of the same concerns, including separating the analysts who evaluate credit risk and prepare our ratings from those employees who manage our business relationships with issuers; establishing a compliance department to ensure we are following our procedures in developing ratings; appointing a chief credit officer who is independent of the analysts to oversee the development and updating of our methodologies; and putting in place an independent review of our criteria.

The changes made in advance of Dodd-Frank positioned Fitch well to comply with the requirements of the new law.

Dodd-Frank also created the Office of Credit Ratings (OCR), that the Securities and Exchange Commission launched in June 2012. The Commission charged the OCR with administering the rules of the Commission and overseeing the practices of NRSROs, promoting accuracy in credit ratings, and working to ensure that they are not unduly influenced by conflicts of interest.

The OCR conducts annual and other examinations of NRSROs to assess and promote compliance with statutory and Commission requirements, and routinely monitors the activities of NRSROs. The OCR and its staff are solely dedicated to the oversight, examination, and supervision of credit rating agencies.

In addition to U.S. regulations, credit rating agencies are subject to the regulatory mandates outside of the U.S., including in the European Securities and Markets Authority and the U.K.’s Financial Conduct Authority. The EU has enacted its own registration and oversight system and related rules for rating agencies. Other nations have adopted similar measures. As a result, Fitch, along with the other global rating agencies, is subject to regulation and examination in every single country in which it operates.

Fitch believes that the global regulatory framework created since Dodd-Frank has brought greater transparency and rigor to the credit rating process. The regulations respect the analytical independence of rating agencies by being procedural and not substantive in nature. The current law strikes the right balance between ensuring proper government oversight, while maintaining

the rating agencies' ability to express their opinions without undue government interference, and free competition and choice in the marketplace.

We appreciate that there is interest in Congress to expand on the framework of Dodd-Frank with further regulation related to credit ratings. Fitch welcomes changes that would improve the public's understanding of and confidence in credit ratings. However, the proposals that we understand are under consideration are concerning to us and could, in our view, have negative consequences for securities markets, NRSROs, and investors who rely on our ratings for an independent assessment of risk.

I address these concerns more fully in my written testimony.

Thank you for your time and for the work that you do for the United States, and I welcome any questions that you may have.

Thank you.

[The prepared statement of Mr. Linnell can be found on page 47 of the appendix.]

Chairman SHERMAN. Thank you.

We now move on to Mr. Nadler, president and CEO of Kroll Bond Rating Agency.

**STATEMENT OF JIM NADLER, PRESIDENT AND CEO, KROLL
BOND RATING AGENCY (KBRA)**

Mr. NADLER. Chairman Sherman, Ranking Member Huizenga, and members of the subcommittee, thank you for the opportunity to testify today. I am Jim Nadler, the CEO of Kroll Bond Rating Agency (KBRA).

KBRA was founded on the premise that open competition helps protect investors and can increase market liquidity. KBRA is a full-service rating agency, and one of the five largest rating agencies globally, and the largest rating agency established since the financial crisis.

We believe that KBRA's entry into the market has been hugely positive for investors. Two excellent examples of the positive impact of competition and our innovation are in the community banks and in the Environmental, Social, and Corporate Governance (ESG) spaces.

Despite our success over the past 10 years, we still face barriers to competition. The three largest NRSROs still command over 95-percent market share, and are written into the plumbing of the financial system. An example of this includes the investment guidelines of institutional investors that specifically name only the incumbent agencies. We believe that all investor guidelines across financial markets should permit the use of any SEC-registered NRSROs.

Another example is the recent Federal Reserve Emergency Lending Facilities, which initially required the use of the ratings by one of only three large rating agencies. As a result of the intervention of members of this committee, the House passed legislation requiring the Federal Reserve and the Treasury to accept securities rated by any NRSRO registered with the SEC. We support broadening that legislation to ensure that no government agency can limit competition.

I would also like to offer input to the Commercial Credit Rating Reform Act that is being discussed today. We appreciate Representative Sherman's long-standing leadership on issue of competition and NRSROs.

That said, we have concerns regarding unintended consequences of this legislation. While government assignment of ratings would increase the market share of smaller NRSROs like mine, it would discourage thorough research. If an NRSRO is assured of receiving regular rating assignments via a government panel, some might not devote resources to quality research. That would be detrimental to investors who would lose access to diverse, transparent, and thorough market information.

Mr. Chairman, we believe that many components of the Dodd-Frank Act have been highly successful and have all served to improve outcomes for investors, including increased disclosure, the required development of internal controls, and supervision and annual examination by the SEC.

In addition, the requirement that NRSROs publicly post their methodologies and substantive changes thereto allows investors to familiarize themselves and scrutinize methodologies and determine which methodologies align with their viewpoint. This is a positive change that protects investors and allows them to play an active role in pushing NRSROs to maintain high and relevant standards.

We understand that some policymakers, including members of this subcommittee, have questions about potential conflicts of interest in the issuer pay model. As a general matter, I believe it is not possible to completely eliminate all potential conflicts in the NRSROs space, regardless of the issuer pay or investor pay model, and that the current SEC disclosure requirements mitigate potential risks in this area. We are concerned that views on the issuer pay model were also driven partly by a false narrative regarding rating inflation and competition in the structured finance space that is based on incomplete data and poor media reporting. Our data shows that competition improved research and ratings and does not inflate ratings.

We also have concerns that the investor pay model would disadvantage smaller investors. The benefit of issuer-pay ratings is that the issuers typically make those ratings publicly available to all investors, large and small, that can benefit from the ratings and research published by the NRSRO. We believe that the investor-pay model would solely benefit the largest institutional investors who could afford to pay for multiple ratings and the best research available.

Finally, Mr. Chairman, we believe that the current SEC regulatory framework provides the appropriate level of liability for NRSROs.

I thank you and the subcommittee for the opportunity to testify today, and I look forward to any questions.

[The prepared statement of Mr. Nadler can be found on page 70 of the appendix.]

Chairman SHERMAN. Thank you for disrupting the oligopoly.

And I now want to move on to Robert Rhee, a professor at the University of Florida Law School.

**STATEMENT OF ROBERT J. RHEE, PROFESSOR, UNIVERSITY
OF FLORIDA LAW SCHOOL**

Mr. RHEE. My name is Robert Rhee, and I am here at your invitation to testify as a witness. I thank the subcommittee for the opportunity to be heard.

Reform of the credit rating industry is an important subject of Congress' attention. Rating agencies are important market institutions and gatekeepers. The perceived problems of rating agencies have long percolated. Critics have argued that they have long underperformed with little accountability.

The proper functioning of rating agencies is not only a matter of markets and money; it is a matter of national security. Economic stability is a matter of national security. No country is immune to instability in the credit market.

Also, due to many factors, including the COVID-19 pandemic, countries are more brittle and vulnerable than before. We can ill-afford another financial crisis.

The importance of rating agencies is underscored by the fact that they pose a deep problem on public policy. A survey of scholarly literature shows a strong line of thought about the nature of the problem.

First, many commentators have identified the issuer pay model. Second, many commentators have identified the industry concentration. These factors compound to produce bad outcomes.

The rating industry is not competitive, and the incentives are poor. The goal, the policy goal, should be to elicit a race to the top, which means a competition for the most accurate bias-free ratings. Competitiveness depends on the right incentives. The incentives currently are not robust.

In the staff memorandum, five draft bills were identified for discussion today. I believe that each of these proposed bills has merit and good purpose. I will comment briefly on each.

The Commercial Credit Rating Reform Act mandates a lottery system of engagement, with consideration given to certain merit-based factors. This proposed bill has much merit. It represents a sharp move away from the problematic issuer pay model, and reduces poor incentives.

The Uniform Treatment of NRSROs Act permits the Federal Reserve to not use credit ratings if they are unreliable, or not in the public interest. This exception recognizes that ordinary credit analysis may not be relevant in transitory periods of high uncertainty or exogenous shock, where ordinary market values and information signals may not be reliable. The Federal Reserve should have the ultimate discretion to use or not use credit ratings based on the public interest.

The Transparency and Accountability of NRSROs Act would prohibit the current SEC practice of shielding the identity of noncomplying firms. This bill would impose no regulatory cost on the industry. Because the number of credit ratings is an independent factor, meaning that deficiencies of individual firms would not affect the demand for credit ratings, the regulatory and economic effect on the industry would be nil.

The Restoring NRSRO Accountability Act would nullify a no-action letter issued by the SEC that shields rating agencies from Sec-

tion 11 liability under the Securities Act of 1933. Despite a clear mandate in the Dodd-Frank Act, the SEC provided in no-action letters permitting the deemed exclusion of credit ratings from registration statements. While the issue of enhanced liability is complex, I believe that exposure to Section 11 liability would result in the expenditure of greater care and due diligence by the ratings agencies.

Lastly, the Accurate Climate Risk Information Act requires disclosure of climate risk. A disclosure approach is compelling. Rating agencies should consider climate risk, or explain to regulators and the public why they believe climate risk is immaterial to credit risk. Ultimately, a climate risk disclosure may influence the efficient allocation of capital in the capital markets in an era of climate change.

So, in summary, past reform of the credit rating industry has been incomplete. The five proposed bills contemplated by the subcommittee advance the goal towards a more complete reform of the credit rating industry.

Thank you for the opportunity to be heard, and for your attention.

[The prepared statement of Professor Rhee can be found on page 76 of the appendix.

Chairman SHERMAN. Thank you.

And now, our final witness, Michael Bright.

STATEMENT OF MICHAEL R. BRIGHT, CHIEF EXECUTIVE OFFICER, THE STRUCTURED FINANCE ASSOCIATION (SFA)

Mr. BRIGHT. Chairman Sherman, Ranking Member Huizenga, and members of the subcommittee, my name is Michael Bright, and I am the CEO of the Structured Finance Association, or SFA. On behalf of the member companies of SFA, I thank you for inviting me to testify today.

The Structured Finance Association is a consensus-driven trade association with over 370 institutional members. We represent the entire value chain of the securitization market from loan origination to secondary market trading. This market provides over \$15 trillion of capital to consumers and businesses. Our members facilitate credit and capital information across a wide breadth of asset classes, such as auto loans, mortgage loans, student loans, commercial real estate, and business loans. Our members include issuers and investors, rating agencies, data and analytical firms, law firms, servicers, accounting firms, and trustees, among others. Our investor members are fiduciaries to their clients.

Before we take any advocacy position, our governance requires us to achieve consensus by agreement rather than a simple majority vote, ensuring that the perspectives of all of our diverse membership are included in our policy views. As a trade association, we also take a leading role in helping to craft best practices across the institutions and asset classes that we represent.

Turning to the NRSRO process itself, some of the discussion drafts provided to us in conjunction with today's hearing would possibly represent a sea change in how our capital markets operate. It will take some time for our members to analyze these discussion draft provisions, and we are happy to convene our issuer

and investor members to discuss them further. As always, we will do so in a methodical and dispassionate way.

Importantly, our members believe that it is straightforward to understand and conclude that the issuer pay model creates a potential for conflicts of interest. When assessing what rating agency to engage, our members know that issuers consider a variety of factors. These include the rating agency's criteria and historical performance, the historical volatility of the rating agency's ratings, and investor demand for the rating, among others.

Our members also appreciate the comprehensive changes to the oversight regime for NRSROs that have been adopted since the financial crisis. We hope that the focus for regulators can be to continue to build upon the transparency and the controls put into place over the past decade.

In response to the SEC's FIMSAC discussion papers last year, our members ruminated at length over the pros and cons of alternative compensation schemes for new issue securities. We discussed an investor subscription model and an assignment model. In both cases, issuers and investors both found that those alternative models presented new potential conflicts of interest while not materially improving the credit rating process overall.

Nevertheless, SFA members welcome continued dialog to consider additional means that could further strengthen disclosure practices so that investors can be armed with all of the information needed to make informed investment decisions on behalf of their customers.

For example, investors are always receptive to additional information for issuers on how and why they selected a particular NRSRO. An area where SFA is also working closely with our issuers, investors, and rating agencies is around ESG disclosure for our markets, sometimes called sustainable investing, or impact investing. We have seen a major influx of retail investor demand for products that can be labeled with these terms.

Our primary concern at the moment is that the markets must keep up with the demand without degrading standards. To that end, SFA is working hard to build best practices for disclosures and reporting that can be used by the securitization markets. We very much look forward to working with this committee on these issues in the years to come.

In conclusion, it is important to make abundantly clear that the members of the Structured Finance Association are committed to being part of the healthy progression of our markets and their regulatory infrastructure. We aim to provide responsible lending and investment opportunities for all American communities, households, and businesses.

We are absolutely determined to bring more gender and racial diversity to the decision-making corridors of our industry, as we see this as essential to the functioning and continued evolution of our markets and of our economy. And we support all efforts to debate and discuss ways to enhance the regulation and transparency of our industry and the markets it serves.

Our members take seriously the role that they play in the American as well as the global economy. We know that the decisions we

make, models we employ, and controls we build have a direct and meaningful impact on the lives of millions of people.

For those reasons, I thank you, again, for the opportunity to discuss this important issue with you today, and I look forward to answering any questions you may have.

[The prepared statement of Mr. Bright can be found on page 38 of the appendix.]

Chairman SHERMAN. Thank you.

Without objection, we will enter into the record a letter from Better Markets in support of a system in which there would be a panel of bond rating agencies and the SEC would select which one is applicable.

Without objection, it is so ordered.

I will now recognize myself for 5 minutes for questions.

We are told by those who want no reform at all that the answer is simple: Just ignore the bond rating. That begs the question why we as a society are paying \$14 billion for ratings we are not supposed to rely on, but it also is incredibly unfair to the individual investor. If you have \$50,000 to invest, how are you supposed to select which bonds to invest in if you can't rely on the bond rating? Are you really supposed to go out and visit the company?

Likewise, if you are trying to choose which bond fund to invest in, and both of them average a AA rating on their portfolio, and one yields 2.1 and one yields 2.2, on what basis would you not just invest in the one with the higher yield and the same rating? Are you really supposed to review the 400 or 500 portfolio holdings of each bond fund, and decide on your own the appropriate rating of each one of those bonds? The fact is, we need bond rating agencies and we need reliable ones.

I agree with the ranking member when he says that when people screw up, there should be ramifications. And I want to, again, point out that the Financial Crisis Inquiry Commission, established by Congress to look at the greatest economic disaster in our history, the history of those of us born after 1933, found that the rating agencies inflated mortgage-backed securities and other asset-based securities, and that this was a primary cause of the 2008 financial crisis.

All I can say is that the system we have now would be for baseball as if the home team selected the umpire, and each umpire was paid \$1 million per game. Under such circumstances, every time Clayton Kershaw pitched the ball, it would be a strike.

Now, Congress tried, in Dodd-Frank, to require the bond rating agencies to accept some liability. I have a proposal that actually is less severe in terms of the liability, in that it would apply liability only if there was a showing of gross negligence.

Mr. Nadler, if, for you to do business, you had to accept that you would be sued if there was a showing of gross negligence, would you stay in business, or would you go on strike the way the bond rating agencies did in 2010?

Mr. NADLER. I would have to look at that more carefully. I think that the point you are making is that there needs to be consequences for bad behavior. And as I outlined in my written comments, and I tried to talk about in my opening statement, for us, it looks as though the framework that Dodd-Frank has set up,

added, in conjunction with the 1933 Act, the 1934 Act, and the 1940 Act, are sufficient to create an environment where rating agencies are encouraged and could realize that there are penalties—

Chairman SHERMAN. I'm sorry. Thank you for your answer. I am going to try and squeeze in one more question.

Mr. Linnell, this is an easier question, because it won't cost you a penny or subject you to any liability. Right now, for one of the rating agencies, the biggest, their fifth-best rating is an A+. For another one, the fourth-best rating is Aa3. Now, if my kids come home from school with, "A13 omega epsilon," I am not going to know what it is, even though the educators might know.

Do you see any harm—or what harm do you see if every credit rating agency gave an A+ to the best, and then an A, and an A-, and a B+, so that the ratings could be understood by somebody who is a parent, not somebody who apparently works on Wall Street?

Mr. LINNELL. I think there are probably a few answers to that, but the main one is our credit ratings are meant for professional investors. They are not met for the retail level with a man or woman on the street. And the professional investor pretty much understands the ratings definitions and the rating scales that we provide because we—

Chairman SHERMAN. My time has expired. I will simply say that as an investor, I am paying you the \$14 billion, and I deserve something I can understand.

I will now recognize the gentleman from Michigan, the ranking member, Mr. Huizenga.

Mr. HUIZENGA. Thanks, Mr. Chairman.

Mr. Linnell, Mr. Nadler, I think you are the only two practitioners on the panel who actually operate a rating agency. I am curious, what is your price?

Mr. LINNELL. Did you say, what is your price?

Mr. HUIZENGA. Yes. What is your price, because it has been implied that for \$1 million, a rating agency will pass and put a good rating on, much like if you paid the umpire \$1 million, they would throw a game? So, I am just curious if you are for sale?

Mr. LINNELL. If I may take the first stab at that—

Mr. HUIZENGA. It can be a short stab. It can be a yes or a no. Are you going to throw your ratings based on what you get paid?

Mr. LINNELL. There is no price you can pay that is high enough to compromise the quality and the reputation of those in the ratings agencies.

Mr. HUIZENGA. Okay. How about Mr. Nadler with Kroll?

Mr. NADLER. I have the exact same answer. And I would add one thing, which is that if the games were televised, people would very quickly stop watching them.

Mr. HUIZENGA. Okay. I think you are right.

Mr. Nadler, I would like to stick with you, because I think in your written testimony—and I am summarizing it here, but I just want you to expound on it maybe a little bit. You are saying that some sort of rotational system, which you, I believe, as the fifth-largest, but a bit smaller than the others, would actually help your

business. But what I heard is that it wouldn't necessarily help your profession, is that correct?

Mr. NADLER. I think that is right. I think that competition has been one of the driving force for better transparency, better research, and I can talk about a number of areas where we have led the industry toward better research through being a viable competitor.

Mr. HUIZENGA. Great. Thank you.

And, by the way, I am happy to hear that you are not for sale and you are not going to throw your ratings, no matter what that price tag is, because that is certainly what has been discussed. And if that is the case, in my mind, that is illegal and it should be punished.

I want to move on.

Mr. BRIGHT, you have been involved on all sides of the market for a number of years, and I am curious, there has been lots of discussion about 2008 and the crash, and the effects in 2009 and into 2010. So very, very briefly, what has changed between 2008 and today?

Mr. BRIGHT. An understanding that the underlying asset prices can go down. That was probably the number-one mistake made by everyone, bank regulators to securities regulators, prior to 2008. I think we have better knowledgeable assumptions, coupled with a lot of changes in regulation and the passage of time.

Mr. HUIZENGA. Okay. And do you believe that investors have an adequate voice in these discussions?

Mr. BRIGHT. We try to make sure they do.

Mr. HUIZENGA. What do you hear from your members who buy bonds daily?

Mr. BRIGHT. I would definitely say that they will tell you that they have a very good dialogue with both the issuers and the rating agencies. I think the rating agencies almost see the investor as their customer quite a bit, so they subject themselves to as many qualitative questions as they can answer from them.

Mr. HUIZENGA. And do you believe that fixed income markets are working efficiently? And do they believe in the integrity and resiliency of the ratings?

Mr. BRIGHT. Certainly, substantially more so now. A lot of fixed income investments in the United States are currently purchased by the Fed, but a lot has changed in the last 10 years, for sure.

Mr. HUIZENGA. Okay. Mr. Linnell, as former Democrat SEC Commissioner Roel Campos stated regarding the potential system of new government-supervised ratings, "Such a system would not necessarily be preferable to dealing with the existing CRA conflicts of interests through today's careful supervision by the SEC where investors pay for ratings that affect their portfolio values."

How would a government entity assess the performance of credit ratings?

Mr. LINNELL. I feel that is a perennial challenge for any policymaker or regulator, given the very nature of credit ratings being opinions. But the way that the market has traditionally gotten around that is by looking at the level of transparency that agencies give around the performance of their credit ratings over a period of time.

So, you will see now that there is substantially additional disclosure, at a very granular level, around the performance of credit ratings, default statistics, migration statistics, a huge amount of information that is available, and most of it is freely available on websites. So, transparency and disclosure around performance is the typical way that the market assesses the relative performance of rating agencies.

Chairman SHERMAN. The gentleman's time has expired.

The gentleman from Illinois, who is also the Chair of our Artificial Intelligence Task Force, Mr. Foster, is now recognized for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman, and thank you for your attention to this important subject, which is one of the unfinished items left over from Dodd-Frank.

First, could anyone explain to me what the downside of standardizing the three-letter ratings would be, and potentially associating e-trading with a range of default probabilities under industry-standard stress scenarios? Why is that a bad idea? How would that hurt things?

Mr. NADLER. I believe the standardization, in and of itself, won't change anything, and I don't see anything particularly wrong with standardization. I think that the rating agencies do a good job of putting information and descriptions around each of the ratings that talk about default frequency assigned to certain ratings. But I think that is already part of the system. But from standardization, I don't see—I think it would be something that would be benign for the industry.

Mr. FOSTER. And what about assigning default probabilities under industry-standard stress scenarios so you can actually hold up after a crisis has occurred, compare the prediction with what actually happened in terms of the observed default rates following a crisis?

It is my understanding that that was done in the past, I think prior to maybe the mid-1990s, or something like that. There used to be default probabilities associated with ratings, and somehow that doesn't seem to happen anymore, and I was wondering why returning to that, —as well as standardization, might be a bad idea?

Mr. LINNELL. If I may add, rating agencies do publish quite comprehensive probability of default (PD) data, default data associated with each of its ratings and ratings categories, but the agencies don't define those ratings according to those PDs. And the reason why you don't define them according to a specific PD set is because you are trying to look through economic cycles, and obviously, default rates will change with recycles and that the ratings become part volatile you will exacerbate procyclicality. But many users do indeed find the PD rates associated with a given rating level as being very useful in their decision-making process, and that is why the rating agencies provide them in a very granular and detailed way. As I said before, it is freely available.

So, to a large extent, investors are getting the best of both worlds. They are getting the qualitative rating scale that the credit rating agency scale traditionally provides as well as the transparency and inside performance on a PD basis.

Mr. FOSTER. That is interesting. I was unaware that you could actually predict what the default rate was going to be based on—if you have some portfolio bonds that you could actually go and look at the three letter ratings and say, therefore, it should hold up this well under this scenario for an economic downturn.

I think at the end of this, the ultimate answer may be to publish the models and predict how individual classes of bonds with a certain rating might perform under certain well-defined stress scenarios, very much the way big banks go through a variety of stress tests, and they make sure that their overall capitalization is robust against a variety of stress scenarios that is providing that sort of information to users, and potentially just letting them run an app that looks at their bond portfolios, run the models provided by the industry, should ultimately allow them to know whatever portfolio they are holding, how you guys predict it should hold up. And then, if they see a big difference, actually be able to have something to discuss after that.

What are the possibilities that people have discussed for putting some skin in the game, for example, by requiring rating agencies to simply carry insurance against the possibility that their ratings turn out to be so not good? The insurance payout, for example, would be going to the investors that have been harmed by bad ratings. It seems to me that would provide—whoever provided that insurance with a really well-motivated, independent look at the accuracy of your ratings, and their best guess as to how accurate they are. Are there mechanisms like that that have been proposed to make sure that there is really an independent set of eyes, and give a profit motive to finding mistakes that your industry is making?

Any observations of all of the different mechanisms of people to—

Mr. LINNELL. Yes, if I may, I would say that the ultimate sanction on poor performance of ratings from a rating agency is that that rating agency would or should be fairly quickly out of business. The only asset a rating agency has is its reputation for the quality of the ratings it provides and its associated and supporting analytics.

In terms of any punitive regime, as I mentioned before, we are very heavily-regulated now in nearly every single country that we operate in and all of those regulators—

Chairman SHERMAN. The time has expired, and actually, more than expired. I hate to cut you off, but you can add to the record with the rest of your answer.

The gentlewoman from Missouri, Mrs. Wagner, is recognized for 5 minutes.

Mrs. WAGNER. Thank you, Mr. Chairman.

One of the factors that led to the 2008 financial crisis was investors' overreliance on credit ratings to evaluate the risk of structured finance products. However, credit rating agencies are just one of many, many causes of the financial crisis. Between 2008 and 2009, the 3 largest rating agencies undertook a number of steps to reform the ratings process, including reviews of originator due diligence, improved ratings methodologies, and increased disclosures to investors regarding their ratings.

In 2010, with the passage of Dodd-Frank, these nationally recognized statistical rating organizations, or NRSROs, were hit with

new requirements aimed at enhancing their disclosures and transparency. Unfortunately, this blanket approach to annual reporting requirements mandated under Section 932 of Dodd-Frank placed unnecessary burdens and compliance costs on small credit rating agencies that were in no way responsible for the financial crisis.

After the Office of Credit Ratings was created in 2012, and the new requirements went into place, smaller credit rating agencies have been prevented from entering the marketplace, and providing necessary competition. Contrary to what some may think, more regulation does not solve everything. That is why this week I have reintroduced the Risk-Based Credit Examination Act, with Congressman Foster, and this bill makes the criteria required for annual reporting by the NRSROs just that: risk-based.

A move to a risk-based model will alleviate the burden on small credit rating agencies while continuing to maintain oversight and transparency over the industry. The marketplace needs this fix.

Former SEC Chair Mary Jo White has spoken in support of the SEC moving to a risk-based approach. Likewise, former SEC Commissioner Gallagher has also previously highlighted how burdensome the Dodd-Frank regulatory requirements will be. And as a result, smaller credit rating agencies have to devote more resources to compliance than the largest credit rating agencies.

I want to be clear: This bill does not eliminate reporting requirements for credit rating agencies. Instead it simply makes the criteria required in annual reports risk-based. Credit rating agencies will still be held accountable while allowing real competition in the market.

I want to thank Congressman Foster for his support of this issue since, frankly, the 114th Congress.

Mr. Linnell, in my limited time, will you describe the environment in the rating industry since the 2008 financial crisis? Is it more competitive or less competitive?

Mr. LINNELL. Simply put, more competitive, and before the financial crisis, Fitch was the biggest and most traditional competitor to what was really seen by many participants as the duopoly of S&P and Moody's. And Fitch has grown substantially since 1997 through a series of mergers, acquisitions, and substantial organic investment.

So, we were the main competitor in the market, but since then, we have seen the growth of other agencies. And, in fact, until recently, there were six very active rating agencies in the structured finance space, for example. So six recently, because we are now down to five following the merger of DBRS and Morningstar, but Kroll and DBRS are now taking a 20-percent market share. It is a very competitive market.

Mrs. WAGNER. Thank you, Mr. Linnell.

Mr. Bright, in 2011, the SEC approved more than 500 pages of proposed rules to implement the provisions in Dodd-Frank for NRSROs. The proposed rules required NRSROs to have effective internal governance mechanisms related to how the NRSRO determined the credit ratings and to provide annual reports to the SEC.

Since then, can you describe the performance of credit ratings?

Mr. BRIGHT. Especially looking at the recent COVID crisis, the volatility of them has substantially decreased, since these initiatives have taken place.

Mrs. WAGNER. Have they improved since—

Mr. BRIGHT. That would be the way I would define improvement, yes, is that they are more reliable, especially in the face of a major economic event such as the COVID-19 crisis.

Mrs. WAGNER. My time has expired. Mr. Chairman, I yield back. And I thank the witnesses.

Chairman SHERMAN. Thank you.

I now recognize the Vice Chair of the subcommittee, Mr. Casten, for 5 minutes.

Mr. CASTEN. Thank you, Mr. Chairman. And thank you to all of our witnesses.

I want to talk a little bit about climate risk. I have been spending a lot of time thinking about the risks to our financial system that climate poses. And I want to start, if I could, with you, Mr. Nadler, because you mentioned that in your written testimony. And I want to be clear. I don't know the answer to any of the questions I am about to ask, and I recognize that you all are focused on the dead end of the financial system. We have a lot of other moving pieces. But I would like to understand to what degree the private sector is already doing calculations we don't need to repeat and to what degree there may be some gaps, so that is sort of the spirit of the question.

Mr. Nadler, in your written testimony, you said, "I would like to provide some views on climate risk and credit ratings. KBRA fully incorporates ESG risks." I just want to understand, do you evaluate climate risks in your products independent of ESG or is it only as a subset of ESG?

Mr. NADLER. We evaluate anything, including climate risk, that impacts the credit rating. We include that in the analysis of the credit rating. We also are working with issuers across-the-board, financial institutions, structured finance credit rating, to begin to include more disclosure around ESG risk, including all ESG risk—climate change, social risk, governance risk—that may not impact the credit today, but could have an impact on the credit in the future or could impact the market liquidity of the bonds in the future.

So we are looking at both, including factors that directly affect the credit, but also working with issuers to include more disclosure across—more around ESG.

Mr. CASTEN. Okay. And I want to separate from ESG, because with ESG, you might be improving on, "E," but are worse on, "S," and now you have a complication of how you score it. So looking just at climate risk, do you differentiate between transition risks and physical risks? In other words, you are exposed to flooding, which is one set of risks, and you are exposed to loss of market to cleaner technologies, which is another risk. Do you differentiate between those in your analysis?

Mr. NADLER. We do.

Mr. CASTEN. Mr. Linnell, do you include climate risk, and do you differentiate between transition and physical?

Mr. LINNELL. We don't—the focus of our analysis is, do the ESG factors affect the full pay of the future risk of the company? And if we think it is a credit issue, then it is incorporated into the analysis. This is obviously a very fast-moving space. We actually assign what we call ESG relevant scores, from a scale of 1 where—

Mr. CASTEN. I'm sorry, because I just want to stay on topic. I just want to focus on climate, not ESG. In other words—

Mr. LINNELL. Okay.

Mr. CASTEN. —there are parts of the country that are at physical risk of climate that we know where those are. And I am just asking, do you include that in your analysis?

Mr. LINNELL. Yes. And we score it between 1 and 5. Five means it has been a key rating driver, and one means it is irrelevant.

Mr. CASTEN. Okay. So back to Mr. Nadler, if you are including those physical risks, leaving aside the transitional, are there geographies in the United States where you are downgrading in the absence of some greater insurance product at this point that we should be sensitive to as we think about capital movements around the country?

Mr. NADLER. We haven't seen downgrades yet. What we have seen is that there is more attention both on the positive side, where we are seeing issuers that are much more interested in the changes that are taking place and they are putting in motion particular procedures or setting aside money to take care of that. And we are also having better conversations among issuers about those risks now that we incorporate them in the current rating.

I do think as this climate risk becomes more understandable, we are going to see a divergence in ratings for cities, towns that are more resilient—

Mr. CASTEN. I am sorry to cut you off, but we are getting to the end of my time. I am really not asking a judgment question, but we are sitting here with wildfires raging across the country, with huge flooding events. And are you telling me that knowing what we know, knowing that is coming, that we are not yet downgrading any of those credits or we are not yet requiring greater insurance? So, who bears that risk of loss right now? Do investors understand that in your ratings?

Mr. NADLER. KBRA doesn't yet have a broad portfolio of municipal ratings, so I would defer to the rating agencies that have large municipal ratings throughout the country.

Mr. CASTEN. Thank you. I am out of time, but I would love to continue the conversation.

I yield back.

Chairman SHERMAN. The gentleman from Arkansas, Mr. Hill, is now recognized for 5 minutes.

Mr. HILL. I thank the chairman. I appreciate his calling this hearing and I know of his significant passion and work on this issue for improvements for many, many years. And I appreciate the expertise of our witnesses.

Mr. Bright, as I look at the draft legislation that we have before us, explain to me some of the limitations, in your view, of using this rotational model to try to assign credit ratings?

Mr. BRIGHT. I think a dynamic that we want to harness and build upon—and to be clear, we do support as much additional

transparency and governance and controls as possible, as feasible, to ensure that rating agencies are publishing criteria and any changes of criteria and selection process issuers are using. So, just as a baseline.

But there is a very healthy tension that is built into a system of issuers having to sell their bond to an investor with a particular rating, and then the rating agency needing to explain to their investor the methodology that they used, the criteria that they used. And the investors very much appreciate that discussion and that dialogue. And it can be two-way feedback, which helps make sure that they are not making criteria too conservative, just to cover themselves, or too weak, just to run a business. It is more of a discussion that brings to bear a lot of market forces. And I think that you want to build upon that tension to continue to improve the process.

If it was simply a selection criteria, where once you meet some basic minimum threshold, all of a sudden you are now in this rotation system, I would worry. And I know that, more importantly, our investors would worry that that would eliminate the incentive for the rating agency to work with them to improve the quality of the ratings and the reliability of their model.

Mr. HILL. Thanks for that. That is helpful, and it makes me think about my work in investment banking. I have a great associate who worked for me, who is training at Bank of America, and Merrill Lynch. And in all of our experiences, one of those deals before they go public that was just a primary objective was that any true deal had to have two ratings from the big three agencies or the public investing community wouldn't take the transaction seriously.

So, Mr. Linnell, can you speak to this? It is in addition to what I asked Mr. Bright. Can you specifically talk about how the rotational model that would only produce one rating would undercut that opportunity to have two independent looks at a particular investment for investors?

Mr. LINNELL. I think the reason why people went to two ratings from the big agencies is because they wanted to see high-quality ratings, which typically comes from those agencies, and they have a demonstrable track record, they have large coverage, and they have execution capability to give what the issuer and the investor requires.

I think when we look at the proposal that is on the table, we continue to believe that investors are best served by agencies competing with each other on the quality of the work that they actually do, making the ratings as predictive as possible, having them supported by high-quality analytics and research, not allocated by a particular board or body. And it is by competing in this way that standards improve and that transparency improves. That way, the users of ratings understand how they are being determined, and what they mean. And it is this transparency in performance that ultimately eliminates ratings shopping and not allocation from the board.

Mr. HILL. Yes. That is helpful. And I am always dubious about a one-size-fits-all sort of governmental solution without that market touch and that market competition. So, that is kind of where

I come from on this. But there is an ongoing responsibility that these credit rating agencies have and perform in our capital market system.

Mr. Nadler, can you discuss the important role that the credit rating process plays in surveilling the companies or the issuers that they have actually rated, so that ongoing surveillance responsibility?

Mr. NADLER. One of the most important aspects of what rating agencies do is this ongoing surveillance. And I think that was one of the breakdowns in the financial crisis, was this feedback loop of looking at what is going on during the surveillance period and using that to help you with your primary research. So, this role in surveilling is critical. And I think that one of the things you worry about in an assigning rating regime is that rating agencies will spend less time and less money on this surveillance aspect.

Mr. HILL. Thank you.

Mr. Chairman, I appreciate the time and the witnesses' expertise. And I yield back.

Chairman SHERMAN. Thank you.

And I do want to clarify for the record that the legislative proposal before us does not prevent an issuer from getting a second rating from any rating agency they like.

With that, I recognize the gentleman from Missouri, Mr. Cleaver, who is also the Chair of our Subcommittee on Housing, Community Development, and Insurance, for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman. And thank you for holding this hearing. I think it is important.

I want to follow up on Mr. Foster's questioning because it intrigued me. I have been on the Housing and Insurance Subcommittee for almost 18 years. And he raised a question about insuring your ratings and what happens in terms of insurance, if things go as they did in 2008, that the ratings go awry, and we have an economic collapse. What would be wrong with requiring that you insure your ratings?

Not all at once. Go ahead, please?

Mr. LINNELL. I was just going to say that credit ratings are essentially a prediction of the future, what is going to happen in 10 years, or 15 years, or 20 years. We do our best job to do that, make sure people understand how we have come to that decision, and what is supporting our analysis and the credit rating. But it is essentially a prediction about the future. So, I would probably find that insurance company to insure your predictions with 100-percent accuracy is going to be prohibitively expensive. I just don't think it would necessarily work from a practical perspective.

Mr. CLEAVER. Yes. I was on this committee—I probably am the only one in here who was here when we had the credit rating agencies sitting here in 2008—or actually maybe—yes, 2008, and everything was great. And so, we took your prediction literally and ended up in trouble. Plus, no insurance company in the world would do the insurance, as you probably know. They would want to have a government backstop, which wouldn't happen either.

Mr. Rhee, you mentioned in your testimony that there should be vigorous competition for the most accurate and bias-free ratings, and that we have not included in any kind of legislation anything

that would incentivize the industry to be a little more active, but careful, in their bias-free ratings. And then, you also said that it is not robust at the present time.

I would like to ask you and Ms. McGarrity, what else do we need to do? If you could write something out for Congress to do, a to-do list on these credit rating agencies, what would it be? What is not there that we should have there?

Mr. RHEE. The fundamental structure of the credit rating agency, I don't believe has really changed that much from 2008 to now. You look at the dominance of the rating agencies, you look at the compensation model; they are essentially the same. And so, there is a question of whether or not we want to promote a race to the top or a race to the bottom. I think competition needs to be defined in terms of competition for what, competition for revenues or competition for the best quality?

So I think, to answer your question, Congressman, I would like to see a competition for a link between compensation and performance; in other words, pay for performance. That would be my answer.

Mr. CLEAVER. Ms. McGarrity?

Ms. MCGARRITY. From my perspective, I put forward a number of ideas through my written testimony. But at the heart of the problem, in my opinion, is the issuer pay models. So, I support also pay for performance and generating additional competition in the industry and reduce the oligopoly or the market segmentation that doesn't exist, the market fragmentation that doesn't exist, and support the smaller market players.

Mr. CLEAVER. I had to get into it, Mr. Chairman. My time is running out, so I will yield back the balance of my time.

Chairman SHERMAN. Thank you.

The Chair now recognizes the gentleman from Texas, Mr. Taylor.

Mr. TAYLOR. Thank you, Mr. Chairman. I think this is an important topic. And I appreciate the opportunity to visit it. I think we should visit it more often.

I guess I will start with a comment that ratings are important, but it is imperfect. I think that two different people, very bright, capable people can look at the exact same data set and come to different conclusions. And so, analytics is ultimately imperfect because it is human. I think we should begin with that.

I guess where I grow concerned is when the analytics become groupthink. And I will go back to the commercial mortgage-backed securities (CMBS) industry, something I am familiar with, where you looked at the subordination levels so the AAA piece got bigger and bigger and bigger going into 2008. And that allowed for more aggressive pricing of loan products to the borrowers and higher leverage levels, the underwriting was weakened, and then you came into a crisis in 2008.

One thing, as I was going through the written testimony for Mr. Nadler, you said, "a false narrative regarding ratings inflation and competition, incomplete data, and poor reporting." Could you clarify for me what you mean by that? Because I certainly, in my business experience, have seen groupthink. And I think what we saw with CMBS and other products was you just saw subordination levels declining, so the rating agencies basically fell down on the job.

Mr. NADLER. What I was referring to was an article that was written about pre-crisis and post-crisis, and the narrative of the article was that rating agencies post-crisis competition had created rating inflation. And it was specifically talking about the commercial mortgage-backed securities market and the part of the market where they put together a group of commercial loans. And, in fact, the data doesn't support that.

But before the crisis, there were ostensibly three rating agencies, and the average BBB credit enhancement level or what you would call the BBB risk assignment or default probability was about 3.5 to 4 percent.

Post-crisis, when there were six rating agencies—now there are five—that number doubled, and leverage in the industry has gone down. The same is true of the BBB tranche during the pre-crisis when there were fewer rating agencies, from today, today it is about double what it was post-crisis.

Mr. TAYLOR. Okay. I think I understand.

Mr. NADLER. It is hard for me to understand how they made—

Mr. TAYLOR. I understand where you are going. And I guess I would again iterate that it isn't so much that you are going to be imperfect in your ratings, and I get that. No one is perfect in their ratings because it is ultimately a human endeavor.

My concern is when there is groupthink and you watch subordination levels decline, and then you set up investors to go into a product that is not correctly structured, and then your pricing goes wrong.

And I will make this comment. The real estate crises of the 1980s and in 2008 were both presaged by overlending and overborrowing. And at some level, the poor rating efforts led to the overlending, because the lower subordination levels allowed for lower pricing and weaker underwriting. And the underwriting agencies, on some level—I am looking to you to tell me, yes, these guys were underwriting less effectively. I don't know if you want to defend yourselves on that point. But that was my experience of what I saw in the markets leading up to the crisis in 2008.

Mr. LINNELL. May I add one or two comments on these points?

Mr. TAYLOR. Sure.

Mr. LINNELL. I will just say that there is always a danger of groupthink. And that is why I think efforts to harmonize too much between criteria and rating agency scales and so on could actually increase systemic risk in the financial system. But there are actually significant differences between rating agencies, sometimes to aggregate its statistics to go and show a different story. But going into the financial crisis, for example, we were actually tightening the amount of credit enhancement that was required in the U.S. residential-backed securities. We weren't active in the structured investment vehicle market because we wouldn't rate higher than single A. It was a AAA market, with a very small share in the CDO market, in synthetic CDOs, because our criteria was more conservative and so was our subprime RMBS—

Mr. TAYLOR. I apologize. Our time—I am sorry to cut you off.

Chairman SHERMAN. Your time has expired.

Mr. TAYLOR. I yield back.

Chairman SHERMAN. I now recognize Mr. Vargas for 5 minutes.

Mr. VARGAS. Thank you very much, Mr. Chairman, for holding this hearing. I know you have a deep interest in this. I appreciate it very much.

I guess I would start with this. We had the honor of meeting my good friend, Mr. Huizenga's, son today. It was a thrill. That was very nice to meet your son today. That was great. He asked a question. He said, "What has changed from 2008 to 2010?" And, Mr. Bright, I think you answered that you found out the prices and values can go down, and then something about Dodd-Frank also, there are some changes in there.

I would say that—prospectively, what are the things that could potentially be on the horizon. I would say two. One, the issue of climate change in particular, and also, cybersecurity or cybercrime. Those are the two that really would get me. I would add those on.

But I would ask this. It was interesting that my good friend, Mr. Casten, asked the question, are you downgrading any parts of the country in—geographical parts of the country with respect to either transitional risk or physical risks. And I think you all said—well, not all, but the two who are actually involved in the rating agency said, "No."

But I looked up Fitch ratings here, from March 2021, with respect to Pacific Gas and Electric (PG&E). And you did downgrade PG&E in the Bay Area because of the wildfires, the catastrophic wildfires. And they filed Chapter 11, as you know, back in—what was it—2019, because of the potential liability. And I would associate those wildfires with climate change, climate risk.

So that being said, maybe you haven't downgraded geographical areas, but I think you certainly have taken a look at companies. Is that not the case, Mr. Linnell?

Mr. LINNELL. Yes. I actually did say that we assessed environmental, social, and governance (ESG) factors that specifically reflect and affect credit risk in companies. And we actually score them, where 1 is, it is irrelevant and 5 is, it has been a key rating driver. And we have changed many ratings as a result of companies being given a 5 in the environmental issues.

But, actually, when you look at the whole ESG spectrum, social issues and poor governance are typically more significant rating factors that you see often than environmental factors. So, all three of those issues are important when you are looking at credit risk.

Mr. VARGAS. I am glad you said that, because I had a bill that we passed out of here that dealt exactly with ESG. Next time, we will remember to add you onto the list of those witnesses. So, thank you for testifying. I appreciate it. I will remember you, of course. And thank you for your bravery of being here. I guess the other ones chickened out.

I would ask this then: How should we incorporate ESG?

Mr. Bright, I saw here that you write almost entirely about investors demanding this, that we do ESG. It is not really driven by politics, or you call it regulatory fiat. I would say that there are some of us who are very interested in this. So, how would you incorporate it? Because I think it is one of the issues that we are going to have to face. And dramatically, if you take a look at PG&E, how it was downgraded, I think appropriately so, because there is this risk of wildfire that is associated—I don't care what

anybody says—it is associated with climate change. We do have climate change and it is dangerous.

Go ahead?

Mr. BRIGHT. Really quickly, for this committee, something you can do is have FEMA update the National Flood Insurance Program (NFIP) maps, which is something that really keeps getting pushed. So, since I never miss an opportunity to upset the REALTORS, I figured I would mention that while I was here today.

Mr. VARGAS. Fair enough.

Mr. BRIGHT. But the ESG work that we are doing, and I think the point that I was making is that younger investors have this insatiable demand for sustainable certified asset investments. And I think that is a really great thing.

Mr. VARGAS. Me, too.

Mr. BRIGHT. Absolutely. The concern that we have is that it is almost so big that it sounds comical. You look at numbers like \$74 trillion of U.S. domiciled assets are labeled as sustainable, and that just seems completely bogus. It can't be.

So what I am worried about is that these things degrade so much and people are putting stamps on something that aren't actually meaningful, and then investors become cynical and we lose this opportunity to certify it. So, there is a regulatory role, a legislative role, and a market role, in my opinion.

Mr. VARGAS. My time is almost over, so I just have to reclaim it. I would agree with everything you said, with the exception that potentially, it is not comical. If you take a look at what happened in Germany, if you take a look at what is happening out in the West, it is real, and it is big, and it is dangerous, and the numbers are gigantic.

Again, I thank you very much for being here.

My time has expired. I yield back. Thank you.

Chairman SHERMAN. Thank you.

I now recognize the very patient gentleman from Wisconsin, Mr. Steil.

Mr. STEIL. Thank you very much, Mr. Chairman.

Just to follow up, if I can, Mr. Linnell, really quickly to my previous colleague's comments discussing what is in and what is out of the ratings analysis, do you have a materiality standard for what you include and what you don't include in those ratings?

Mr. LINNELL. In terms of the, "E," or just in the credit ratings in general?

Mr. STEIL. Just in your credit ratings in general, as you look at things that you are considering inside that radius, the materiality threshold for you.

Mr. LINNELL. Yes. That is entirely the matter of the credit committee, and the credit committee is composed of—

Mr. STEIL. For sure. I am not trying to get deeper into the weeds, but there is a materiality threshold as you look at some of these factors in your—it is just, I think, a relevant point for this committee to always keep in mind the importance of materiality.

I am going to continue on, because I have limited time, but I will stick with you, if I can, Mr. Linnell.

In your testimony, you outline some of the changes made to the ratings industry after 2008 that have improved the reliability of

those ratings. And last year, those reforms were really tested as our economy experienced a severe contraction due to the global pandemic. The circumstances were obviously very different than the previous recession, but the NRSROs were also on probably a more solid footing. And the SEC noted in a July 2020 statement by their COVID-19 working group that, “In addition to substantially different economic conditions and stresses, the relevant analytical assumptions and methodologies used by rating agencies in that period were also substantially different.”

Could you highlight what changes had the biggest impact on your firm’s performance through 2020?

Mr. LINNELL. I think, post-Dodd-Frank, there was a huge amount of changes, obviously as I have mentioned before, where they are heavily regulated, subject to annual inspections, and we have 30 different regulators around the world. But Dodd-Frank also meant that we significantly invested in our controls and procedures around the rating policies, and also invested in procedures around managing conflicts of interest.

And in addition to that, away from just the control infrastructure, we invested a lot of time and effort in really trying to explain to investors and to issuers what were the key rating drivers, what are the key rating sensitivities. So, a lot more effort to try and explain what were the driving risk factors behind credit ratings. We also made—

Mr. STEIL. Thank you. I am at risk of letting you go on for the whole time. I just appreciate you highlighting a few of those.

Mr. LINNELL. Yes.

Mr. STEIL. I am going to shift gears, if I can, to Mr. Bright.

Much of today’s conversations focused on the issues, the potential conflict of interest inherent in the selection process for NRSROs. We all recognize that conflicts of interest can be a problem, but we can hopefully also mitigate these with good oversight.

How do market participants account for the potential bias arising from some of the conflicts of interest? Can you shed some light on this for us?

Mr. BRIGHT. Our investors, first off, have a dialogue with the rating agencies, and they will very gladly point out when they think something is wrong. And then, they vote with their feet and with their money. I have read some studies that show that certain rating agencies or certain tranches that have only a single rating are issued at higher yields, which is what you would expect if the process is not working.

So, we want to make sure that there is as much governance internally but as much transparency as investors said that they need in order to understand why a rating agency was selected. They do that in a variety of ways right now. And that is what I would focus on.

Mr. STEIL. To shift gears on that, if you look at the market share for existing NRSROs, it is clear that some specialize in analyzing certain industries or asset classes. For instance, AM Best, which accounts for less than half of 1 percent of all credit ratings, issues about 34, call it about a third of ratings in the insurance industry, more than S&P, Moody’s, or Fitch. Would an assignment model, which is being discussed here, that really seems to ignore the spe-

cialization or other relevant factors, lead to a more or a less reliable credit rating?

Mr. BRIGHT. We believe strongly that it would be less reliable.

Mr. STEIL. Your members are the end users to some of these credit ratings. Are they advocating for some of these pretty drastic changes proposed by some of my colleagues?

Mr. BRIGHT. No, they are not. And many of them are members of the FinTech Commission which looked at this last year as well, and did not advocate for this.

Mr. STEIL. I appreciate your feedback.

Cognizant of my time, Mr. Chairman, I will yield back.

Chairman SHERMAN. Thank you.

I now recognize Mr. Hollingsworth from Indiana.

Mr. HOLLINGSWORTH. Good afternoon. I appreciate everyone being here.

One of my favorite quotes about predicting the future comes from a famous economist, Mr. Galbraith, who said, "There are two kinds of forecasters: Those who don't know and those who don't know they don't know."

I have heard a plethora of comments today characterizing credit rating agencies as poor forecasters. Even the most notable false and hyperbolic point to CRAs as the, "primary cause" of the 2008 financial crisis. These assertions certainly stop short of offering any meaningful alternatives that have proven consistently correct or at least nearer in their rectitude than the CRAs.

To state that CRAs have been wrong is to compare them to what? We can't simply compare them against what we now know looking back, but instead should look for contemporaneous forecasts or forecasters who proved more correct in forecasting the future.

Many of my colleagues across the aisle stop short of this because the alternative doesn't exist. So, we have proposed here something that has no evidence of being further correct in those forecasts. We have mobilized the CRA's, "lack of rectitude," a characteristic that can also be attributed to Federal Government agencies, banks, economists, consultants, academic researchers, et cetera, and then state that lack of rectitude must mean that there is a latent bias that needs rectifying, needs correcting, a diagnosis that is surely incorrect. And not shockingly, we have the wrong cure.

Specifically, I want to talk about one question that keeps coming up. I keep hearing from my friends across the aisle as though these credit rating agencies have no incentive whatsoever to be right in rating these particular issuances.

Mr. Linnell and Mr. Nadler, there have been several accusations made today about credit rating agencies inflating ratings or otherwise providing incorrect credit ratings in an attempt to maintain consumers, or alternatively, because consumers are paying them more to do so. Can you describe the reputational risk to credit rating agencies such as yours and the broader market implications of intentionally distorting those ratings?

Mr. Linnell, I will let you go first.

Mr. LINNELL. Again, it is simple to yield back business. You won't have a long-term viable future if you just simply inflate all of your ratings when you are in business.

Mr. HOLLINGSWORTH. Right.

Mr. LINNELL. And that is why you can say, for us, we have low market share in many sectors because we have a different credit rating.

Mr. HOLLINGSWORTH. Right. So, in short, it doesn't make sense to take a few extra dollars today if it might destroy the entirety of your business going forward, should investors fail to be able to rely on the ratings that you provide?

Mr. LINNELL. Professional investors are not stupid. They can see when there is rating inflation and what is happening. Investors want to see credible credit ratings but by a long-term record. And that is what we try and compete and that is what we try and provide.

Mr. HOLLINGSWORTH. Mr. Nadler, any comments from you?

Mr. NADLER. I think that is absolutely true. And I think using the description that Chairman Sherman started with, of the baseball game where the—I can go back to my statement—where the umpire is paid \$1 million and he calls the game wrong and everyone knows it, nobody is going to show up for the next game. Nobody is going to watch. And that is the same thing that would happen to rating agencies. Investors would very quickly lose interest in seeing that rating agency on any of the issues that they were willing to buy or pay for.

Mr. HOLLINGSWORTH. Exactly. This is the same incentive structure that many other businesses have, and you have all the reason in the world to not sacrifice long-term viability for business for a few small, short-term gains.

And, with that, I will yield back.

Chairman SHERMAN. I now recognize the very patient gentleman from Ohio, Mr. Gonzalez.

Mr. GONZALEZ OF OHIO. Thank you, Mr. Chairman, for holding this hearing today. And thank you to our witnesses for your participation.

While I certainly have concerns with the legislation attached to today's hearing, in particular the Commercial Credit Rating Reform Act, I think it is important that this committee continues to provide proper oversight of NRSROs. We should want a marketplace that has strong competition and transparency to help market participants make smarter investment decisions.

I want to start with Mr. Bright. In June 2020, the SEC Fixed Income Market Structure Advisory Committee released recommendations on how to mitigate conflicts of interest in credit rating agencies. And I think that is important. One of the recommendations was to enhance issuer disclosures, detailing the process issuers use to select an NRSRO.

Do you have any views on this recommendation and how there could be additional disclosures for issuers?

Mr. BRIGHT. There are a lot of disclosures. If you look at a deal, it is hundreds of pages of information. The problem with that quantity of information is that sometimes it is not exactly what you want. So, I think that an iterative process that involves investors, it involves the SEC, it involves the credit rating agencies about what they are going to explain to investors in terms of how they selected the NRSRO for a deal, I think that we have a lot of sup-

port from our membership on that. I don't have a template, but I think it is a worthy conversation piece for sure.

Mr. GONZALEZ OF OHIO. Who is on the other side of that? Because it seems like an obvious answer. What is the argument against something like that?

Mr. BRIGHT. It is just researchers and time. But I don't think it is prohibitive of researchers and time.

Mr. GONZALEZ OF OHIO. Okay. That same report discussed recommendations for bringing more transparency to NRSRO models by requiring NRSROs to disclose more in-depth information about their models specifically and how they differ by industry. Do you have a perspective on that recommendation, especially in the context of how NRSROs already make their methodologies freely and publicly available?

Mr. BRIGHT. Yes. At some point, it can get a little weeded. So, it is not a binary thing where I would say absolutely not or absolutely so. I do think it is important to know that models are not right, ever. By definition, a model is to take a universe of infinite variables and distill it down to the 50 you think matter. You just want to have a conversation about what assumptions are going in, what empirical data you have or don't have for it, and what criteria you use around that in terms of making a decision. That is the important thing.

Mr. GONZALEZ OF OHIO. Yes. It reminds me of a professor I had, Keith Hennessey, who used to work for President Bush. And he said, when people talk about their models, it sounds like this wonderful, deeply accurate thing. If you just translate that on a spreadsheet, you are starting to actually get more of what it is. It is just, at the end of the day, somebody's best set of—

Mr. BRIGHT. Fermilab has some good models, I would say, for Congressman—

Mr. GONZALEZ OF OHIO. I am not saying all models are bad. I am just suggesting that they are made by humans and they are always inaccurate, although helpful in making decisions.

In your testimony, you state that your organization found that alternative compensation schemes, such as the investor subscription model and an assignment model, presented even greater risks and consequences than that of the existing system. Can you just sort of double-click on that and go through that?

Mr. BRIGHT. Very quickly, again, the assignment model, degradation of quality standards, no incentive for a rating agency to have to sell, and explain its models and methodologies and criteria to the investor, that kind of goes away. It is just that, as I understand it, once you are in, that is a rotational thing.

That said, as I mentioned in my testimony, we will discuss it, and we will take it and further analyze that.

With the investor pay model, there are a lot of conflicts there. Right? An investor who owns a bond has a particular interest in how it is rated. An investor that doesn't own a bond but wants to purchase a bond would have a different interest. And so, it presents conflicts of interest that could be problematic as well. It is really more about, I think, having a robust dialogue between the rating agencies and the investors to make sure that the whole things works as well as possible.

Mr. GONZALEZ OF OHIO. I appreciate that. And I tend to agree. And like I said, this is not a perfect system. There is no perfect way to do this, I think, that anybody has come up with. But to some of the earlier points, the legislation, in particular the assignment model, I just, frankly, think is nuts.

But, with that, I will yield back.

Chairman SHERMAN. Thank you.

We are honored with the presence of the Chair of the Full Committee, Chairwoman Waters, who is recognized for 5 minutes.

Chairwoman WATERS. Thank you very much. And I appreciate this so much, Mr. Chairman.

Mr. Linnell, in 2011, your firm settled with CalPERS for providing inflated ratings for structured investment vehicles in the years leading up to the financial crisis. These inflated ratings led to a \$1 billion loss for CalPERS, which managed the retirement savings of government employees and their families in my home State.

In the decade since the crisis, does Fitch have any regrets about how its ratings harmed my constituents?

Mr. Linnell?

Is he still here?

Mr. LINNELL. I'm sorry. Are you sure it was us that rated the structured vehicle that you are talking about?

Chairwoman WATERS. Am I sure of what?

Mr. LINNELL. Are you sure it was Fitch?

Chairwoman WATERS. Yes. I am sure that in 2011, your firm settled with CalPERS. CalPERS is the California Public Employees' Retirement System. And that amounted to—these inflated ratings led to a \$1 billion loss. That is why you had to get involved with a settlement. You don't recall this? You don't know anything about this?

Mr. LINNELL. I think the settlement that we made with CalPERS was very, very small. But the structured investment vehicle sector, which was very large at that moment in time leading to the financial crisis, was one of the areas where Fitch showed a much more conservative approach than S&P and Moody's, which dominated that space.

Typically, our ratings would not be any higher than, "A." And the standard for that market was, "AAA." So, we had a very small market.

Our rating was still too high in retrospect for that structured vehicle that CalPERS had exposure to. Then, obviously, we were not happy that their ratings performed in that way. And if your constituents lost money as a result of that and then—I am sorry.

Chairwoman WATERS. Okay. I am sorry, too. But let me just go ahead and tell you that the Financial Crisis Inquiry Commission reported that in the lead-up to the financial crisis and the Great Recession, the machine turning out collateral debt obligations (CDOs) would not have worked without the stamp of approval given to these deals by the three leading rating agencies: Moody's; S&P; and Fitch. And as we painfully learned, these CDOs were time bombs that brought down our economy.

So rather than saying you're sorry, which I have an appreciation for, what can you say about what you have learned, how you can

prevent the kind of actions that were taken that caused PERS to harm all of those who were depending on retirement? What have you learned? And what advice do you have? What would you do differently? What have you done to correct and not be involved that way anymore?

Mr. LINNELL. I would say that a large amount of our ratings portfolio going into the financial crisis, including the CDO market, actually held up pretty well. The ratings performed pretty decently, given the supreme stress that the markets went through in the financial crisis. Our nonperformance of our ratings was heavily concentrated in U.S. RMBS transactions, and to a small extent, the small CDO portfolio and synthetic CDOs that we had.

But what we learned was that our criteria needed to be more conservative, that we needed to make the rating process more robust, and we needed to be more transparent about the key rating drivers and sensitivities that our ratings represent. And we have substantially increased our levels of disclosure to address those issues. And if you look at the performance of our [inaudible] Those very same asset classes during COVID, the default rate of our U.S. CLOs—sorry, not default rate, but the downgrade rate of our U.S. CDOs is currently less than half a percent, despite the COVID impact being probably the biggest macro shock we have seen since the Second World War.

Chairwoman WATERS. Have you in any way shown your appreciation for the fact that we bailed you out?

Mr. LINNELL. You bailed us out? How?

Chairwoman WATERS. We bailed you out.

Mr. LINNELL. As an industry or the economy?

When you say, “We bailed you out,” do you mean that you bailed out the economy as of—

Chairwoman WATERS. Yes.

Mr. LINNELL. —because of the massive [inaudible] COVID?

Chairwoman WATERS. Yes. That is what I mean.

Mr. LINNELL. Yes. That has been a huge credit positive. I wouldn’t say you bailed us out, but clearly, the huge amount of government intervention around the world has had tremendous success in building a bridge between a pre-COVID world and a post-COVID economy. And that is a real credit factor that needs to be reflected in people’s analytics.

Without that, then, yes, the macroeconomic shock would have been much more severe, and rating downgrades and ultimately credit losses would have been higher. But our ratings would have not predicted a global pandemic.

Chairwoman WATERS. My time has expired. But I think that the revelations about your role and how we bailed out the economy, as you referred to, is something that we must always be aware of, take into consideration, and never get in that position again.

I yield back.

Chairman SHERMAN. Thank you.

I will now recognize Mr. Mooney from Virginia.

Mr. MOONEY. Thank you, Mr. Chairman. But I’m from West Virginia. In 1865, we separated—

Chairman SHERMAN. Congratulations on that.

Mr. MOONEY. So, bond rating agencies play an essential role in our financial markets. They measure the risks that influence investment decisions for everyone from a hedge fund to a small-dollar retail investor. Our focus on this subcommittee should be ensuring that bond rating agencies do their job by properly weighing those risks. I think that the general goal of better, more accurate credit ratings is one that both sides of the aisle can generally agree upon.

So I was surprised to see the, "Accurate Climate Risk Information Act," which was noticed for this hearing. That bill would direct the SEC to adopt rules dictating how bond rating agencies should measure climate risk.

Mr. Linnell, if credit ratings were less reliable due to political interference, what would that mean for the broader financial sector?

Mr. LINNELL. I think any impediment on the independence and the integrity of credit ratings would reduce their value and their contribution to the financial sector. It's as simple as that.

Mr. MOONEY. Okay. Thank you, Mr. Linnell.

I am very concerned about Democrats' efforts to politicize the credit rating process. For Democrats in Congress to make a top-down ruling on climate risk would have damaging effects. With all due respect to my colleagues across the aisle, they are not experts in measuring risk. Leave that to the bond rating agencies.

I am also concerned about how the Democrats' climate rules could impact industries in my district, like coal, despite continued innovations in energy, like carbon capture, which makes using coal environmentally friendly. Democrats continually ostracize the coal industry, that is important to districts like mine across the country.

This bill is nothing more than another attempt by Democrats to insert their leftist ideology into another aspect of the financial market. They pursued the same strategy with public disclosures, and now they are going after bond ratings. We should leave left-wing politics out of the regulation of bond rating agencies. Let them focus on properly weighing risk in our economy. Doing otherwise is unfair to investors and unfair to important industries in my district, like coal.

Thank you, Mr. Chairman. And I yield back the balance of my time.

Chairman SHERMAN. Thank you for yielding back.

I now recognize the ranking member, Mr. Huizenga, for a 2-minute closing statement.

Mr. HUIZENGA. Thank you, Mr. Chairman. I am glad that we could have this conversation again.

Some interests my friend from California had talked about, how the world has changed, and I would agree. We are certainly financially in a different place than we at the end of 2008, going into 2009. And appropriately, we have tighter regulations. We have closer oversight by the SEC. We have seen the SEC and the GAO do a study that looked into various models. They concluded that it could create incentives that run contrary to the goal of ratings quality. That is why they issued these nonenforcement letters.

I would kind of draw on some of my own personal experience from when I graduated from college with my oh-so-employable political science degree. Usually, political science majors chuckle at

that, because they know exactly what I am talking about. I went into real estate. My family has been involved in construction for 3 generations, and has done real estate developing and building, among other things.

And there are a lot of changes happening in that industry, including appraisals and how they ended up putting a rotation of appraisals in. It hasn't worked, because you have people who don't know the market, they don't know the area, they don't know the context and the circumstances, making decisions that are affecting those things. I am afraid that is exactly what might happen here.

Here are a couple of things that we know have not changed. There are still natural disasters, but materiality still reigns supreme. And a rotational assignment model is still a bad idea.

One last thing, Mr. Chairman, and it is important. I do have a couple of articles that I would like to submit for the record. But I do want to clarify that Fitch, "settled"—and I use the air quotes around that for you, Mr. Linnell, because there was no payment to CalPERS with that settlement. There was no admission of guilt. It was just dropped. But that was deemed a, "settlement."

So, with that, Mr. Chairman, without objection, I would like to submit the following statements for the record: A written statement by S&P Global Ratings, and then also a letter on behalf of Moody's Investors Service; the report that I had talked about in my opening, a report from PPI, which is the Progressive Policy Institute, titled, "Credit rating agencies: Sending a Clear Signal"; an opinion article from former Democrat SEC Commissioner Roel Campos, titled, "We Should Not Initiate Risky Experiments in the Credit Markets"; and finally, a report from the Committee on Capital Markets Regulation entitled, "The Role of Credit Rating Agencies During COVID-19."

Chairman SHERMAN. Without objection, it is so ordered.

And I now recognize myself for a closing statement.

It is my intention to hold another hearing on this subject, just as soon as we can get Moody's and S&P to show up. And by show up, I don't mean just send a letter to be included in the record.

I point out that while the Federal Government did not write a check to any of the bond rating agencies, both in 2008 and in 2020, many hundreds of billions of dollars were invested by the Federal Government, thus bailing out the credit markets, and preventing what would have been a huge rash of downgrades that otherwise would have occurred and would have affected the reputation of the bond rating agencies.

I strongly disagree with Mr. Linnell when he says that it is just fine if a rating is expressed as big A, small A, three, epsilon, omega, or something else equally confusing, on the theory that bond ratings should only be read by the professionals on Wall Street. If I am in a bond fund, they send me a list of all of the bonds they own and the ratings. If I am a part of a pension plan, I have a right to know how the money is invested and how the bonds are rated. And to say that things should be deliberately confusing shows a contempt for ordinary Americans.

I also think that Mr. Linnell was very interesting when he pointed out that his rating agency is more conservative than his competitors in rating certain classes of dead instruments, and so they

don't get that portion of the market. Those dead instruments go to his competitors. That proves that while perhaps the integrity of Fitch is to those particular instruments, it shows the bias in the system. You can get the liberal rating; you just can't get it from Fitch.

As to the baseball analogies, I do not think that if the umpires were paid and selected by one of the teams, that nothing Kershaw threw would be a ball, but there is the risk that the strike zone would just be an inch wider. That is why professional baseball won't let one of the teams buy a dinner for an umpire. Yet we, in our capital allocation system, allow for the bond rating agency to be selected and paid by the issuer.

There are two systems to control this. One is liability. If we don't need liability, why are accountants held liable or why are auditors held liable? They have the same level of personal integrity. If personal integrity is enough, then why are we subjecting them to lawsuits?

The other way to do it is through selection and having a panel selection process similar to what we do for bankruptcy trustees. But to leave this in this circumstance where the umpire is incredibly well paid, where the umpire is selected and paid by one of the teams, was a disaster for our country in 2008, and was a primary cause of a financial disaster that is still affecting America today in tragic ways.

So, I look forward to another hearing. And I look forward to the CEOs of Moody's and S&P joining us.

The Chair notes that some Members may have additional questions for these witnesses, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And this hearing is hereby adjourned.

[Whereupon, at 5:18 p.m., the hearing was adjourned.]

A P P E N D I X

July 21, 2021

Written Statement of Michael R. Bright
Chief Executive Officer, The Structured Finance Association
Before the United States House Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets
"Bond Rating Agencies: Examining the 'Nationally Recognized Statistical Rating Organizations'"
July 21, 2021



Introduction and Background

Chairman Sherman, Ranking Member Huizenga, and other members of the Subcommittee, my name is Michael Bright, CEO of the Structured Finance Association, or "SFA." On behalf of the member companies of SFA, I thank you for inviting me to testify today, and for your focus on the importance of appropriately managing potential conflicts of interest in the so-called "issuer pay" ratings model. I also thank you for your continued oversight of the healthy functioning of our country's capital markets.

The Structured Finance Association is a consensus-driven trade association with over 370 institutional members representing the entire value chain of the securitization market. This market provides over \$15 trillion of capital to consumers and businesses. Our members facilitate credit and capital formation across a wide breadth of asset classes, including auto loans, mortgage loans, student loans, commercial real estate, business loans, among others. Our members include issuers and investors, rating agencies, data and analytic firms, law firms, servicers, accounting firms, and trustees. Unlike some associations, before we take any advocacy position our governance requires us to achieve consensus by agreement rather than majority vote, ensuring the perspectives of all our diverse membership is included. This diversity is our strength, as it builds healthy tension into our positions. Because we speak on behalf of the entire industry, we are methodical and thoughtful as we analyze the pros and cons of legislative and regulatory proposals, as well as market dynamics, before we reach a mutually acceptable position that represents the entirety of the capital markets.

Securitization and structured finance are critical elements of today's economy. The pooling of loans into a security, coupled with the separation of highest credit and prepayment risks from lower prepayment and credit risks, allow for efficient matching of borrower and investor preferences. This segmentation of risks lowers the cost of credit to the consumers and businesses that the capital markets fund while

providing more tailored investment options to investors with varying risk preferences. Absent a functioning securitization market, the only source of financing for life's biggest goals – buying a home, buying a car, paying for ever-increasing college tuition, or starting a business – would be incredibly large banks with massive balance sheets, as we see in countries outside of the U.S.

There is a reason that much of the rest of the world, Asia in particular, is now looking to securitization as a mechanism for financing growing economies without reliance on just a few monolithic institutions. Connecting borrowers with the domestic and global capital markets consistently provides the lowest borrowing costs, tailored product set of loans, and most dynamic system of credit finance in the world. Our country's model of securitization coupled with fiduciary responsibilities on the part of institutional investors allow for substantial economic dynamism and growth, expanded fixed income investment options, and access to responsible credit at affordable rates.

Of course, the role of regulation, oversight, and governance is critical to the functioning of these markets. In particular, the past twelve years have seen a good deal of substantive regulation established, much of which were badly needed. Our members appreciate the comprehensive changes to the oversight regime for NRSROs that have been adopted since the financial crisis. New proposals, in our view, should be evaluated against these regulations, as well as against the benefits and consequences they will bring.

SFA Response to 2020 FIMSAC Concept Papers

As I mentioned above, when regulatory or legislative proposals are put forth, SFA pulls together its entire membership to debate, analyze, and provide our feedback. In 2020 we undertook such a process as we followed the SEC's FIMSAC debate over the issuer-pay rating model. Some of the work we conducted at the time is applicable to this hearing, and so today I will borrow from those discussions.

Analyzing the FIMSAC discussion documents did present some challenges, as many of the ideas presented were very light on specifics. But on several thematic items, we were successful in reaching a collective position across our member firms, including our investor, issuer, and rating agency members.

Investors emphasized repeatedly that they use the credit ratings and the associated analysis made publicly available by the ratings firms as one consideration in the investment process, but that they conduct their own independent risk assessments to make their investment decisions. They also emphasized that they do so with knowledge of the dynamics inherent in the issuer-pay model fully in-mind.

It was relatively straightforward to conclude that the issuer-pay model creates a *potential* for conflicts of interest. Neither investors nor other market participants are naive to the fact that the issuer of a bond will sometimes use the best ratings available. But market participants also understand that many factors go into the selection of a rating agency. When assessing what rating agency to engage, issuers consider a variety of factors, including the rating agency's criteria and historical performance in their respective asset class, the historical volatility of an NRSRO's ratings, investor demand for a particular NRSRO's rating, the rating agency's ability to meet the issuer's fundraising timeline, the cost of the rating, and others.

Our members ruminated at length over the pros and cons as well as the viability of alternative compensation schemes, such as an investor-subscription model and an assignment model. In all, they found those models also presented potential conflicts of interest. Further, in all cases considered, our members concluded that the alternatives presented even greater risks and undesirable consequences than the existing system, and so at present we are unable to be supportive of those alternative models.

Nevertheless, during last year's discussions, SFA member firms welcomed continued dialogue to consider additional means that could further strengthen the disclosure practices so that investors can be

armed with all the information needed. Specifically, investors mentioned two areas where they are working with market participants to further enhance disclosure. One, investors appreciate additional disclosures that issuers can provide on the selection process for the NRSROs they engaged to rate their deal. Two, investors appreciate disclosures from the rating agencies if there is any changes to their standard criteria. Much of this occurs already. But if rating agencies deviate from published criteria, investors need to know.

And while transparency is a core objective, SFA firms – including our investors – also expressed that disclosure practices should not result in a requirement that written consents of NRSROs be filed with the Commission in connection with prospectuses that are filed with the Commission. If that were to happen, NRSROs would likely find it necessary to withhold their consents to avoid potential securities law liability as “experts” for related portions of the prospectuses in question because their opinions are forward-looking. That would result in transactions moving from the publicly registered market to the Rule 144A market or other non-public markets, where there are no similar consent requirements or related consequences related to potential liability, but there are fewer disclosure requirements as well as fewer investor protections. Furthermore, members are also quite concerned that the Rule 144A market and other non-public markets could not support the volume of transactions that are currently supported by the public markets.

Rotation System for NRSROs

The discussion draft legislative proposal that we have recently seen in conjunction with today’s hearing is something we are happy to bring to our members for further analysis. But our initial response is that this would represent a massive sea change to the functioning of our capital markets, and one that is likely even more disruptive and fundamental than some of the other ideas discussed in the past. The

repercussions of having a quasi-government agency select a rating will likely prove substantial. While ratings are only one input into the investment decisions made by investors, inserting the SEC into the details of the process of issuance presents an enormously confusing dynamic for global and domestic investors alike. If not carefully deliberated upon, this proposal could harm the current recovery phase following the pandemic shock and negatively impact the housing market.

Over the long-term, our members are concerned a government-controlled assignment system will perversely reduce the incentive to compete on the quality of ratings. Quality of services and products are driven by the need to compete for customers and the reward of increased demand and higher pricing. Instead, a rating assignment system would likely set a minimum level of qualification, at a set price for all rating agencies, and rotating assignments thereby creating considerable concerns that this will lead to ratings quality that just meets the requirements to qualify as an approved rating agency with no market pricing or demand dynamics to incentivize better quality.

It is also not difficult to foresee potential political pressure placed on the rating agencies and their criteria due to the impact ratings have on the cost of credit for both consumer and corporate constituents, and federal, state and local governments. This is an important dynamic that should not be minimized.

In today's environment, an incredible amount of work goes into the process of bringing a securitization deal to market, and of investing in such an instrument on behalf of savers and retirees. While not perfect by any means, the capital market is quite efficient at understanding the dynamics involved in this process. This is the case even more so since the passage of legislation and regulation to increase the transparency and oversight of the ratings process itself. Ultimately, it is important to separate a faulty assumption - even a major one such as the pre-2008 faulty assumption that home prices will never decline nationally - from a faulty market structure. What is most helpful to maintain financial stability in

our markets today is to ensure that transparency remains the goal and that existing regulations are effectively enforced.

Other SFA Initiatives Impacting the Health of Capital Markets

As a trade association, we not only involve ourselves in the intricacies of technical regulatory debate, but we also work with participants in our industry to make lasting and impactful change at a high level. For example, SFA and our member companies have expressed a commitment to diversity, equity, and inclusion, (“DEI”) at both our trade association itself as well as the c-suites and board rooms of our member firms. To be sure, much work needs to be done. But we are committed to lasting change.

I raise this issue today because we see it as essential to the functional safety and soundness of the securitization markets. The purpose of this hearing is to discuss the role of ratings in our financial markets, but surely the intent is to do so in the context of market stability as well as ensuring the capital markets in the United States properly serve all American communities. To us at SFA, this goal is indistinguishable from the goal of diversity in our industry. Racial diversity, gender diversity, diversity of background, and diversity of lifestyle and thought are all critical ingredients to avoiding groupthink while striving for successful innovation. This goes for all participants in our industry. Diversity of perspective brings healthy debate and tension, and much like the debate and tension that characterize our membership and our markets - we are committed to diversity among the people who lead our industry because it is inextricably linked to the underlying premise of building sustainable capital markets and communities.

At SFA, we have also undertaken an initiative to bring disclosure standardization and best practices to the structured finance markets for ESG investing. The rating agencies are working closely with us and our member firms to help establish these disclosure frameworks. Thus far, most ESG discussions

globally have centered on corporate level equity and debt instruments. We believe, however, that the structured finance markets are going to play a critical role in the success of ESG as an investment thesis in the years to come.

Securitization offers the challenge and the opportunity of analyzing not just the issuer of a financial instrument but also the underlying collateral for its impact to our society and environment. And so, we are working through the many questions around how to provide consistent, comparable, and material disclosure to support investors and other market participants ability to analyze sustainability and ESG aspects of issuers and ABS collateral. Importantly, in our markets right now in the U.S., the energy behind this new investment thesis is being driven almost entirely by investor demand as opposed to regulatory fiat. SFA is working to harness this energy to help ensure that minimum data and reporting standards are in place for the avoidance of “green washing” and to help ensure that this important evolution to our market remains meaningful and impactful.

The NRSROs are playing an important role in this nascent but growing market, and we work with them along with our issuers, investors and other data providers to analyze everything from the social impact an investment has on communities to the environment effects of certain lending practices.

Conclusion

In conclusion, it is important to make abundantly clear that the membership of the Structured Finance Association is committed to being part of the healthy evolution and productive improvements in our markets and their regulatory infrastructure to provide responsible lending and investment opportunities for American households and businesses. We support all efforts to debate and discuss ways to enhance the regulation and transparency of our industry and the markets that it serves. Further, our members take seriously the role that they play in the American, as well as global, economy. We know that the

decisions we make, models we employ, and controls we build have a direct and meaningful impact on the lives of millions of people.

From a consumer in need of borrowing to an investor in need of a stable retirement savings, our members represent every person involved in, and every facet of, the global capital markets. For these reasons, we thank you again for your continued oversight of how our markets can best serve the real economy in a safe and successful way. And we thank you for the opportunity to discuss this important issue with you today.



**Statement of Ian Linnell
President
Fitch Ratings
before a hearing of the
United States House Committee on Financial Services,
Subcommittee
on Investor Protection, Entrepreneurship, and Capital Markets
on**

Bond Rating Agencies:

Examining the “Nationally Recognized” Statistical Rating Organizations (“NRSROs”)

July 21, 2021

Chairman Sherman, Ranking Member Huizenga, and distinguished members of the Subcommittee, I appreciate the invitation to appear before you to talk about Fitch Ratings, Inc. (“Fitch”) and the role of credit rating agencies in the capital markets. Credit ratings provide a forward-looking and relative opinion on credit risk- namely, how likely investors will be repaid in full and on time. Credit risk is an important factor when considering whether to buy a bond. Unfortunately, for a variety of reasons, some investors do not adequately assess credit risk. Fitch helps to make sense of credit risk with ratings based on a simple letter scale - AAA is the highest rating, indicating the least credit risk, and D is the lowest rating. Fitch innovated this scale a century ago, and it remains a widely used way for investors to assess credit risk. With over 2,200 employees working in over 30 countries, including over 1,250 analysts, Fitch, part of the Fitch Group and a wholly owned subsidiary of Hearst Corporation, is dedicated to providing the financial markets with timely, independent, and objective credit ratings.

Dodd-Frank and Credit Rating Agency Regulation

In the wake of the 2007 financial crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”). Congress designed many of the provisions of Dodd-Frank to address concerns about the credit rating process that regulators believed contributed to the financial crisis. In response to Dodd-Frank, NRSROs implemented many changes designed to enhance the reliability and transparency of their rating opinions and related analytics. These changes included:

- Establishing internal control structures governing their policies, procedures, and criteria for determining credit ratings;
- Creating procedures to address and manage conflicts of interest;
- Requiring their board of directors to approve the procedures and criteria to determine ratings; and
- Designating a compliance officer to ensure compliance with the securities laws.

Even before Dodd-Frank’s requirements went into effect, Fitch had implemented a variety of changes to its business designed to address many of the same concerns, including:

- Separating the analysts who evaluate credit risk and prepare our ratings from those employees who manage our business relationships with credit issuers;
- Establishing a compliance department to ensure we are following our own procedures in developing ratings;
- Appointing a Chief Credit Officer who is independent of the analysts to oversee the development and updating of our methodologies; and
- Putting in place independent review of our methodologies.

The changes Fitch made in advance of Dodd-Frank positioned Fitch well to comply with the requirements of the new law.

Dodd-Frank also created the Office of Credit Ratings (“OCR”) that the Securities and Exchange Commission (the “Commission”) launched in June 2012. The Commission charged

the OCR with administering the rules of the Commission and overseeing the practices of NRSROs, promoting accuracy in credit ratings, and working to ensure that they are not unduly influenced by conflicts of interest. The OCR also promotes greater transparency and disclosure to investors.

The OCR conducts annual, and other examinations of NRSROs, to assess and promote compliance with statutory and Commission requirements and routinely monitors the activities of NRSROs. The OCR develops and administers rules affecting NRSROs and provides guidance concerning the Commission's regulatory initiatives related to NRSROs. The OCR and its staff are solely dedicated to the oversight, examination, and supervision of NRSROs.

In addition to US regulations, credit rating agencies ("CRAs") are subject to the regulatory mandates of authorities outside of the US, including the European Securities and Markets Authority ("ESMA") and the UK Financial Conduct Authority. ESMA has enacted its own registration and oversight system and related rules for CRAs. Other nations have adopted similar measures. As a result, Fitch, along with the other global rating agencies, is subject to regulation and examination in every country in which it operates.

Fitch believes that the global regulatory framework created since Dodd-Frank has brought greater transparency and rigor to the credit rating process. The regulations respect the analytical independence of CRAs by being procedural and not substantive in nature. The current laws strike the right balance between ensuring proper government oversight while maintaining the CRAs' ability to express their opinions without undue government interference and permitting free competition and choice in the marketplace. The changing landscape in U.S. structured finance ratings reflects this strong competitive environment. Since 2009, the market

share of the smaller credit rating agencies has significantly increased while the market share of the large agencies has been volatile and declined, as reflected in the chart on Annex 1.

We appreciate that there is an interest in Congress to expand on the framework of Dodd-Frank with further regulation related to credit ratings. Fitch welcomes changes that would improve the public's understanding of and confidence in credit ratings. However, the proposals that we understand are under consideration are concerning, and could, in our view, have negative consequences for securities markets, NRSROs and investors who rely on our ratings for an independent assessment of risk.

Specifically, Fitch understands that the legislative proposals are: (i) to create a new quasi-government board that would be responsible for assigning an NRSRO to provide a rating for each securities issuance; (ii) to override a Commission no action letter stating that an asset-backed issuer ("ABS Issuer") does not have to include credit rating information in its various securities filings; (iii) to standardize NRSRO methodologies in a way that could homogenize credit ratings, and consequently quash the diversity of opinion provided by NRSROs as to the creditworthiness of companies, financial institutions, government entities and the securities that these entities issue and (iv) to compel equal treatment of NRSRO ratings.

Alternative Rating Selection Process

We understand that some members of Congress are considering a version of the Dodd-Frank-era proposal widely known as the Franken Amendment. Though it was ultimately not included in Dodd-Frank, the Franken Amendment would have created a quasi-government board charged with overseeing a "Designation Model" for credit ratings, in which the board would assign an NRSRO to rate structured finance transactions. Our understanding is that a version of this Designation Model currently being considered would expand the original idea of the

Franken Amendment to cover ratings of corporations and possibly financial institutions, and government entities beyond structured finance. As with the original Franken Amendment, the Designation Model, while designed to address concerns about “rating shopping,” could actually lead to less reliable credit ratings, and less useful evaluations of credit risk for market participants, without alleviating the potential conflicts of interest such a model is intended to address.

The term “rating shopping” refers to instances where an issuer selects the NRSRO that it thinks will provide the most optimistic credit rating opinion. Some commentators assert that rating shopping is a direct result of the issuer-pays business model, in which the issuer contracts directly with an NRSRO to provide the rating. The thought, then, is that a different business model –like the Designation Model, in which an NRSRO is independently assigned, rather than hired – would remove potential conflicts of interest inherent when an issuer chooses the NRSRO it wants, and, hopefully, would lead to more credible credit ratings.

Unfortunately, changing “who pays” (or selects) NRSROs will not eliminate the potential for conflicts.¹ The introduction of a new and untested assignment approach to credit ratings could introduce new conflicts of interest in how NRSROs are selected and who participates in the assignment process; and, with the government effectively assigning credit rating agencies, the system may create market confusion as to who is accountable for the rating. Furthermore, although different NRSROs have different levels of expertise, different credit rating transition and default histories, and different levels of market confidence and acceptance, we understand that the proposed bill prohibits issuers from obtaining ratings from an NRSRO other than the one assigned to a particular issue.

¹ The potential for conflicts of interest are inherent across all participants in economic markets, with issuers, investors and sovereigns motivated to seek out ratings that bear creditworthiness that meets their varied credit needs or investment strategies.

Fitch believes a much more effective way of managing conflicts of interest would be to further emphasize the value and importance of educating the investment community on creditworthiness assessments. Dodd-Frank sought to achieve this objective through improvements in transparency into the processes and methodologies developed by NRSROs, and, as noted above, Fitch has embraced that approach. Investors expect objective, predictive, and relatively stable opinions about creditworthiness. The value the investment community places in any rating opinion will turn on the reputation of the NRSRO that offers it. That reputation, in turn, relies on a record of delivering credible and predictive assessments of risk, with transparency in explaining how the assessments are reached and what they mean. While it is prudent to be wary of the risks of rating shopping, it is through increased transparency in how the rating opinions are developed – including insight into the management of potential conflicts of interest – that the market gains greater confidence that the ratings are credible. It is this credibility that NRSROs build with investors that is the best defense against rating shopping. The existing competition that exists among NRSROs is a great motivator for NRSROs to improve the reliability and the predictiveness of their assessments of risk.

Rule 436(g)

Another proposal we understand is under consideration involves overriding a Commission no action letter (the “Letter”) that addressed the Dodd-Frank nullification of Commission Rule 436(g). Enacted in 1982, Rule 436(g), promulgated under the Securities Act of 1933 (the “Securities Act”), provided that a credit rating assigned by an NRSRO would not be considered a part of a registration statement prepared or certified by an expert. As a result, NRSROs’ credit ratings could be included in registration statements without the NRSROs’ consent; if consent had been required, any consenting NRSRO could have exposed itself to

liability under Section 11 of the Securities Act. In 2004, the Commission enacted Regulation AB (“Reg AB”), which clarified and codified certain registration requirements for asset-backed securities under the Securities Act. Reg AB requires ABS issuers to disclose their credit ratings information in their registration statements.

With the nullification of Rule 436(g), ABS issuers became concerned that even though they were obligated to disclose credit ratings in their offering documents, the NRSROs had already indicated that they were not going to provide the necessary consent. As a result, in response to Dodd-Frank’s rescission of Rule 436(g), on July 22, 2010, the Commission issued the Letter indicating that the Commission would take “no action” against an ABS issuer who failed to include ratings information in its registration statements. If the Commission’s Letter were to be rescinded, then ABS issuers would again be required to receive NRSRO consent to include credit ratings in prospectuses.

To be clear, Fitch will not give its consent for its credit ratings to be included in registrations. Providing consent could potentially expose Fitch to “expert” liability under Section 11 of the Securities Act. As a result of our position on consent, we recognize that if the Letter is rescinded, then ABS issuers will face the same regulatory concern that existed prior to the issuance of the Letter. Nevertheless, when we issue ratings, Fitch will continue to make them widely and freely available to the public through our website at www.fitchratings.com and through major financial media outlets and financial information providers. We also will continue to make freely available the rating commentary that we issue with every rating action and the pre-sale reports we produce for structured finance issuances.

Standard Setting

In addition, we understand that another legislative proposal would set specific “standards” for rating agencies’ methodologies. Investors benefit from the various analytical perspectives of different NRSROs. Credit ratings are opinions. While we at Fitch believe that our opinions are the most predictive of the bunch, we also believe that the variety of NRSRO opinions – and the diversity of their methodologies – can offer valuable insight to the investor attempting to purchase securities. Any standards applied to NRSROs that reduce their analytical independence and result in greater homogeneity of their criteria will be detrimental to the marketplace and will mean investors will have fewer materially different opinions to weigh when evaluating the credit risks of a particular securities issuance.

Equal Treatment

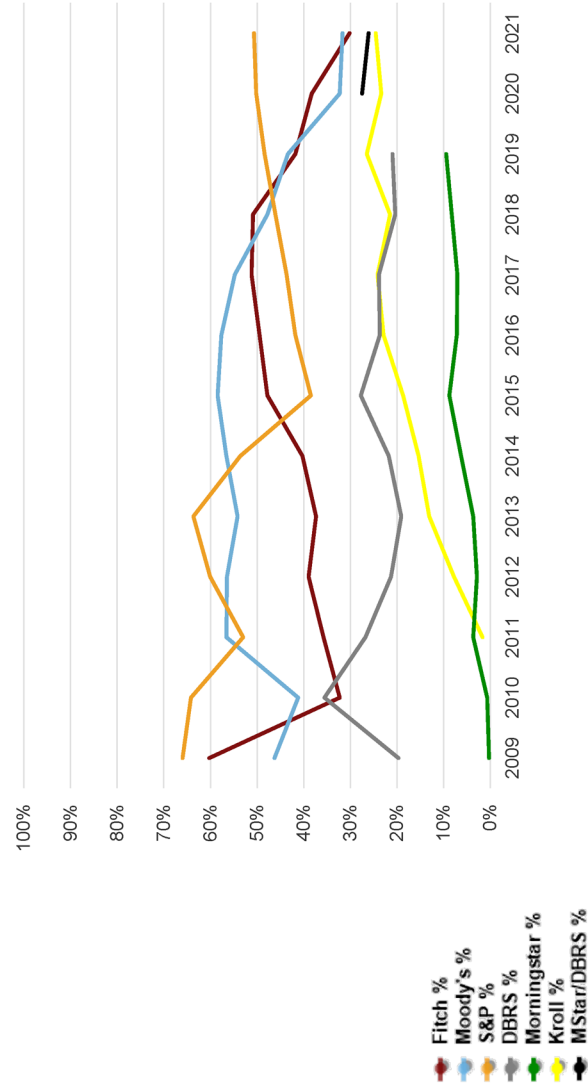
Furthermore, we understand that some members may be contemplating a legislative proposal to require the Federal Reserve Bank, the US Treasury, and other agencies that use ratings in a program to accept the ratings of all NRSROs, regardless of their level of expertise or historical ratings performance. Fitch believes that choice and competition are necessary if NRSROs are to improve their criteria and procedures. Compelling the equal acceptance of credit ratings from different NRSROs would undermine the competitive environment that makes continuous improvement necessary. Furthermore, users of credit ratings, whether private or public entities, should be free to decide for themselves which credit ratings to use based on their assessment of the expertise and reputation of the NRSROs.

Finally, we understand that there are other bills being considered that I am happy to discuss during my questioning.

I close by thanking Fitch's employees for their commitment to providing timely and insightful ratings and research to the marketplace. Over the last year, they maintained and increased their productivity while working remotely and navigating personal challenges. By working together and focusing on our mission, we continued to serve the global investor community proudly.

Thank you for your time and the work that you do for the United States. I welcome any questions that you may have.

Annex 1 NA Structured Finance Market Coverage



Through Q1 2021
Based on # of transactions



Testimony of Amy Copeland McGarrity, Chief Investment Officer

Colorado Public Employees' Retirement Association

before the

United States House of Representatives

Committee on Financial Services

Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets

Hearing on Bond Rating Agencies: Examining the "Nationally Recognized"

Statistical Rating Organizations

July 21, 2021

Chairman Sherman, Ranking Member Huizenga, and members of the Subcommittee,

Thank you for the opportunity to discuss ideas for improving the oversight of Nationally Recognized Statistical Ratings Organizations ("NRSROs"). My name is Amy McGarrity, and I serve as the Chief Investment Officer for the Colorado Public Employees' Retirement Association ("Colorado PERA" or "PERA").¹

My testimony includes a brief overview of Colorado PERA and its investment approach, followed by an overview of concerns with conflicts of interest and credit ratings quality. I will review the efforts of the Dodd-Frank Act to address those concerns and then review my perspective as the Chair of the Credit Ratings Subcommittee of the Fixed Income Market Structure Advisory Committee ("FIMSAC") of the Securities and Exchange Commission ("SEC"), which was tasked with exploring ways to reduce conflicts of interest and improve the quality of ratings. Lastly, I will offer some suggestions to reduce the conflicts of interest and improve the quality of ratings, which will benefit investor and stakeholder outcomes, including those of Colorado PERA.

Colorado PERA

Colorado PERA is a public pension plan with over \$60 billion in assets. We serve more than 620,000 current and former teachers, state troopers, snowplow drivers, corrections officers, and other public employees in the state of Colorado.² One of the unique attributes of our fund is that we internally manage over 60% of our assets. As such, we act not only as an asset allocator, but also as an investment manager.

PERA's Fixed Income assets (approximately \$12.2 billion)³ are entirely internally managed by PERA staff. The asset class is broadly diversified, and is core oriented (*i.e.*, there are no structural allocations to high yield or emerging market debt). The team actively manages treasuries, MBS, CMBS, ABS, government-related, and corporate debt

¹ In addition to my role with PERA, I serve on the Board of Directors for the Healthy Markets Association ("HMA"), an investor-focused not-for-profit organization that seeks to promote transparency and reduce conflicts of interest in the capital markets. In addition, Colorado PERA is an active member of both HMA and the Council of Institutional Investors ("CII"). Nearly a decade ago, CII members approved policies for best practices that support improvements to Nationally Recognized Statistical Ratings Organizations. See Council of Institutional Investors, CII Policies on Other Issues, Credit Rating Agencies (adopted Apr. 3, 2012), available at https://www.cii.org/policies_other_issues#credit_rating_agencies; Council of Institutional Investors, CII Policies on Other Issues, Financial Gatekeepers (adopted Apr. 13, 2010), https://www.cii.org/policies_other_issues#fin_gatekeepers; see also A Report of the Investors' Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective 6, 19-21 (July 2009), available at https://www.cii.org/files/issues_and_advocacy/dodd-frank_act/07_01_09_iwg_report.pdf; CII, Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective (Apr. 2009), available at https://www.cii.org/files/publications/white_papers/04_14_09_credit_rating_agencies.pdf.

² See Public Employees' Retirement Association of Colorado, Comprehensive Annual Financial Report, Transforming to Connect. Connecting to Serve. For the Year Ending December 31, 2020 at 48, 188 (June 18, 2021), available at <https://www.copera.org/sites/default/files/documents/5-20-20.pdf>.

³ *Id.* at 132.

securities and related instruments. In the management of these portfolios, our investment professionals are routinely assessing the risks and opportunities of individual investments.

PERA's investment professionals typically look well beyond the credit ratings and other assessments of securities provided by the ratings agencies. Thus, while a particular credit rating may be a component of our investment decision-making process, our team also conducts proprietary fundamental and relative value analysis in order to derive our investment decisions. This process is necessary, in part, due to the relatively poor historical performance of credit ratings and our significant institutional expertise and resources. We try to look beyond the ratings because we typically have the ability and resources to do so. As we make our investment decisions, we may look at material risks to the issuer and the issuer's ability to fulfill its obligations.

Importantly, credit ratings may also impact our investment decisions more indirectly, such as their use in screening for inclusion or exclusion due to a particular portfolio benchmark index.⁴ In addition, each applicable portfolio has internal guidelines which may refer to credit ratings and allowed securities.

Concerns with Credit Rating Agencies' Conflicts of Interest and Quality of Ratings

The NRSROs have faced criticism (as well as liability) for conflicted and inaccurate ratings for decades, most prominently in 2008 with the mis-rating of Collateralized Debt Obligations ("CDOs"),⁵ and again during the coronavirus pandemic in 2020.⁶

For example, from the first quarter of 2005 to the third quarter of 2007, downgrades dramatically increased. Standard and Poor's (2008) reports, covering that period for CDOs of asset backed securities showed that 66% were downgraded and 44% were downgraded from investment grade to speculative grade, including default. For residential subprime mortgages backed securities, 17% were downgraded, and 9.8% were downgraded from investment grade to speculative grade, including default.⁷ And the Financial Crisis ultimately worsened significantly from that point.

⁴ *Id.* at 135 (Asset class benchmark is currently Bloomberg Barclays U.S. Aggregate).

⁵ See, e.g., [A Report of the Investors' Working Group](#), U.S. Financial Regulatory Reform: The Investors' Perspective at 20 ("The leading NRSROs—Fitch Ratings, Moody's Investors Service and Standard & Poor's Ratings Services—maintained high investment-grade ratings on many troubled financial institutions until they were on the brink of failure or collapse [and] [a]nd well into the credit crisis, NRSROs maintained triple-A ratings on complex structured financial instruments despite the poor and deteriorating the quality of the sub-prime assets underlying those securities."); Scott Cohn, *S&P Officials: We'd Do a Deal 'Structured by Cows'*, CNBC (Oct. 22, 2008), available at <https://www.cnbc.com/id/27321998>

⁶ See, e.g., Adam Tempkin, *Ratings Shopping Never Died in CMBS Market Now Facing Crisis*, Bloomberg (Oct. 1, 2020), available at <https://www.bloomberg.com/news/articles/2020-10-01/ratings-shopping-never-died-in-cmbs-market-now-facing-crisis> ("The risks are particularly acute in the CMBS market, where shutdowns stemming from the coronavirus pandemic have battered revenues for malls, hotels and other commercial properties that back the debt, spurring a raft of downgrades.").

⁷ See Michel G. Crouhy et al., *The Subprime Credit Crisis* of 07 at 8 (rev. July 4, 2008), available at <https://www.fdic.gov/analysis/cfr/bank-research-conference/annual-8th/turnbull-jarrow.pdf>

While thousands of mortgage products were awarded AAA status, and were marketed and sold to investors as ultra-safe, that didn't last long. Ultimately, "over 90% of the AAA ratings given to mortgage-backed securities in 2006 and 2007 were downgraded to junk status."⁸ And overall, of all the CDO tranches awarded the highest rating of AAA, 43% of them would end up defaulting over the course of the Financial Crisis of 2008.⁹ In 2015, S&P Global ended up paying a \$1.5 billion settlement to the Department of Justice and several states over its inflated ratings that contributed to the financial crisis.¹⁰

Not only did the investors in these securities lose money, but the financial system experienced significant disruption, as liquidity broadly froze and as massive downgrades of thousands of products reverberated through the global capital markets.

More recently, the Coronavirus pandemic slowed the global economy and severely impacted many industries, again causing significant downgrades to some debt issuers and structured products.¹¹ The question exists whether NRSROs are really considering crisis-type events in rating the underlying bonds and structuring ratings tranches. While structured products, in particular, are generally designed to benefit from diversification of the underlying industries and/or collateral, unforeseen events may raise systemic risk, thus reducing the diversification benefits. For example, the travel and tourism industry was virtually non-existent during the heart of the pandemic. Cirque du Soleil was among many live entertainment shows that had to be cancelled. Its loans were packaged with other loans in a CLO, and when its credit rating was lowered, the value of its loans declined significantly.¹² Cirque was obviously not the only impacted company and to the extent CLOs included a number of companies (across industries) suffering due to the Coronavirus crisis, diversification benefits were limited and as such, the value of the ratings.

Interestingly, for years leading up to the pandemic, we and other market participants became increasingly concerned with what appeared to be a large and growing bubble of "just-barely" investment-grade securities.¹³ While significant monetary and fiscal stimulus

⁸ Press Release, Senate Investigations Subcommittee Releases Levin-Coburn Report On the Financial Crisis, U.S. Senate Cmte on Homeland Security and Governmental Affairs, Permanent Subcmte on Investigations, Apr. 13, 2011, available at <https://www.hsgac.senate.gov/subcommittees/investigations/media/senate-investigations-subcommittee-releases-levin-coburn-report-on-the-financial-crisis>.

⁹ Moody's, Global corporate default rate 1983-2018.

¹⁰ See Justice News, *The United States Department of Justice, Justice Department and State Partners Secure \$1.375 Billion Settlement with S&P for Defrauding Investors in the Lead Up to the Financial Crisis* (Feb. 3, 2015) available at <https://www.justice.gov/opa/pr/justice-department-and-state-partners-secure-1375-billion-settlement-sp-defrauding-investors>.

¹¹ See, e.g., Adam Tempkin, *Ratings Shopping Never Died in CMBS Market Now Facing Crisis*, Bloomberg.

¹² See Cezary Podkul & Paul J. Davies, *Financial Engineering Made Risky Loans Seem Safe. Now They Face a Huge Test*, Wall St. J. (Mar. 20, 2020), available at <https://www.wsj.com/articles/financial-engineering-made-risky-loans-seem-safe-now-they-face-a-huge-test-11584702000>.

¹³ See, e.g., Transcript, Meeting for the Fixed Income Market Structure Advisory Cmte, SEC, Oct. 29, 2018, available at <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-102918transcript.txt>;

has mitigated some of the pandemic's impact to many industries and securities, the pain to the investors in many of these securities may be permanent to those forced to sell for liquidity.

Many of the same problems that have plagued the quality of credit ratings for years have continued. And it is clear that NRSROs are still facing some of the same conflicts of interest. For example, the SEC just recently fined one of the large NRSRO's for altering ratings of paying clients.¹⁴ Given the failures of past efforts to improve the quality of credit ratings, more clearly needs to be done.

Lastly, it is important to remember that credit ratings are intended to provide investors and other market participants with accurate assessments of the risk of a default. That risk could arise for any reason. Further, to the extent that credit ratings provided by NRSROs may be inaccurate, that may lead to some investors mispricing their risks, and inefficiently allocating their capital. While these inaccuracies may lead to investment opportunities for large, sophisticated market participants with the resources and expertise needed to make accurate credit risk assessments, smaller investors more dependent upon ratings for their pricing determinations may be adversely affected. In fact, historically, some market participants would seek to exploit less sophisticated investors who were more dependent upon credit ratings in making their investment decisions.

Some investors, who may bring greater information, expertise, and resources may properly make their own judgments as to the risks of securities, and seek to profit from their efforts. After all, that is how our markets are supposed to work. However, structural inefficiencies that disadvantage smaller investors and inhibit confidence in capital formation appear to go against the mandate of the SEC.

Put another way, inaccurate credit ratings may impact different market participants in materially different ways—but in all respects, the losers of having more conflicted and inaccurate ratings are the smaller investors and market participants who are generally most dependent upon them.

Incomplete Actions from the Dodd-Frank Act and Subsequent Rating Agency Reform Efforts

Not surprisingly, one of the principal takeaways from the Financial Crisis of 2008 was that the existing business model for ratings, and specifically the “issuer-pay” model, creates significant conflicts of interest that may materially undermine the quality of the ratings

see also, *Is the BBB Credit Bubble Ready to Burst?*, Institutional Investor, (Nov. 30, 2018), available at <https://www.institutionalinvestor.com/article/b1bx8y2ddw2p1f/is-the-bbb-credit-bubble-ready-to-burst>.

¹⁴ See Erik Larson, *Morningstar Tweaked Ratings of Paying Clients, SEC Claims*, Bloomberg (Feb. 16, 2021), available at <https://www.bloomberg.com/news/articles/2021-02-16/morningstar-analysts-tweaked-ratings-of-paying-clients-sec-says>.

provided.¹⁵ Further, significant market concentration among the top agencies persists, suggesting a lack of sufficient market competition.¹⁶

The Dodd-Frank Wall Street Reform and Consumer Protection Act dedicates no less than seventeen sections to addressing the well-documented failures of credit ratings.¹⁷ One of the most concrete conflicts of interest arises from the current practice of having the issuers of securities pay for the ratings—which can lead to ratings inflation.¹⁸ Section 939D of the Dodd-Frank Act directs the Government Accountability Office to

conduct a study on alternative means for compensating nationally recognized statistical rating organizations in order to create incentives for nationally recognized statistical rating organizations to provide more accurate credit ratings, including any statutory changes that would be required to facilitate the use of an alternative means of compensation.

Section 932 of the Dodd-Frank Act seeks to separate the ratings process from “sales and marketing.” And Section 939F of the Dodd-Frank Act instructs the SEC to conduct a study, make recommendations to Congress for changes, and directly adopt rules to

establish a system for the assignment of nationally recognized statistical rating organizations to determine the initial credit ratings of structured finance products, in a manner that prevents the issuer, sponsor, or underwriter of the structured finance product from selecting the nationally recognized statistical rating organization that will determine the initial credit ratings and monitor such credit ratings.

¹⁵ *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, Majority and Minority Staff Report of the Permanent Subcmte on Investigations of the U.S. Senate Cmte on Homeland Security and Governmental Affairs, Section V Inflated Credit Ratings: Case Study of Moody's and Standard and Poor's, available at [https://www.hsqac.senate.gov/imo/media/doc/PSI%20REPORT%20-%20Wall%20Street%20&%20the%20Financial%20Crisis-Anatomy%20of%20a%20Financial%20Collapse%20\(FINAL%205-10-11\).pdf](https://www.hsqac.senate.gov/imo/media/doc/PSI%20REPORT%20-%20Wall%20Street%20&%20the%20Financial%20Crisis-Anatomy%20of%20a%20Financial%20Collapse%20(FINAL%205-10-11).pdf) (“Bipartisan Senate PSI Report”); *A Report of the Investors' Working Group*, U.S. Financial Regulatory Reform: The Investors' Perspective at 21 (specifically recommending that “Congress and the Administration should consider ways to encourage alternatives to the predominant issuer-pays NRSRO business model.”).

¹⁶ See Council of Institutional Investors, CII Policies on Other Issues, Credit Rating Agencies (supporting “a credit ratings environment . . . [that] fosters competition and innovation.”).

¹⁷ Sections 931-939H.

¹⁸ See Bipartisan Senate PSI Report, at 245; see also Council of Institutional Investors, CII Policies on Other Issues, Credit Rating Agencies (finding that “[b]reakdowns in diligence due to fundamental principal-agent challenges, exacerbated by the practice of ‘ratings shopping’ that chipped away at the quality of analysis, has prompted some observers to call for eliminating this [issuer-pay] model.”).

That SEC study was released in December 2012.¹⁹ The SEC also released a report on NRSRO independence in November 2013²⁰ and hosted a Credit Ratings Roundtable in May 2013 that discussed the potential creation of a credit rating assignment system for asset-backed securities (ABS), the effectiveness of the current system to encourage unsolicited ratings for ABS, and alternatives to the issuer-pay model.²¹

Nevertheless, the SEC never adopted an assignment system. It never prohibited the issuer-pay model, nor took serious efforts to constrain it. Significant questions persist regarding NRSRO independence, and the NRSRO market remains highly concentrated. At the same time, we have seen little evidence of a material improvement in ratings quality.

Credit Ratings Subcommittee of the Fixed Income Market Structure Committee of the SEC

The SEC established the Fixed Income Market Structure Advisory Committee ("FIMSAC") in 2017 to look into a variety of fixed income-specific market-related issues. The FIMSAC members have diverse backgrounds and expertise, and include asset owners, investment advisors, trading platform providers, academics, issuers, and a regulator.²²

In early 2019, I was asked to Chair the Credit Ratings Subcommittee of the FIMSAC. The Credit Ratings Subcommittee ("Subcommittee") was formed to consider the role of credit ratings issued by NRSROs in the corporate bond and municipal securities markets.²³

One main area of exploration was conflicts of interest in the industry payment model (i.e., issuer pays for the credit ratings assignment and maintenance) and its impact on market structure and efficiency. The Subcommittee heard from many industry participants on this topic and hosted panels at FIMSAC meetings to expose the broader Committee to its deliberations.

In February 2020, the Subcommittee published a "working document"²⁴ to seek feedback on alternate ratings models. That Subcommittee consultation document suggested asking the SEC to oversee a random assignment process for both structured products

¹⁹ *Report to Congress on Assigned Credit Ratings*, SEC, Dec. 2012, available at <https://www.sec.gov/files/assigned-credit-ratings-study.pdf>.

²⁰ *Report to Congress on Credit Rating Agency Independence Study*, SEC, Nov. 2013, available at <https://www.sec.gov/news/studies/2013/credit-rating-agency-independence-study-2013.pdf>.

²¹ Press Release, *SEC Announces Panelists for Credit Ratings Roundtable*, SEC, May 7, 2013, available at <https://www.sec.gov/news/press-release/2013-2013-83.htm>; see also, Agenda, SEC, May 14, 2013, available at <https://www.sec.gov/opa/Article/2013-2013-71---additional-information.html>.

²² *Spotlight on Fixed Income Market Structure Advisory Committee (FIMSAC)*, SEC, available at <https://www.sec.gov/spotlight/fixed-income-advisory-committee>.

²³ *Fixed Income Market Structure Advisory Committee — Subcommittees*, SEC, available at <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fixed-income-market-structure-advisory-committee-subcommittees.htm>.

²⁴ FIMSAC, *Discussion Document: Alternate Model and Other Potential Initiatives*, at 2 (Feb. 10, 2020), available at <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-021020-crs-working-document-alternate-model-and-potential-initiatives.pdf>.

and corporate bond ratings, with at least two NRSROs being assigned to each issue, to provide diversity of views. Under that model, issuers could continue to pay for ratings through fees assessed by the “oversight entity” and an additional amount could be set aside for the administration costs associated with the “oversight entity”. This entity could be responsible for setting the compensation for initial and maintenance ratings.

Additionally, the Subcommittee discussed the potential for the SEC to create a workable (and simple) performance scorecard for the NRSROs, and explore increased NRSRO public disclosure of deviations from ratings methodologies. Ultimately, as any random selection model matures, the selection could be based on performance, in that the higher the performance (i.e., more relevant and accurate ratings), the greater the chance of being selected to rate issues.

The discussion document received feedback²⁵ from a variety of market participants. Ultimately, there was considerable pushback from some commenters²⁶ and some Subcommittee members, and the Subcommittee dropped this discussion and moved onto alternate recommendations.

The Subcommittee’s streamlined recommendation was presented and approved by the broader FIMSAC in June 2020.²⁷ The FIMSAC recommendation had three elements that reinforce each other to mitigate potential conflicts. The Subcommittee concluded that all three elements likely would be beneficial and would improve transparency and potential outcomes for investors. Broadly, the FIMSAC recommendation included:

- Increasing NRSRO disclosure (in particular, regarding models and deviations);
- Enhancing issuer disclosures for both corporate securities and securitized products; and
- Establishing a mechanism for bondholders to vote on the issuer-selected NRSROs.

Increased NRSRO Disclosure

While various disclosure requirements for NRSROs currently exist, either to the SEC or publicly (or both), FIMSAC concluded that additional disclosures would benefit users of credit ratings. More specifically, the FIMSAC recommendation was for the SEC to require NRSROs to disclose more in-depth information about their models and how the models differ by industry. In deriving a methodology or model, there may be qualitative inputs in

²⁵ See Comments on the Fixed Income Market Structure Advisory Committee (FIMSAC), SEC, File No. 265-30, available at <https://www.sec.gov/comments/265-30/265-30.htm>.

²⁶ See, e.g., Letter from Michael West, Moody’s Investor Service, to Michael Heaney, FIMSAC, Jan. 29, 2020, available at <https://www.sec.gov/comments/265-30/26530-6722500-206306.pdf>.

²⁷ Recommendation Regarding Ways to Mitigate Conflicts of Interest in Credit Ratings, FIMSAC, SEC, June 1, 2020, available at <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-recommendations-credit-ratings-subcommittee.pdf>.

the application of a model. These inputs should be disclosed by the NRSRO to improve transparency and understanding of the development of model-implied ratings.

NRSROs should disclose the credit ratings produced by their model-implied ratings and discuss the rationales for any material differences between their model-implied credit rating and their final issued rating (currently a recordkeeping requirement of Exchange Act Rule 17g-2.). Also, if an NRSRO does not use a systematic approach that can be captured by model-implied ratings disclosure, the NRSRO should disclose the information and qualitative inputs considered to derive their ultimate rating, to provide context to investors. This information should be disclosed publicly (so that it may inform investors who may rely on the rating), as well as to the SEC.

While NRSROs may sometimes have justification to deviate from pure quantitative scores, they should provide more in-depth disclosures of those deviations, including when and how the NRSRO's modeling approach changes and why.

The FIMSAC believed that additional summary statistics on how often, and to what extent, NRSROs deviate from their stated methodologies would allow interested users to analyze and incorporate this information into their evaluation of the relevance of ratings. Also, the increased transparency into the development of model-implied and ultimate ratings, including the objective and subjective elements that go into a rating, may contribute to better outcomes by allowing for additional clarity in ratings development.

Enhanced Issuer Disclosure

Corporate Credit

The FIMSAC Recommendation recognized that many corporate credit issuers currently institute disclosure practices that may be considered "best practices." Further enhancing disclosure of how issuers select credit rating agencies would be beneficial for investors. Such disclosure would provide greater insights into each issuer's process for choosing NRSROs and would also encourage wider adoption of these "best practices." FIMSAC recommended that the SEC to partner with appropriate trade groups to develop a set of best practices for choosing NRSROs and, once established, to require corporate issuers to disclose if/why they deviated from these practices in their annual reports.

Securitized Products

The FIMSAC Recommendation recognized that many securitized issuers, at the time of the recommendation, voluntarily engaged in NRSRO rotation and other "best practices." Like the recommendation above, the FIMSAC expressed the view that enhancing disclosure on how securitized issuers select NRSROs would benefit investors. Establishment of a set of "best practices," and subsequent disclosures of deviations from them by issuers, would improve transparency and potentially add insight into potential conflicts. Additionally, issuers should disclose any non-disclosed NRSROs that rated the deal, to enable investors to gauge potential ratings shopping.

Bondholder Vote on "Ratification" of Issuer-Selected NRSRO

The FIMSAC Recommendation suggested that the SEC explore a "ratification" of issuer-selected NRSROs. Periodically, holders of publicly-issued bonds should vote to ratify — or simply confirm confidence in — the NRSROs chosen by each issuer. Like the ratification of the public auditor, the election would be a simple up/down vote. The risk of censure that these votes would place on credit rating agencies could provide additional discipline to the quality of their work.

Other Issues

The FIMSAC Recommendation acknowledged that, even with the implementation of these recommendations, issues would remain. For example, some investors use benchmarks that require issues rated by specific NRSROs or investor guidelines that specifically reference NRSROs. These requirements contribute to the persistence of NRSRO market concentration. Additionally, some investors own bonds that strictly meet their guidelines (e.g., investment grade, or "IG"), but which market participants know are not accurately assessed (i.e., they should be classified as "high-yield"). Such bonds trade with wider spreads than other IG bonds and expose investors to risks more similar to high yield bonds, and yet the investor may end up holding such bonds despite investment guidelines or restrictions on high yield bonds.

The FIMSAC also recognized that existing statutory, regulatory, or legal constructs could prevent the implementation of the FIMSAC recommendations.

Additional Issues Not Included in Subcommittee Recommendations

Unfortunately, there were numerous potential reforms that we explored in the Subcommittee that did not make it into the final, formal FIMSAC Recommendation, which I personally believe should be considered.

Issuer Pay Model

The core of the issue with credit ratings remains the conflicts of interest associated with the payment model itself, in that the issuer pays for its own ratings. This obvious and fundamental conflict of interest has been highlighted in the numerous government reports, including the Bipartisan Senate PSI Report,²⁸ as well as numerous industry and private reports.

I agree that this conflict of interest lies at the heart of the discussion of improving credit rating quality.

²⁸ See, e.g., Bipartisan Senate PSI Report, at 273 ("The conflict of interest inherent in an issuer-pay setup is clear: rating agencies are incentivized to offer the highest ratings, as opposed to offering the most accurate ratings, in order to attract business.").

The idea that was considered in the Discussion Document finds a balance between investor and issuer protection, by allowing direct oversight of credit ratings by regulators, while at the same time allowing issuers to continue to pay for ratings if they choose. In addition, by rotating NRSROs, competition may increase as the smaller NRSROs rate more deals (through the rotation system), which may also improve outcomes. And competition should not make ratings more aggressive, as some have suggested, because the incentive to ratings shop is removed (*i.e.*, multiple, unbiased “published” opinions in the marketplace).

Unfortunately, while FIMSAC explored alternate payment models (as described above), we ultimately did not reach a consensus among the members of the FIMSAC.

Competition and Access to Information

Concerns remain surrounding NRSROs, competition, and why a standalone subscriber payment model has not been viable. One major contributor is likely to be access to information.

Most debt instruments are sold to investors pursuant to one or more exemptions from the federal securities laws. As a result, information about the debt securities that may be material to assessing its credit risk may not be publicly available. This limited access to essential information will put non-hired NRSROs at a material disadvantage to hired NRSROs.

Among hosted panel participants, there was broad consensus that meetings with management are a critical component to effective ratings diligence, and without a relationship with the company, there is really no incentive for issuers to engage with other NRSROs.

Further, given that sophisticated investors often have such little confidence in ratings generally, there is often little reward for investors to having yet “another” rating on a given security. Institutional investors are generally going to seek to engage in our own due diligence, often rendering the actual ratings to be of limited utility.²⁹ Of course, many investors are not so lucky, and do rely far more heavily upon the ratings provided by the NRSROs.

There is one area, however, where even the most sophisticated investors are often dependent up credit ratings: index composition. Typically, indexes require ratings from only the largest two or three NRSROs. At the same time, indexes are a large and growing segment of the fixed income marketplace. In fact, issuers often engage in material negotiations and even revisions to their deal terms in order to satisfy a particular index.

²⁹ See, e.g., Patrick Jenkins, *Opinion Inside Business, Credit Ratings, Like Dodgy Boilers, Can Still Blow Up the House*, Financial Times (Jan. 13, 2020), available at <https://www.ft.com/content/164a6a44-331d-11ea-a329-0bcf87a328f2> (“Pimco . . . has spent the past decade building a team of 70 in-house credit analysts, obviating the need to use S&P and Moody’s research all.”).

Thus, the willingness of indexes to accept ratings from such a limited pool of providers contributes to the concentration of the industry.

Ratings Shopping

For decades, investors and other market participants in the U.S. have been concerned that issuers may seek to hire the NRSROs that are likely to provide the issuers' securities with the highest quality ratings—a practice generally referred to as “ratings shopping.” These concerns are supported by significant evidence.

For example, in the lead up to the Financial Crisis, a detailed review of credit ratings from Moody's, S&P, and Fitch in 2006 found “strong evidence of rating shopping behavior.”³⁰ And the SEC's \$2 million fine against Kroll Bond Rating Agency Inc. in 2020³¹ appears to confirm that “the battle against ratings shopping was never truly won.”³²

The SEC should require issuers disclose all “non-chosen” NRSROs in securitized deals, in order to highlight potential ratings shopping.

Rule 17g-5

SEC's Rule 17g-5 program was intended to address conflicts of interest, as well as promote competition and improve the quality of credit ratings for structured finance products. Rule 17g-5 requires NRSROs hired to rate these products on an issuer-pay basis to have a website listing each such product they are in the process of rating, and the website address where the issuer posts all information given to the hired NRSRO for an initial or surveillance rating. This information is required to be posted on an issuer's password-protected website at the same time it is provided to the hired NRSRO, and to be made available to other NRSROs that provide certain certifications. The idea was that non-hired NRSROs would access the data and develop ratings that could be used by the market, alongside the hired ratings.

The Subcommittee explored the idea of potentially expanding the types of fixed income products subject to 17g-5 to include corporate debt instruments. The belief was that if the program was working as intended, competition could potentially be increased in the corporate space as well. However, the Subcommittee's research indicated that the program is not necessarily working as intended.

From the issuer perspective, while general support existed for the mission and purpose of 17g-5, the sense was that complying with Rule 17g-5 was unnecessarily burdensome,

³⁰ Thomas Mahlmann, Do bond issuers shop for a better credit rating? 1 (2006) (Dep't of Banking, U. of Cologne), available at <https://www.bis.org/bcbs/events/rf06maehlmann.pdf>.

³¹ See Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15E(d) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Release No. 34-90037 (Sept. 29, 2020), available at <https://www.sec.gov/litigation/admin/2020/34-90038.pdf>.

³² Adam Tempkin, *Ratings Shopping Never Died in CMBS Market Now Facing Crisis*, Bloomberg.

requiring website maintenance and additional staff time, without much uptake by the market. In addition, the important conversations with management must be recorded, or minutes taken and posted, which may impair the free flow of information and discourage transparency.

Generally, the “smaller” NRSROs’ views were that Rule 17g-5 may be increasing transparency and access to information, and might, if changed, improve research and models. However, competition has not increased as unsolicited ratings remain difficult to perform – in part due to the information asymmetries identified above and to investors’ general unwillingness to pay for them.

Through the course of the Subcommittee’s work, we also learned that there is a sense that rating securities on an unsolicited basis could create significant, uncompensated liability risks for an un-hired NRSRO.

The overall takeaway from the study of 17g-5, incorporating feedback from issuers and smaller NRSROs, is that it is not working as intended. I would suggest that the SEC revise the process to ease the burdens on un-hired NRSROs to offer “competing” ratings.

NRSRO Accountability and Liability

Ultimately, those providing credit risk assessments to the marketplace should be unbiased, thorough, expert, and accountable. Unfortunately, the current system does not consistently meet that standard. In addition to the reforms outlined above, Congress and the SEC should consider direct steps to promote NRSRO accountability for their processes and ratings. This may include:

- having the SEC identify firms that were found to have failures, by name, in its annual report. This will allow for investors, lenders, and other market participants who may rely on those NRSROs to more effectively engage in their own due diligence and efforts to protect themselves;
- requiring NRSROs to more effectively disclose their processes and consideration of all appropriate credit risk factors

Conclusion

I appreciate that this Subcommittee and the SEC are again exploring ways to improve the accuracy of ratings to better protect investors, but also to drive more fair, orderly, and efficient markets. Less conflicted, and higher quality, credit ratings will benefit Colorado PERA and the markets overall.

Thank you for the opportunity to speak with you today, and I look forward to any questions.

President and CEO
Kroll Bond Rating Agency
Hearing – Bond Rating Agencies: Examining the “Nationally Recognized Statistical
Ratings Organizations”
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets
House Committee on Financial Services
July 21, 2021

Chairman Sherman, Ranking Member Huizenga and members of the subcommittee, thank you for the opportunity to testify today. I am testifying on behalf of Kroll Bond Rating Agency, LLC (KBRA).

KBRA is a global, full-service rating agency established after the financial crisis in 2010 and registered with the Securities and Exchange Commission (SEC) as a Nationally Recognized Statistical Rating Organization (NRSRO). KBRA's mission is to provide transparent ratings, information to market participants, and thorough, decision-useful research. Our widely available research challenges entrenched and conventional thinking, and this approach has resonated powerfully with investors. Today, KBRA is one of the five largest rating agencies globally and the largest rating agency established after the 2008 crisis. KBRA has more than 400 employees in offices in the United States, Europe and the UK and has issued more than 44,500 ratings representing \$2.2 trillion in rated issuances.

The Benefits of Competition in the NRSRO Market

Mr. Chairman, KBRA was founded on the premise that open competition helps protect investors and can provide access to ratings to worthy issuers that may be overlooked by the largest incumbent rating agencies.

Community Banks. One powerful example is in the community bank space. KBRA began rating community banks in 2013. Other rating agencies had historically demonstrated a size bias and only rated banks with a certain minimum revenue, and the other credit rating agencies failed to account for other factors such as strength of management. KBRA conducted a study of bank defaults after the 2008 financial crisis and found that community banks performed better than their much larger counterparts, due in large part to the strength of their management. Based on this study, KBRA devised a bank rating methodology that recognized the strength of management and allowed for smaller banks to be rated. As a result, KBRA has rated over 200 community and regional banks. On the heels of our thorough published research and entry into this market, the incumbent rating agencies followed suit and began rating community banks as well. KBRA's ratings have opened markets to community banks that had previously and unfairly struggled to access important sources of capital. The strength of our ratings is demonstrated by the fact that these markets are as liquid as those for the larger banks.

Higher Education. We have recently begun to apply this same approach and rigor to the higher education space and are reviewing the performance of historically black colleges and universities (HBCUs) in particular. Similar to our experience with community banks, we believe that HBCUs may benefit from a more thorough, careful approach to assessing their credit quality, because it is quite possible that current research does not accurately reflect their financial strength and the strength of their management. I believe that newer market entrants such as KBRA taking a closer look at HBCUs may ultimately have a positive effect for those issuers and investors.

Barriers to Competition in the NRSRO Market

Despite KBRA's success over the past 10 years, we still experience barriers to fair competition. In fact, this problem has persisted for decades, well before KBRA was founded. It is widely acknowledged that concentration in the credit rating space as it stood pre-crisis was a major cause of the 2008 financial crisis, and Congress sought to address that in the Dodd-Frank Act in 2010. KBRA was established in the wake of the financial crisis with a mission to change the credit rating agency status quo, and as a result we are in a unique position to comment on the current state of competition in the market.

As you know, the three largest NRSROs still command over 95 percent market share¹, down from over 98 percent pre-2008 crisis. We believe that the continued lack of open competition is *by far* the biggest problem in the credit rating space today. KBRA has been successful because of our relentless focus on thorough research and listening to investors – but it has not been easy. There are myriad ways in which the largest NRSROs are still written into the plumbing of our financial system. In our view, while largely unintentional, this entrenchment is bad for the financial markets, investors, and the public writ large.

Investor Guidelines. As one example, many institutional investors, including public and private pensions, require the use of one or more of the largest NRSROs *by name* in their investor guidelines. Many of those guidelines are 40 years old or more and were written before other rating agencies existed. However, this has become a very significant barrier to competition today. The process to change investor guidelines can be time-consuming and laborious. KBRA has had some success in helping individual institutional investors open their investment guidelines to *any* NRSRO so they can access our and other smaller NRSRO's research and ratings. We appreciate the success we have had in this regard, but this approach will take many years to change the market sufficiently to the benefit of investors. We believe that all investor guidelines across financial markets should permit the use of any duly SEC-registered NRSRO that is licensed to rate the relevant asset class. One clear example is in the pension space, where plan sponsors have a fiduciary duty to pensioners. Opening up pension guidelines to any NRSRO is critical to ensuring access to the most thorough research and ratings and protecting plan participants.

Government Regulations and References to NRSROs. During the height of the pandemic, barriers to competition were again apparent in the Federal Reserve emergency lending facilities. These facilities initially required the use of a rating by one or more of the three largest incumbent NRSROs. Investors and other market participants were unhappy with the Federal Reserve's initial position and Congress, including members of this subcommittee, intervened.

As a result, the Federal Reserve changed its position with respect to certain of the facilities, and the House unanimously passed legislation requiring the Federal Reserve and the Treasury to accept securities rated by *any* NRSRO registered with the SEC. But there is more work to do. In our view, consistent with section 939A of the Dodd-Frank Act, all government agencies should be required to remove any references to specific NRSROs in any regulations and should use all of their powers to require supervised entities to do the same. The Department of Labor recently reopened the comment period on the agency's approach to 939A, which was never fully implemented.²

Opening the Path to SEC Registration. Currently, SEC regulation requires new NRSRO applicants to provide written statements from investors who have used the applicant credit rating agency's credit ratings for at least three years.³ This requirement dates back to the Credit Rating Agency Reform Act of 2006. It is already difficult to enter the credit rating agency market with SEC registration; we believe that this requirement as it currently stands is essentially blocks new entrants. We encourage reconsidering certain registration requirements to allow new competitors to enter the credit rating agency market.

Mr. Chairman, there is clearly more work to do in ensuring that the government and private market participants support open competition among NRSROs. We strongly support the legislation regarding the Federal Reserve emergency facilities, introduced by Reps. Madeleine Dean (D-PA) and Andy Barr (R-KY), that passed the House unanimously last year and is being discussed as part of today's hearing. We also support broadening that legislation to ensure that no other federal government agency requires ratings by specific NRSROs, as is currently the case, for example, with certain Federal Home Loan Banks.

Other Policy Ideas to Support Competition

I would also like to provide some input on the Commercial Credit Rating Reform Act (Act), which is being discussed today. We support efforts to improve competition, but we do have some concerns regarding unintended consequences with this legislation. While a government assignment of ratings would by its

¹ See SEC Annual Report on Nationally Recognized Statistical Rating Organizations, December 2020, available at <https://www.sec.gov/files/2020-annual-report-on-nrsros.pdf>, last visited 7/18/2021.

² Available at <https://www.govinfo.gov/content/pkg/FR-2021-06-24/pdf/2021-13149.pdf>, last visited 7/20/2021.

³ See Securities Exchange Act of 1934 Section 15E(a)(1)(C).

nature increase the market share of non-incumbent NRSROs, it could have the unintended consequence of discouraging thorough research. If any NRSRO, including incumbent NRSROs, were assured of receiving steady business via a government panel, some of those NRSROs might determine not to devote resources to solid research if they were going to be engaged regardless of the quality of their research and whether they provide research at all. That would ultimately be detrimental to investors, who would suffer from the lack of transparent and thorough information being provided to the market.

Government assignment of ratings pursuant to the Act would also restrict the ability of investors to choose NRSROs for ratings. It is our experience that investors often drive issuers to choose different NRSROs in various asset classes because of the strength of an NRSRO's experience and research in that asset class. If a government panel selected an NRSRO that did not meet investors' needs, investors would potentially not buy the rated securities and the transaction could flounder or fail.

Our strong conviction is that removing institutional barriers to competition and allowing open competition to flourish is a better way, and indeed, the best way, to protect investors. We greatly appreciate the concerns animating this proposal and would welcome the opportunity to provide input throughout the legislative process.

The Effect of the Dodd-Frank NRSRO Reforms

As an NRSRO that was established at essentially the same time as the Dodd-Frank Act was enacted, KBRA has matured alongside the Dodd-Frank Act and has a unique perspective on the efficacy of recent reforms in the credit rating space. The Dodd-Frank Act included a number of specific and rigorous requirements for NRSROs.

In our view, many components of the Dodd-Frank Act NRSRO provisions have been highly successful. The creation of the Office of Credit Ratings (OCR) at the SEC, the requirement that methodologies are made public, the SEC's rules requiring the development of internal controls, and supervision and annual examination have all served to improve outcomes for investors. Further, in 2014 the SEC imposed new requirements on NRSROs to establish procedures to protect the integrity of ratings methodologies and implement stricter standards for training and competence of credit analysts. The SEC also required that NRSROs publicly disclose credit rating performance statistics including initial credit ratings and any subsequent changes to those ratings to allow investors to evaluate them for accuracy and compare the performance of ratings across credit ratings agencies.

To provide a specific example of what we believe has worked well, pursuant to Dodd-Frank Act, in 2014 the SEC issued rules to prevent an NRSRO's sales and marketing considerations from influencing their credit ratings. This firewall between business development and analytics, one that must be certified by the CEO on an annual basis, has been highly effective in focusing our analysis on producing the highest quality, thorough research for investors. As KBRA's CEO, this difference has been very apparent to me in my interactions with employees, and I think it has been very positive for investors.

I also think the frequent interaction with OCR's staff has benefitted and strengthened KBRA and its internal processes. We have found the annual examinations a useful, and at times a challenging experience, but the staff's observations enable KBRA to enhance its internal control structure.

Liability Proposals

We believe that the current SEC regulatory oversight provides the appropriate level of liability for NRSROs. Since the introduction of Dodd-Frank Act, the SEC has had the ability to – and has exercised – their ability to enforce existing federal regulation. The SEC has multiple tools in their enforcement arsenal; not only can the agency enforce the current credit rating agency regulation but can also seek to hold NRSROs liable pursuant to the antifraud and negligence provisions of the Securities Exchange Act of 1934 and the Securities Act of 1933, respectively. Moreover, as we saw from the private litigation post-financial crisis, investors have myriad avenues of recourse against NRSROs in the courts.

We do not believe that additional liability is necessary or prudent and would instead have a chilling effect on the diversity of views provided by NRSROs and would ultimately harm the market.

First, we believe that holding NRSROs liable pursuant to Section 11 of the Securities Act of 1933 is in direct conflict with how the market already functions as a result of the changes provided by the Dodd-Frank Act. Because credit ratings are based entirely on the information provided to an NRSRO by or on behalf of an issuer, NRSROs generally require issuers or other parties who engage with NRSROs to represent and warrant the accuracy of the information they are providing for the ratings being conducted. This means that the information the NRSRO receives should be exactly the same as the information being provided in the registration statement that is the subject of Section 11. As such, NRSROs are in the same position as the investors receiving the information from the transaction parties and should be treated as such.

Second, pursuant to Rule 17g-5(c)(5), NRSROs are prohibited from making recommendations about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security. As a result, NRSROs are required to take the information as it is provided to them to conduct the rating and do not function as due-diligence providers with respect to such information. Those who have the expertise to structure transactions do so. NRSROs are not those experts; they rate what those with the expertise structure and present to them.

Third, additional liability would ultimately narrow the NRSRO market and make ratings less useful to investors. To avoid liability, NRSROs would likely converge to a single, narrow view. This would eliminate the diversity of views NRSROs currently provide and leave investors with diminished choice. It would also naturally limit the amount of research and transparency NRSROs currently provide, leaving investors with less thorough information with which to make their investment decisions.

In short, we are of the opinion the current regulatory and legal frameworks provide the tools for holding NRSROs responsible, and we believe the SEC and the investing public make good use of them.

Issuer-Pay Model and Perceived Conflicts of Interest

We believe that the Dodd-Frank Act and the resulting SEC regulation successfully mitigate problems associated with potential conflicts of interest. That said, we understand that some policymakers, including members of this subcommittee, have questions about potential conflicts of interest in the issuer-pay model. As a general matter, I believe that it is not possible to completely eliminate all potential conflicts in the NRSRO space, either in the case of issuer-pay or investor-pay, and that the current SEC Rule 17g-7 disclosure requirements mitigate potential risks in this area. However, we support efforts to ameliorate potential conflicts.

Perceived Rating Inflation. We are concerned that the interest in an issuer-pay model is partly driven by a false narrative regarding ratings inflation and competition that is based on incomplete data and poor reporting. We feel strongly that competition helps improve research and ratings, not inflate ratings. One very important change that helps protect against ratings inflation is the Dodd-Frank Act requirement that all rating agencies post their methodologies, and substantive changes thereto, publicly on their websites. This provides investors the opportunity to comment directly on an NRSRO's methodologies as they are being developed and changed. NRSROs are also required to consider public comments in finalizing their methodologies. This is a critical positive change that in our view has been successful in helping to protect investors and give them an active role in pushing for NRSROs to maintain high and relevant standards. We observed the opacity of rating methodologies pre-crisis, and in fact, heard about this issue frequently from investors early on. The Dodd-Frank Act requires NRSROs to adhere to their own published methodologies when performing credit ratings, and the SEC enforces this adherence through their exam and enforcement procedures. In addition to methodologies being public, and the SEC exam and enforcement process, as discussed earlier, NRSROs are subject to liability and all applicable securities laws. In our view, these frameworks work well, individually and in tandem, to protect against rating inflation.

One example of the framework functioning well is the BBB- credit enhancement levels in commercial mortgage-backed securities (CMBS). The easiest way to think of credit enhancement levels in a transaction is as insurance to enhance the safety of the underlying investment. Credit enhancement levels vary with different rating levels, and typically they are inversely related to the quality of the rating, such

that lower ratings are associated with more insurance, or credit enhancement. Pre-2008-crisis, the three largest NRSROs rated CMBS with credit enhancement levels at an average of 4.0 at BBB-, which is typically the lowest "investment grade" level rating. Post-crisis, with the addition of two other NRSRO rating CMBS, credit enhancement levels for BBB- CMBS deals are *higher* and now average 6.95. In other words, since the Dodd-Frank Act and our entry into the market, BBB- ratings for CMBS are safer as evidenced by the increased credit enhancement. This is the opposite of ratings inflation – in fact, increased competition is helping drive a safer, more transparent market.

Despite the clear facts regarding ratings pre- and post-crisis, some articles on this point have misreported the facts and failed to correct their errors even when we have pointed them out, to the serious detriment of the policy debate. It is very important to understand that precisely because of the entrenchment of the incumbent rating agencies and the guidelines problem I discussed earlier, most major issuers feel they need a Moody's and/or S&P rating. The suggestion that KBRA and other smaller NRSROs are willing to give higher ratings to get business from investment bankers, issuers and investors is inaccurate, and reporting of this occurrence is based on conjecture and not fact. Missing from the reporting is the volume of ratings where smaller NRSROs may be considered but not chosen, and the smaller NRSRO's ratings in those cases may very well be lower than S&P and Moody's - but public statistics would never demonstrate that. It is worth noting that investment banks, issuers and investors often approach NRSROs with a particular rating in mind, but that rating may not be achievable. KBRA will never provide a credit rating based on what is requested by a market participant – in fact, KBRA has walked away from deals where we did not believe that a certain rating was appropriate. We believe that lack of competition - not rating inflation - is the single biggest problem in the NRSRO space, and that the discourse regarding rating inflation has simply gotten the facts wrong, and risks distracting us from where reforms are needed.

Investors Have Agendas, Too. It is important to recognize that investors have their own agendas when purchasing or asking issuers to purchase credit ratings. Different institutional investors – the large majority of users of credit ratings – are often focused on their own investment thesis. This drives them to want higher or lower ratings, depending on where the subject transaction fits into their thesis. We see reports every day about billionaire investors and hedge funds taking large positions in companies so they may control their futures. It is important to recognize that most investors have their own goals and agendas and can present just as much of a conflict on the rating process as issuers may. This is why we think sunlight is the best disinfectant – letting the whole world know who paid for a rating will allow other users of that rating to factor that information into their investment decisions. This is exactly what the current disclosure requirements already allow.

Effect on Smaller Investors. In addition to our concerns regarding the debate on rating inflation, we also have concerns that an investor pay model would present problems with conflicts of interest. We believe that an investor-pay model would strongly and perhaps solely benefit the largest institutional investors, who can afford to pay for multiple ratings and the best available research. The benefit of issuer pay ratings is that issuers frequently make those ratings public so that all investors, large and small, can benefit from the ratings and research published by the NRSRO. Investor ratings tend to be unpublished or private, as investors usually purchase them only for their own benefit. If the investor pay model were required, we believe fewer ratings and research would be made public and smaller, investors could very well be left out in the cold. This runs directly counter to congressional intent in Dodd-Frank, which was clearly to open up competition and protect investors.

KBRA's Views on Incorporating Climate Risk into Credit Ratings

Mr. Chairman, I would also like to provide our views on climate risk and credit ratings. KBRA fully incorporates ESG risks into our credit analysis as opposed to issuing separate paid ESG ratings. In our view, the proliferation of ESG and climate "scores" and separate ratings has only served to confuse investors and dilute the utility of these ratings in making investment decisions.

Our approach to climate risk and other ESG factors is informed by hundreds of conversations with investors on the topic over the past several years. We are proud of our ESG methodology, which is posted for public comment, and is also described in a recent research report entitled "Credit Ratings Deserve ESG Risk Analysis not ESG Scores." In the context of any particular rating, we engage in a bottoms-up fundamental credit analysis of all material risks, including ESG risks where appropriate. On all

ratings, we engage in a thorough, management-focused analysis that has lent itself well to directly incorporating material ESG risks into our credit assessment. We believe that our approach provides integral information that investors and other stakeholders demand and deserve.

Conclusion

Mr. Chairman, I am confident in KBRA's mission, our team, and our research and ratings. In my view, KBRA's entrance into this marketplace has enhanced the quality of research, opened up markets, and improved outcomes for investors. I believe this is what Congress intended with the Dodd-Frank Act and look forward to being part of this critical policy debate. I thank the subcommittee for the opportunity to testify today, and I look forward to your questions



Levin College of Law
Offices of the Faculty

Professor Robert Rhee
John H. and Mary Lou Dasburg Professor of Law

378 Holland Hall
PO Box 117625
Gainesville, FL 32611-7625
Telephone: 352-273-0958
Email: Rhee@law.ufl.edu

July 19, 2021

Re: Written Testimony of Professor Robert J. Rhee, John H. and Mary Lou Dasburg Professor of Law, University of Florida Levin College of Law, for the hearing entitled "Bond Rating Agencies: Examining the 'Nationally Recognized' Statistical Rating Organizations," on July 21, 2021

Dear Honorable Members of the U.S. House of Representatives, Committee on Financial Services, Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets:

Upon your invitation to participate as an expert witness in the above hearing, I provide this written testimony.¹ I respectfully request that you accept this written testimony into the Congressional records.

Introduction

Credit rating agencies are important institutions in the American and global capital markets. The U.S. capital markets are the deepest and most liquid markets, and many American firms are market leaders, including major rating agencies. Although some commentators dismiss the utility of rating agencies, I believe that rating agencies are important and useful. The credit market is enormous, and debt constitutes the largest form of capital. Rating agencies have a basic market utility: They sort and categorize a vast amount of information in the credit market, and this function serves market efficiency.² Efficient information markets do not exist in a state of nature. The sorting and categorization of information promotes efficient allocation of market resources and price discovery. This function is the key public utility of rating agencies

¹ This written testimony and the expected oral testimony on July 21, 2021, are solely mine and do not represent the opinion or position of the University of Florida or the Levin College of Law.

² Robert J. Rhee, *Why Credit Rating Agencies Exist*, 44 Economic Notes: Review of Banking, Finance and Monetary Economics 161 (Issue 2, July 2015).

for which they are given regulatory license. The importance of rating agencies is underscored by the fact that they pose a profound problem of public policy.

Rating agencies are important gatekeepers.³ Aside from regulators and the axial ends of capital transactions (issuers and investors), the key players in machinery of the capital markets are lawyers, bankers, accountants, exchanges, and rating agencies. The systemic failure of any single group of players could trigger a market crisis. For example, the failures of auditors resulted in the accounting scandals of the 1990s, prompting the enactment of the Sarbanes-Oxley Act of 2002. Among the group of key market players, auditors, exchanges, and rating agencies have much more direct connection to the public good. Their roles serve a public function, even as they are private firms seeking profits. They are more like public goods than private transaction advisers such as investment bankers and lawyers. Exchanges and auditors are meaningfully regulated. Like exchanges and auditors, rating agencies ought to be regulated with the primacy of the public interest in mind, even as such entities are privately owned and have real obligation to make profit for owners.

The perceived problems of rating agencies have long percolated. As the American economy and capital markets became more dynamic and complex starting in the 1970s and accelerating in the 1980s and 1990s, rating agencies took on greater importance. Critics have argued that rating agencies have long delivered poor outcomes with little accountability.⁴ They point to flawed ratings in cases such as Enron and WorldCom. More conclusively, critics point to the failures of rating agencies during the financial crisis of 2008. No one can seriously question this narrative for it is history now. If rating agencies had performed properly, the financial crisis would not have happened. This statement is not intended to assign a greater quantum of blame on rating industry in relation to, say, banks and broker-dealers. The point is simpler: In the chain of causality and counterfactuals, rating agencies were the final gatekeepers before “toxic” ABS/MBS and CDO securities could be released into the capital markets. The deals could have stopped at the conference rooms of credit committees, but they were not.

The United States and the world cannot afford another financial crisis for more reasons than money and markets. History has repeatedly shown that because the credit market is so consequential for sovereigns, governmental bodies, and corporations, major disturbances therein have profound consequences on economies, nations, and societies. The consequences of the financial crisis of 2008 still reverberate. We must also consider the real possibility that another systemic failure of rating agencies could interact with the post-Covid-19 world.

³ E.g., John C. Coffee Jr., *Gatekeepers: The Professions and Corporate Governance* (Oxford 2006).

⁴ E.g., Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 *Washington University Law Quarterly* 619 (1999).

The proper functioning of rating agencies is not only a matter of markets and money. It is a matter of national security. Economic stability is a matter of national security. History has repeatedly shown that instability in the credit market can result in social instability and mass hardship. No country is immune: America, Western Europe, East Asia, and emerging economies. Due to many factors including the Covid-19 pandemic, countries are more brittle and vulnerable than before. For all its past and current flaws, the U.S. financial services industry still holds in trust the largest, most liquid capital market. Good governance should be a global competitive advantage. The systemic mishaps, misdeeds and misjudgments of the financial crisis of 2008 have not only damaged this industry's reputation capital, but also raised questions about the American model of economic organization and capitalism both internally and globally. This scrutiny is not undeserved. There is again a competition for ideas about political and economic organization. It is clear that we can ill afford another financial crisis brought about by mishaps, misdeeds and misjudgments among financial services firms and the markets they hold in trust.

Since the financial crisis of 2008, there has been modest reforms. Past reforms have been modeled on a well-worn regulatory template: registration and disclosure. This regulatory philosophy works well for the issuance of securities and regulation of certain market actors. However, due to the unique configuration of the rating industry, the application of this template largely avoids confronting the core problems.

Fundamental Problems of the Credit Rating Industry

A survey of the scholarly literature shows a strong line of thought that the problems of the credit rating industry stem from several compounding factors.

First, many commentators have identified the issuer-pay model of fees where the corporate issuer pays the rating agency. This problem was also identified for study in the Dodd-Frank Act. The built-in conflict of interest is obvious. Issuers prefer higher ratings since it would reduce the cost of debt and increase the marketability of the issue. The concern is the possibility of "rate shopping" by issuers and structural bias by rating agencies.⁵

⁵ Some defenders of rating agencies may argue that the issuer-pay model is functionally the same compensation model for lawyers, bankers, and auditors, who are also paid by their client companies. This is an imprecise analogy. Lawyers and auditors are governed by professional societies where high professional and ethical standards have long been internalized. The Dodd-Frank Act § 939E requires a study on the creation of an independent professional society like lawyers and auditors. A study was performed, but it was inconclusive. *Credit Rating Analysts: Views Varied on Merits of a Professional Organization, but Creating One Now Viewed as Premature*, U.S. Government Accountability Office (July 2015). With respect to a comparison to auditors, after the Sarbanes-Oxley Act of 2002, auditors are more closely regulated, including prohibitions that constrain their business prospects and models. 15 U.S.C. § 78j-1(g) ("it shall be unlawful for a registered public accounting firm . . . that performs for any issuer any audit . . . to provide to that issuer, contemporaneously with the audit, any non-audit service"). With

Second, many commentators have identified the industry concentration where there are two dominant rating agencies plus another major player. These three rating agencies have always accounting for more than 90 percent of all ratings and revenues. The industry is a “duopoly plus” or more generously an oligopoly. A review of the SEC’s latest annual report on rating agencies show that nothing has changed with respect to basic characteristics of market concentration.⁶

Many commentators have argued that these two dominant factors compound to produce bad outcomes. The rating industry is not competitive. Three major players dominate the market. This fact alone is not antithetical to positive competition. But rating agencies vie for business in which issuers and bankers prefer higher ratings and there is a common practice is to get more than one rating. Few independent industry observers or academics, I believe, would look at this configuration in the abstract and conclude that such an industry would be optimized for proper incentives and peak performance. The Congressional findings in the Dodd-Frank Act § 931 support this view. Empirical experience of the financial crisis of 2008 and other instances of rating failures has conclusively shown that these concerns are real.

The nature of competition is sometimes misunderstood. We occasionally see calls to qualify more NRSROs or easing the barrier to entry for NRSRO status on the premise that increasing the number of qualified NRSROs should elicit greater competition. But this idea as a policy end is flawed. Competition in the abstract is not inherently good. Numerosity of competitors does not automatically translate into good policy end. Many rating agencies vying for deals under the issuer-pay model may result in a classic “race to the bottom” where each firm seeks to ratchet up ratings for the possibility of getting the deal. This is simply the dynamics of firm profit maximization. Under the right conditions, fewer competitors may engage in robust competition toward a good policy

respect to lawyers and bankers, they are transaction engineers and their work on individual deals have little potential for impart systemic effects on the global capital markets. The payment of fees by clients is logical. But rating agencies do not add value as transaction engineers or advisors in the way that bankers and lawyers do. See Robert J. Rhee, *Why Credit Rating Agencies Exist*, 44 *Economic Notes: Review of Banking, Finance and Monetary Economics* 161 (Issue 2, July 2015). With respect to bankers and their role in the financial crisis of 2002, they depended on the credit rating process in the pipeline to convert mortgage receivables to securities. The analogy of the issuer-pay model to an ordinary client relationship would be imprecise and flawed.

⁶ For all practical purposes, little has changed in these matters since the immediate fallout of the financial crisis of 2008 and the enactment of the Dodd-Frank Act and present day. In December 2012, the SEC reported the following: (1) nine NRSROs; (2) the three largest accounted for 96.4% of all outstanding credit ratings; (3) almost 99% of credit ratings were issued under the issuer-pay model. *Annual Report on Nationally Recognized Statistical Rating Organizations*, U.S. Securities and Exchange Commission, at pp. 4, 6 (Dec. 2012). In December 2020, the SEC reported the following: (1) nine NRSROs; (2) the three largest accounted for 95.1% of all outstanding credit ratings; (3) the larger NRSROs accounted for approximately 93%-95% of revenue, meaning the issuer-pay model not including the issuer-pay models of smaller NRSROs. *Annual Report on Nationally Recognized Statistical Rating Organizations*, U.S. Securities and Exchange Commission, at pp. 2, 11, 14 (Dec. 2020).

end. Consider the Super Bowl or the World Series. There are only two competitors, but no one would say that these matches lack for competitive vigor toward a good end.

The policy end should be a competition in which there is a “race to the top.” The policy end should be a vigorous competition for the most accurate, bias-free ratings. Competitiveness depends less on the number of NRSROs—and instead on the right incentives. All NRSROs should be incentivized to provide the most accurate, bias-free ratings. These incentives are currently not robust. This conclusion is supported by the empirical evidence of past history and the Congressional findings in Dodd-Frank.

Current Regulatory Regime and the Need for More Regulations

Commentators have documented the long relationship between the SEC and rating agencies. I briefly highlight only the most recent main developments.

The Credit Rating Agency Reform Act of 2006 required the registration of NRSROs and imposes disclosure requirements related to the issuance of credit ratings. It also requires the SEC to provide annual reports on the state of the credit rating industry.

The Dodd-Frank Act moved the needle in several ways. Section 932 gives the SEC broader powers to regulate rating agencies including matters related to transparency, internal controls, methodologies, and conflict of interest, and created the Office of Credit Ratings inside the SEC to centralize these functions. Section 933 makes the legal liability of rating agencies under federal securities law coterminous with public accounting firm or a securities analyst and clarifies that the state of mind is satisfied when “the credit rating agency knowingly or recklessly failed to conduct a reasonable investigation . . . or to obtain reasonable verification of such factual elements.” Section 939 requires the removal of references to credit ratings, thus purporting to reduce the benefit of “regulatory license” given to rating agencies, and Section 939A ordered the SEC to review the reliance on credit ratings. Sections 939D and 939F require studies of alternative compensation models.

Pursuant to these statutes, the SEC promulgated rules on procedures, standards for registration, and disclosures in Rule 17g-1 to 17-10. I note that Rule 17g-5 deals with “conflict of interest.” But this rule deals with firm- and individual-level conflict of interest (*e.g.*, members of the credit committee lacking independence due to material interests in the issuer). It does not remedy the systemic, structural conflict of interest inherent in the issuer-pay model. This conflict of interest is at the industry level and exists still.

The above reforms have incrementally moved the needle, but reform is incomplete.⁷ They are principally drawn from a common template in federal securities law: registration and disclosure. But they do not fundamentally alter the dynamics of the core problem of issuer-pay and oligopoly. More regulatory reform is needed.

Specific Comments and Responses to Committee Proposed Legislation

In a memorandum by FSC Majority Staff to the Committee on Financial Services dated July 16, 2021, the staff identified five draft bills:

- (1) Commercial Credit Rating Reform Act of 2021 (Sherman)
- (2) Uniform Treatment of NRSROs Act (Dean)
- (3) Transparency and Accountability of NRSROs Act
- (4) Restoring NRSRO Accountability Act
- (5) Accurate Climate Risk Information Act.

I provide the following comments and responses to each of these proposed bills. Each reform is a positive step toward better regulation of the credit rating industry. One proposal (the Sherman proposed bill) squarely deals with the issuer-pay model.

(1) Commercial Credit Rating Reform Act of 2021 (Sherman)

This proposed bill represents a continuation of a line of thought in the Dodd-Frank Act. At one time in the legislative process, the Dodd-Frank as passed by the Senate with supermajority support contained a mandated scheme (the Franken-Wicker amendment) in which an independent credit rating agency board would assign randomly assign rating agencies to provide credit ratings, thus removing the rating-shopping and issuer-bias incentives. These provisions from the final Dodd-Frank Act. The statute instead required studies of alternative compensation models. These studies were conducted,⁸ but ultimately the SEC did not implement the idea.

The proposed Sherman bill seeks to revive the concept of altering the industry compensation model. It establishes a “Credit Rating Agency Board,” the majority composed from the investor industry. It requires that a corporate issuer “may not request a credit rating from” an NRSRO but instead “shall submit a request for a credit rating from the Board.” The Board shall assign the engagement per “either a lottery or blind rotating assignment system” with consideration given to certain merit-based

⁷ See Alice M. Rivlin & John B. Soroushian, *Credit Rating Agency Reform Is Incomplete*, Brookings Institution (Mar. 6, 2017). Among other things, the authors conclude: “we recommend returning to the use of credit ratings for structured products, but if and only if random assignment is implemented.”

⁸ *Report to Congress on Assigned Credit Ratings*, U.S. Securities and Exchange Commission (Dec. 2012); *Credit Rating Agencies: Alternative Compensation Models for Nationally Recognized Statistical Rating Organizations*, U.S. Government Accountability Office (Jan. 2012).

factors such as “how the rated instruments perform . . . the accuracy of the ratings . . . the effectiveness of the methodologies.”

The Sherman bill has much merit. Importantly, it does not envision a pure random lottery system. Otherwise, there would be real drawbacks to the proposal. Purely random assignment may arbitrarily increase or decrease a particular rating agency’s current market share without ability to influence the probability of engagement. It may provide no incentive for effort since the probability of engagement would be decoupled from merit, a situation that may worsen rather than improve the current state. But the Sherman bill avoids these problems by including certain merit-based factors that influence the probability of engagement. The Sherman bill would substantially improve the credit rating industry. It would reduce the poor incentives of the issuer-pay model, which many commentators have identified.

I note one distinction between the current Sherman proposed bill and the former Franken-Wicker amendment (former draft Section 939D). The latter provided: “Nothing in this section shall prohibit an issuer from requesting or receiving additional credit ratings with respect to a debt security, if the initial credit rating is provided in accordance with this section.” There does not appear to be a similar provision in the current Sherman proposed bill. It is common practice for issuers to seek multiple ratings. There may be legitimate reasons for this practice. The possibility of two ratings, one assigned and other chosen, presents several possibilities. One possibility is that it dulls a sharp move away from the issuer-pay model. The potential for industry disruption is lessened. Another possibility is that it sets up an internal competition between two rating agencies engaged by different parties. The longterm dynamics may impact reputation capital and the probability of merit-based engagements. A key unknown is whether the chosen rating agency would be influenced to compete with the assigned rating agency, or whether its incentives are similar to current incentives in the issuer-pay model. The answer may depend on each firm’s cost-benefit analysis of the probability of greater market share under the lottery system.⁹

⁹ I understand that most of the hearing time will be devoted to the proposed bills identified in the Staff memorandum. I respect the Subcommittee’s agenda. I note here briefly that in addition to the thoughtful Sherman proposal, there are other alternative models. In a prior work, I proposed to keep intact the core business model of issuer-pay, thus having the benefit of *not* fundamentally altering the business model of rating agencies. My proposal calls for a mandatory contribution of certain small portion of annual fees earned (e.g., 5%-10%) toward a compensation pool that is managed by a third-party like the proposed Credit Rating Agency Board. At regular intervals, compensation from this pool (a bonus) would be paid to those rating agencies that have performed the best in terms of accuracy. It is a compensation game where each would seek to eat the lunch of the other. Rating agencies would be forced to compete for accuracy, a race to the top. Participation in this bonus pool would be mandatory by making it a condition of the NRSRO status. No rating agency is entitled to the NRSRO status, and it must qualify by meeting all conditions of the regulatory license granted to NRSROs. These conditions and requirements are set by the government, ultimately Congress. This proposal has the benefit of leaving intact the industry model while making at-the-margin changes that encourage positive competition

(2) Uniform Treatment of NRSROs Act (Dean)

This proposed bill requires the Federal Reserve to accept credit rating from any NRSRO if the Federal Reserve “establishes a requirement for an entity, security, or other instrument to carry a minimum credit rating.” It provides an important exception. This rule does not apply if the Federal Reserve, in consultation with the SEC, determines that the NRSRO “is unable to provide reliable and accurate ratings for a particular asset class and that such exclusion is in the public interest.”

The Dean bill provides clarity in situations when the Federal Reserve establishes credit facilities, most likely in emergency or crisis situations. It requires uniform treatment of all borrowers, but perhaps more importantly it gives the Federal Reserve the ultimate discretion. The exception would likely be invoked in situations of emergency or crisis. In times of market turbulence or national emergency, many ordinary “rules of the road” may not or should not apply. For example, in thinking about the financial crisis of 2008, I have argued that ordinary state corporation law of fiduciary duty to shareholders and the law of profit maximization should not apply to director actions in times of a national crisis when corporations have the legal power under state corporation laws to aid the government.¹⁰ This principle should apply in situations like the Covid-19 crisis or other economic disruptions.

In the context of the credit markets, ordinary credit analyses may not be relevant in transitory periods of high uncertainty or exogenous shock where ordinary market values and information signals may not be reliable. Wrong judgments may exacerbate a crisis and may bind regulatory or public remedial actions. In other words, some occasions may be too big to rely on the opinions of just a few private firms with great powers to affect, positively or negatively, a public crisis. In times of market turbulence, the Federal Reserve may serve a mediating role, providing liquidity, capital, and economic and financial coordination. It would be proper for the Federal Reserve to make the ultimate determination of whether the credit ratings are unreliable and the public interest merits an exception.

(3) Transparency and Accountability of NRSROs Act

This proposed bill would require the SEC when it produces a required report to “identify such organization by name.” Since the SEC examines NRSROs and reports on

even when the number of competitors are few. I do not attach my ideas to this written testimony, but the proposals are publicly available. See Robert J. Rhee, *On Duopoly and Compensation Games in the Credit Rating Industry*, 108 Northwestern University Law Review 85 (2013); Robert J. Rhee, *Incentivizing Credit Rating Agencies under the Issuer Pay Model: A Proposal for a Mandatory Compensation Competition*, 33 Banking and Financial Services Policy Report 11-22 (No. 4, April 2014).

¹⁰ Robert J. Rhee, *Fiduciary Exemption for Public Necessity: Shareholder Profit, Public Good, and the Hobson’s Choice during a National Crisis*, 17 George Mason Law Review 661 (2010).

deficiencies and compliance failures, this requirement would identify by name the NRSROs that have significant shortcomings. Currently, the SEC practice is to keep the names anonymous.¹¹ There is no reason for the SEC to provide a shield of anonymity.

This proposed bill would increase accountability by public disclosure of deficient and noncomplying rating agencies. It does not penalize rating agencies any more than what the current regulation provides, the ultimate sanction being decertification of the NRSRO status. The only penalty is the loss of reputation capital. This intangible penalty would incentivize greater compliance and transparency.

Importantly, this disclosure requirement would impose no regulatory cost on the industry. It would impose only reputation costs at the individual firm level. These individual costs are offset by gains achieved by complying firms. This must be so because the number of credit ratings is an independent variable. In other words, the costs and benefits at the individual firm level is zero sum because the demand for credit ratings is unaffected by the imposition of reputation costs at the individual firm level. If noncompliance matters that much to issuers, they will engage the best complying (or least delinquent) firms. The regulatory and economic effect on the industry is nil. The proposed bill is eminently sensible. If certain rating agencies are not in compliance with the modest rules in place, the public should know.

(4) Restoring NRSRO Accountability Act

This proposed bill would nullify a no-action letter issued by the SEC, which states that the SEC would not recommend an enforcement action if ABS issuers did not include NRSRO credit ratings in the registration statement. This proposed bill addresses an interesting prior history.

Dodd-Frank § 939G legislatively overruled SEC Rule 436(g).¹² Former SEC Rule 436(g) shielded rating agencies from liability under Section 11 of the Securities Act of 1933, which imposes liability for money damages for material misstatements or omissions in the registration statement, on among others accountants and other experts named in the registration statement with their consent.¹³ By legal fiat of the SEC, former

¹¹ E.g., *2020 Summary Report on Commission Staff's Examinations of Each Nationally Recognized Statistical Rating Organization*, U.S. Securities and Exchange Commission, pp. 11-23 (Dec. 2020) (listing numerous deficiencies of certain NRSROs but not identifying their names and only indicating "smaller NRSRO" or "larger NRSRO").

¹² "Rule 436(g), promulgated by the Securities and Exchange Commission under the Securities Act of 1933, shall have no force or effect."

¹³ 15 U.S.C. § 77k(a): "In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact . . . any person acquiring such security . . . may, either at law or in equity, . . . sue . . . every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having

Rule 436(g) deemed credit ratings to be not a part of the registration statement or prospectus, a special privilege not accorded to others such as accountants. As a result, NRSROs were not considered experts for the purpose of Section 11, thus shielding them from Section 11 liability. After the passage of the Dodd-Frank Act, rating agencies responded by threatening to withhold credit ratings or their consent to publish them. The SEC blinked. In response and in spite of the clear mandate in the Dodd-Frank Act § 939G, the SEC provided “no-action” letters permitting the exclusion of credit ratings from the registration statement and the prospectus.¹⁴ One surmises that the SEC may have acted in this way for fear of gumming up the deal flow pipeline in particular securities such as structured finance products if the rating agencies’ threat was carried out. These “no-action” letters are the subject of the proposed bill.

The SEC’s action flouts the Congressional intent in the Dodd-Frank Act, but its reasons may be grounded in a rational assessment of the market condition. The proposed bill would be legislative patch to the original concept in the Dodd-Frank Act, which would make the liability of rating agencies coterminous with other securities professionals such as accountants, auditors, and security analysts, including liability under Section 11. There are several groups of consideration at work.

First, one should consider the impact on the overall market if rating agencies in fact strike and withhold their consent. The questions are: (1) Would rating agencies in fact carry out the threat? (2) Would issuers engage rating agencies if they withhold their consent, or at least demand a discount off traditional fee structures on credit ratings without consent? (3) Would the demand of bond investors decline without credit ratings published in the registration statement or prospectus, thus gumming up the market? (4) If not, would steady investor demand marginalize the importance of credit ratings for certain credit products?

Since I am removed from the day-to-day market milieu, I am less qualified to opine on the above matters. It would be helpful to learn the responses from a representative sample of market professionals, including smaller rating agencies, investment bankers who must market bond issues, and an array of bond investors.

Second, one should consider the impact on competition among rating agencies. The questions are: (1) Would all nine NRSROs stand together in the strike, or would several cross the picket line? (2) Would some, particularly the smaller NRSROs, see the strike as a market opportunity and rush to fill the void? (3) Would the fee structures for credit ratings change due to a shrinkage of the supply of credit ratings?

prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation” (Emphasis added.)

¹⁴ SEC No-Action Letter Issued to Ford Motor Credit Company LLC regarding Regulation AB Item 1120 (July 22, 2010); SEC No-Action Letter Issued to Ford Motor Credit Company LLC regarding Regulation AB Item 1120 (Nov. 23, 2010).

It may not be so easy to maintain a strike among a group of nine competitors. Smaller, more entrepreneurial NRSROs may indeed fill the void left by others. Financial industry actors are quick. Deals are rarely left on the table if the pricing is right. It is possible that a shrinkage of supply of credit ratings and a “litigation premium” could result in price increases. This may marginally increase the cost on issuers. But the benefit of such a possibility would be the continued growth of smaller NRSROs who have historically had trouble growing relative to the overall market.¹⁵

Third, one should consider the impact of Section 11 liability for money damages on the rating industry. The questions are: (1) Are rating agencies similarly situated with accountants and appraisers (who are specifically named in Section 11) with respect to liability exposure under Section 11 such that they deserve as a special carve out? (2) What would be the financial impact on rating agencies? (3) What would be the impact on the incentives of rating agencies?

Section 11 makes clear that all consenting experts are potential subject to liability and does not distinguish differences in the qualitative nature of their work. Accountants are subject to professional standards seen in accounting standards such as generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) and supported by a professional body. They have clearer and arguably more rigorous standards (though inter-professional comparisons are tricky), thus greater potential exposure if they deviate from these standards. Some of the qualitative and subjective judgments that go into credit analysis, such as forecasting, would make imposing liability on rating agencies more difficult, absent clear error, bad faith, or other malfeasance. There is no apparent need for distinguishing rating agencies from accountants with a special privilege.

The financial impact of added exposure to legal liability would of course be negative. In the past, rating agencies have paid substantial settlements.¹⁶ Section 11 liability would be different from liability based on other legal theories seen in the case law. Thus far, despite substantial settlements and regulatory fines, the overall success of legal actions against rating agencies seems to be mixed. Rating agencies have a plausible First Amendment defense that have been recognized in federal courts in varying degrees and with caveats of a complex area of constitutional law. Commentators have varying views on this defense. But it seems that litigation outcomes have thus far been a mixed bag, perhaps generally favoring rating agencies on the

¹⁵ See *supra* note 6.

¹⁶ *The Credit Rating Controversy*, Council on Foreign Relations (Feb. 19, 2015) (“In addition to its \$1.37 billion settlement in February, S&P settled two other cases, paying \$125 million to the nation’s largest pension fund, the California Public Employees’ Retirement System (Calpers), while settling with the SEC for \$80 million in a post-crisis fraud case. While these sums combined are more than ten times larger than any other rating agency-related settlement, critics argue that they represent a mere slap on the wrist for S&P, which as part of the deal was not forced to admit to any criminal wrongdoing.”).

whole. Section 11 would change the calculus of legal liability because the risk attaches with each registration statement under a clearly established statutory cause of action under the Securities Act of 1933.

Legal and economic theory states that an actor engages in a cost-benefit analysis to determine whether it should change behavior (take precautions) at each level of marginal increase in potential penalty. In other words, an actor thinks about the bottom line. A rating agency may be incentivized to take additional care against rating mishaps if the expected cost of liability outweighs the cost of precaution. I believe that, consistent with theory, exposure to Section 11 would result in the expenditure of greater care because liability could be high magnitude in light of high dollar values of the bond issuances. This would be a greater cost on the industry, but would produce greater care in the production of credit ratings.

The proposed bill is consistent with Dodd-Frank Act. It enforces the purpose of Section 939G, which legislatively overruled SEC Rule 436(g). It is also consistent with Dodd-Frank Act § 933, which achieves the right balance by making liability under federal securities law coterminous with that of auditors and security analysts.

(5) Accurate Climate Risk Information Act

This proposed bill requires NRSROs to “adopt, integrate, and publish a written policy on how the organization will consider climate-related risks in the credit ratings.” The language “will consider” is ambiguous. It could be construed as a mandate to include climate risk into the ratings model, or it requires only disclosure of how rating agencies treat climate change, if at all. A mandate to include climate risk into the models of rating agencies would encroach upon their substantive work. I say this not because climate risk is insubstantial or speculative. Science says otherwise, and climate change (global warming) affects credit risk on longterm instruments, though each firm applying its own model may differ on the magnitude of the influence on credit risk. But a mandate to include climate risk into credit models poses the question of whether Congress or the SEC has the substantive expertise or, even if they do, whether they should mandate a specific analysis of credit risk to private firms.

On the other hand, a disclosure approach is laudatory and compelling. Even to an informed layperson who believes in science, there can be little doubt that climate change affects credit risk. Consider a longterm 30-year bond issued by the following borrowers: a municipality situated on a coastline, a utility in the western states, a property and casualty insurer in the Gulf states, or a project finance for maritime infrastructure.¹⁷ Climate risk does not necessarily represent a downside-biased in the

¹⁷ The U.S. military, an organization that depends on longterm strategic planning, is well aware of the threat of climate change and its affect on military preparedness. See David Vergun, *Action Team Leads DOD Efforts to Adapt to Climate Change Effects*, U.S. Department of Defense (Apr. 22, 2021), available at

probability of default. Among other things, the likelihood and magnitude of predicted fortuitous events, the issuer's business and pricing model, and its risk management¹⁸ would affect the nature of the credit risk. Rating agencies should consider climate risk as a part of its credit modeling or explain to regulators and the public why they believe climate risk is trivial to credit risk. A disclosure requirement would make transparent how global warming affects credit ratings and the value of longterm debt instruments. This public information may influence the most efficient allocation of capital in an era of climate change, which would have broad consequences.

Concluding Comments

When rating agencies assess and publish credit ratings, they exert enormous power over the largest and important portion of the capital markets—the credit market. Their actions can have profound consequences on companies, investors, markets, nations, and peoples. The industry has a structural problem. They are few and not subject to market forces of good competition and incentives. The current industry configuration, in the main, is the same as it was before 2008.

The Dodd-Frank Act and earlier legislation incrementally reformed the industry. Some of these modest reforms mandate factfinding and contemplation by requiring reports. Numerous reports have been produced over the past decade. But these statutes have not changed the core problem of lack of competition, industry concentration, and structural bias. The reform of the credit rating industry is incomplete. It is my opinion that the five proposed bills contemplated by the House Subcommittee advance the goal toward more complete reform of the credit rating industry.



Robert J. Rhee
John H. and Mary Lou Dasburg Professor of Law
University of Florida Levin College of Law

<https://www.defense.gov/Explore/News/Article/Article/2577354/action-team-leads-dod-efforts-to-adapt-to-climate-change-effects/>. For example, naval bases could be adversely affected by rising seas, and global warming could destabilize some nations affecting the security interests of the United States in the homeland and abroad.

¹⁸ See A. Seetharaman et al., *The Impact of Risk Management in Credit Rating Agencies*, 5 Risk 52 (2017) (concluding that “market risk is internally correlated with credit risk, financial risk, and operational risk”).



July 26, 2021

The Honorable Brad Sherman
Chairman
Subcommittee on Investor Protection,
Entrepreneurship and Capital Markets
Washington, DC 20515

The Honorable Bill Huizenga
Ranking Member
Subcommittee on Investor Protection,
Entrepreneurship and Capital Markets
Washington, DC 20515

Re: Subcommittee hearing “Bond Rating Agencies: Examining the ‘Nationally Recognized’ Statistical Rating Organizations”

Dear Chairman Sherman and Ranking Member Huizenga:

We are pleased to submit comments on the recent Subcommittee hearing entitled “Bond Rating Agencies: Examining the ‘Nationally Recognized’ Statistical Rating Organizations.” Specifically, our comments focus on the draft text of the bill entitled the “NRSRO Reform Act.” While we applaud the bill’s attempt to drive transparency and accountability in the market for corporate and structured-product credit ratings by nationally recognized statistical ratings organizations (NRSROs), we do not believe the bill would enhance the quality of information available to investors—particularly in the institutional leveraged loan and collateralized loan obligation (CLO) markets—and, in fact, could damage the quality of that information and result in barriers to capital formation, impacting the ability of companies to borrow, grow their businesses and create jobs.

As the trade association for the institutional leveraged loan market, our comments focus on the ratings of loans made to large and medium-sized corporations and syndicated to diverse categories of institutional lenders, as well as CLOs. We believe that there is not presently a substantial amount of evidence for conflicts of interest or ratings shopping in these markets, for two primary reasons:

1. **There is recent evidence that corporate credit ratings for leveraged firms are, in fact, very conservative relative to the risks these enterprises face.** For example, in the early months of the pandemic, credit ratings of hundreds of firms with obligations issued in the syndicated loan market were downgraded by NRSROs at levels far exceeding downgrade levels at the height of the Global Financial Crisis (GFC). In May of 2020, the downgrade-to-upgrade ratio for loans listed in the S&P/LSTA Leveraged Loan Index was 43.20, more than five times the 8.45 rate from January



2009.¹ Commensurate with these record downgrades, predicted default rates increased significantly, and some analysts predicted default rates approaching financial crisis levels.²

While default rates temporarily increased, substantial increases in default rates did not occur. The leveraged loan default rate peaked at just over 4% in September 2020. Since then, it has continued to fall and now sits at around 1%, lower than what it was prior to the pandemic.³ As a result of this better-than-expected performance, ratings agencies have corrected their corporate ratings, and in the loan market we are now seeing upgrades exceed downgrades at the fastest rate since 2012.⁴

2. **Claims of ratings inflation in the CLO markets have been overstated.** While corporate credit ratings are largely believed to conform to best disclosure practices, it has been alleged that ratings for securitized products, including CLOs, do not conform to best practices because of the products' complexity. When CLO tranche downgrades remained relatively stable during the pandemic even while corporate ratings were downgraded at high rates, some academic researchers and analysts assumed the corporate downgrades were accurate and the CLO downgrades were inaccurate. Further, they took this mismatch to indicate a conflict of interest in the CLO ratings market.⁵

The test of time has in fact proven that CLO ratings were more resilient than the corporate credit ratings. This is evidenced not only by the fact that the corporate ratings have been readjusted upward in recent months but also by the fact that CLOs themselves have proven to be fundamentally sound. Returns on CLO equity tranches—i.e., the riskiest or “first-loss” tranches—exceeded 11% in 2020, continuing a run of 10 consecutive years of double-digit returns.⁶ Such

¹ Reuters, “U.S. leveraged loan downgrade ratio five times worse than 2009-09,” June 4, 2020. Available here: <https://www.reuters.com/article/uk-health-coronavirus-leveraged-loans-gr-idUKKBN23B2HC>

² LSTA “Loans & Covid-19: Market vs Credit Impact,” March 12, 2020. Available here: <https://www.lsta.org/news-resources/loans-covid-19-market-vs-credit-impact/>

³ S&P Leveraged Commentary & Data, “Leveraged loan default rate tumbles to 1.73%, lowest level since December 2019,” June 2, 2021. Available here: <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/leveraged-loan-default-rate-tumbles-to-1-73-lowest-level-since-december-2019-64793803>

⁴ S&P Leveraged Commentary & Data, “Leveraged loan market upgrades outpace downgrades at fastest rate since 2012,” May 11, 2021. Available here: <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/leveraged-loan-market-upgrades-outpace-downgrades-at-fastest-rate-since-2012-64108167>

⁵ See, for instance: Griffin, John M. and Jordan Nickerson, “Are CLO Collateral and Tranche Ratings Disconnected?” November 2020. Available here:

<https://poseidon01.ssrn.com/delivery.php?ID=665084071084093109084080095067091074057022040093022044117124118105124091093082064074107049044100122125039011079001122092115030026027063013080112090094075115097105076042065010074119085074027070111123068117026094008065111012113013068123074118008124008000&EXT=pdf&INDEX=TRUE>

⁶ S&P Leveraged Commentary & Data, Quarterly Review, 1Q21



strong performance has led to heightened demand in 2021, resulting in the highest level of CLO issuance on record through the first six months of any year.⁷

In addition to these factors, we encourage the members of the Subcommittee to consider the other good reasons for not endorsing the bill—reasons that will no doubt be provided by other organizations in greater and more effective detail and that we likewise endorse, including the following:

- *The SEC has studied the issue twice and both times decided against an assignment model.* The SEC studied the potential application of an assignment model on two separate occasions—once during a Democratic administration and once during a Republican administration. Both times the SEC concluded against the assignment model, instead endorsing a more conservative approach. Following its most recent examination, conducted by the SEC’s Fixed Income Market Structure Advisory Committee (FIMSAC) and concluded in 2020, the FIMSAC recommended strengthening disclosure as a more appropriate response.⁸
- *A Credit Rating Agency Board would shift conflicts of interest instead of eliminating them.* The creation of a rating agency board would not eliminate potential conflicts of interest; it would just shift them from one source to another. In an issuer-pays model, measures must be taken to ensure that issuers don’t influence ratings. Likewise, in a government-chooses model, measures would have to be taken to make sure that the government doesn’t influence ratings. In either event a potential conflict arises, and it is not clear which conflict is more likely to occur.
- *The assignment model would encourage agencies to rate to the Board’s criteria instead of credit quality standards.* If governed by a board that assesses the quality of ratings, ratings agencies would likely rate to the board’s criteria rather than to their own standards of credit quality. This could artificially limit the breadth of information the ratings agencies would be willing to consider in their methodologies, making their ratings less useful for investors. For example, the ratings agencies could be incentivized to be overly conservative in their initial ratings or to hesitate to downgrade during an important credit event, since such actions might be rewarded in Board assessments.
- *The assignment model would reduce competition and information quality.* An assignment model would treat credit ratings like a commodity and reduce competition among the agencies. Improvement in the accuracy of credit ratings would no longer serve as a basis for differentiation, reducing the quality of information for investors.

⁷ S&P Leveraged Commentary & Data, Quarterly Review, 2Q21

⁸ U.S. Securities and Exchange Commission, Fixed Income Market Structure Advisory Committee, *Recommendation Regarding Ways to Mitigate Conflicts of Interest in Credit Ratings*, June 1, 2020. Available here: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-recommendations-credit-ratings-subcommittee.pdf>



- *A Credit Rating Agency Assignment Board would lead to delays and inefficiencies.* The presence of an intermediary between the rating agency and the issuer would increase time to market and make the formation and distribution of capital less efficient. Switching between rating agencies, as would happen under an assignment model, would increase the time and resource cost for issuers, who would pass these costs onto investors.
- *Sophisticated investors perform their own credit analysis.* While credit ratings provide valuable insight into the credit worthiness of borrowers and of structured products, they are neither the sole nor final authority on credit quality. Credit ratings are only a part of the unique and proprietary credit analysis process performed by investors themselves.

We thank the committee for the opportunity to submit comments on this important matter, and we encourage thoughtful consideration of all relevant facts, including those outlined above. We believe credit ratings and ratings for securitized products—CLO tranches most especially—to be fundamentally sound. We look forward to continued engagement with the Subcommittee and would be pleased to discuss these matters in greater detail.

Sincerely,

Lee Shaiman
Executive Director
Loan Syndications & Trading Association

Cc: The Honorable Maxine Waters
The Honorable Patrick McHenry



National Association of Corporate Treasurers
2961-A Hunter Mill Road – Suite 658
Oakton, VA 22124-1704
www.nact.org

July 28, 2021

The Honorable Brad Sherman
 Chairman
 Subcommittee on Investor Protection,
 Entrepreneurship and Capital Markets
 U.S. House of Representatives
 Washington, DC 20515

The Honorable Bill Huizenga
 Ranking Member
 Subcommittee on Investor Protection,
 Entrepreneurship and Capital Markets
 U.S. House of Representatives
 Washington, DC 20515

**Re: Subcommittee Hearing of July 21, 2021 “Bond Rating Agencies: Examining the
 ‘Nationally Recognized’ Statistical Rating Organizations” – Comments for the Hearing Record**

Dear Chairman Sherman and Ranking Member Huizenga:

On behalf of the National Association of Corporate Treasurers (“NACT”) and treasurers across the country, I am writing to provide our views as you consider potential legislation affecting the publicly available ratings of the debt our treasurers’ companies issue to finance their day-to-day operations and keep our economy functioning and growing. NACT is an organization of treasury professionals from some of the largest public and private corporations, as well as many Main Street companies from across the country. Corporate treasurers have the primary responsibility to safeguard their companies’ cash and investments as well as to arrange financing to sustain operations and to provide for future growth.

In these times of rapid change and as we continue to recover from the effects of COVID-19, corporate treasurers need to move quickly to ensure their companies have ready access to the funds they need. This requires them to make sure that their banks and those who purchase the debt securities they issue have all the information they need to make what they hope will be a positive decision to advance them funds. Credit rating agencies (“CRAs”) perform a vital function in this process by devoting their long experience and industry knowledge to understanding the details of the business plans, market positioning and growth prospects, quality and success of management, and many other factors affecting the current and future financial performance of the companies they rate.

Corporate treasurers usually act as the main point of contact with the CRAs. They devote much time to making sure the CRAs have the information they need and to answer whatever

The Honorable Brad Sherman and The Honorable Bill Huizenga
 U.S. House Subcommittee on Investor Protection, Entrepreneurship and Capital Markets
 July 26, 2021
 Page 2

questions the CRAs' analysts may have. As part of this process, CRA analysts ask tough and probing questions. Corporate treasurers in their roles as issuers find that CRAs seek to manage potential conflicts that arise in their business model, since the CRAs depend to a significant degree upon their reputations and the confidence both investors and issuers have in their ratings. Banks and purchasers of debt securities rely on the CRAs' reports as one part of the full picture of a company's creditworthiness they build up to make their credit decisions. The typical relationship issuing companies have with credit rating agencies involves the company choosing which agencies they feel will be capable of understanding their current business position and future prospects and will be the best positioned to convey that information to the banks, institutional investors, and other providers of capital on which they rely. This choice involves an assessment of the experience the rating agency has with the company's business sector – and that knowledge is by no means uniform across all credit rating agencies. As debt issuers, we enter into detailed fee-paid agreement with the chosen rating agency specifying the responsibilities of both parties. This is a competitive fee-for-service model that has served us and the markets well over many years.

I was, most recently for 15 years, treasurer of a large U.S.-based multinational chemical manufacturer. Like most issuers, we chose CRAs that knew our industry and were committed to maintaining that expertise by covering a range of companies in the industry as well as training analysts to be industry knowledgeable and able to render the required expert judgements. We are able to base our assessment of this choice on a variety of factors, including the performance data that CRAs provide to the market. Certainly, we considered how many other companies in our industry the CRA covered and how many of their securities they rated. The investor side is also important. Good CRAs inform their opinions by considering questions from investors on an issuer. Crucially, we take into account the feedback that we receive from the investors to whom we sell this debt and are conscious of which CRAs they consult. This involves a virtuous cycle sustained by the constant flow of information among issuers, rating agencies, and investors. Small CRAs or those without industry expertise are fundamentally unable to participate in these extensive exchanges. Equally important is how disrupting the current model could impede the efficiency of the debt markets, slowing corporate access to funding and our ability to respond agilely to fast-moving debt market conditions, if we had to await an assignment to a CRA for a given transaction.¹ I can only urge you to consider the importance of this and to reject any effort to legislate the relationship among borrowers, lenders, and CRAs, especially imposing some mandatory assignment or rotation system disrupting these relationships.

¹ It is worth highlighting that when the SEC studied the rotation model in 2012, the report found:

Assessing the capacity and expertise of each Qualified NRSRO on an ongoing basis could be a fairly complex process. If not done properly, the selection process could misallocate initial ratings assignments to Qualified NRSROs that do not have sufficient resources to handle the volume of assignments or the inhouse expertise to rate a type of transaction. This could result in lower quality credit ratings or cause delays in bringing ... products to market.

See [Report to Congress on Assigned Credit Ratings, As Required by Section 939F of the Dodd-Frank Wall Street Reform and Consumer Protection Act \(December 2012\)](#) – page 75.

The Honorable Brad Sherman and The Honorable Bill Huizenga
U.S. House Subcommittee on Investor Protection, Entrepreneurship and Capital Markets
July 26, 2021
Page 3

The dynamic nature of business activity and the financial markets we use often require issuers to test the likely ratings outcomes of strategic acquisitions or divestments and the associated financings or debt paydowns. Many corporations use the ratings evaluation or assessment services of the large CRAs. This involves providing confidential information about a potential acquisition or divestment and receiving the judgement of the CRA's ratings committee of the rating consequence qualified by the assumptions given. Not being able to engage quickly with a CRA that already understands the issuer's base business and is thereby able to assess quickly the proposed change, could impair the prospects for achieving a successful strategic change. Depending on a government agency or board to make an assignment of a prospective issuer to a rating agency would be very disruptive to this process, especially with the wide variability of industry expertise and sector coverage across the range of all CRAs that could possibly result in assignment to a CRA without the sufficient qualifications to render the required expert judgements.

In summary, we caution against actions that could be disruptive to companies' ability to finance their business activity in these times of such dynamic change, or the markets more broadly. CRAs play an active role in providing their judgment based on interactions among issuers and investors. While credit ratings are just one element of a lender's credit decision, they are important and a disruption of those interactions by a government-mandated matching of issuers and CRAs would likely have a significant adverse impact. We are concerned that a government-controlled assignment or rotation system could reduce the incentive for CRAs to compete based on the quality of their ratings and their knowledge of the issuer and its industry sector. It must be acknowledged that competition based on quality and price of services is a model that has served us and markets well – let's not disrupt that for a less responsive bureaucratic, mandated process.

Respectfully submitted,



Thomas C. Deas, Jr.
Chairman

Hearing Title: "Bond Rating Agencies: Examining the 'Nationally Recognized' Statistical Rating Organizations."

Hearing Date: July 21, 2021

Requesting Member: Rep. Juan Vargas (D-CA-51)

Name of Witness: Ian Linnell, President, Fitch Ratings

Question: Mr. Linnell, could you please provide insight into how Fitch Ratings' Credit Committee calculates its ESG Relevance scores from 1 to 5 across various corporate sectors and geographical regions? Additionally, why is it important to rate a company from 1 to 5?

Answer: The ESG Relevance scores that our analysts produce are an observation on how much E S or G factors have influenced the credit rating outcome for a specific entity, transaction or program. The credit analyst who makes the rating recommendation to the Credit Committee completes their analysis using our credit ratings criteria (both quantitative and qualitative analysis) and then, having come up with a recommendation, fills out the ESG navigator template for the relevant industry sector to display how much E S or G factors have influenced the rating decision. Once the committee determines the rating, the ESG relevance score sheet is examined to ensure it reflects the decision. If the committee outcome varies from the recommendation then the ESG navigator for that rating decision is adjusted at the end of the committee if there are any changes to influence from E S or G factors.

We have over 100 sector-based ESG navigator templates which indicate the relevance of ESG issues to a particular industry or sector, and these are freely available on our website as an excel compendium. These templates are all based on a set of high-level general risk issue categories for environmental, social and governance risk factors. These general issues are consistent across templates for all revenue supported entities, but social and governance categories are slightly different for tax supported entities and structured finance transactions (see table below).

Environmental	Social	Governance
GHG Emissions & Air Quality	Human Rights, Diversity & Inclusion	Management Strategy
Energy Management	Customer Welfare: Fair Messaging, Privacy & Data Security	Governance Structure
Water & Wastewater Management	Labor Relations & Practices (+ IPF: GREs, USPF: Revenue)	Group Structure
Waste & Hazardous Materials Management, Ecological Impacts	Employee Wellbeing	Financial Transparency
Exposure to Environmental Impacts	Exposure to Social Impacts	Political Stability and Rights
Water Resources & Management	Human Rights & Political Freedoms	Rule of Law, Institutional & Regulatory Quality, Control of Corruption
Biodiversity & Natural Resources Management	Human Development, Health & Education	International Relations & Trade
Natural Disasters & Climate Change	Employment & Income Inequality (Sovereign Only)	Creditor Rights
	Public Safety & Security	Data Quality & Transparency
	Population Demographics (Sovereign Only)	Rule of Law, Institutional & Regulatory Quality
	Demographic Trends (IPF: GREs, USPF: Tax Only)	Transaction & Collateral Structure
		Transaction Parties & Operational Risk
		Data Quality & Privacy

Applies to All Analytical Groups

Applies to Corporates, Financial Institutions, IPF: GREs, USPF: Revenue, Infrastructure, Structured Finance

Applies to Corporates, Financial Institutions, IPF: GREs, USPF: Revenue, Infrastructure

Applies to Sovereigns, IPF: Local and Regional Governments, USPF: Tax

Applies to Structured Finance and Covered Bonds

For each general risk issue category we list the sector specific risk factors that our analysts considered relevant from a credit perspective to entities in the sector which the ESG navigator template represents (eg automotive manufacturers, asset back security transactions, non-life insurers etc). Alongside the sector specific risks we have a reference column which illustrates the main aspects of analysis within our traditional ratings criteria that these risks might impact if they materialized (eg profitability, financial structure, brand positioning etc).

Fitch's ESG Scoring Template: The Example of Auto Manufacturers

Environmental (E)

General Issues	E Score	Sector-Specific Issues	Reference
GHG Emissions & Air Quality		Emissions and pollutants from vehicles sold	Brand Positioning; Profitability; Financial Structure
Energy & Fuel Management		Fuel economy requirements of the product	Brand Positioning; Profitability; Financial Structure
Water & Wastewater Management		Water usage in manufacturing	Competitive Position; Cost Structure; Profitability; Financial Structure
Waste & Hazardous Materials Management; Ecological Impacts		Waste and recycling in manufacturing operations; use of environmentally friendly materials	Brand Positioning; Profitability; Financial Structure

Social (S)

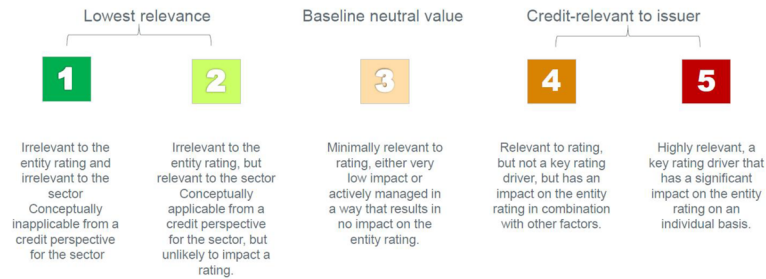
General Issues	S Score	Sector-Specific Issues	Reference
Human Rights, Community Relations, Access & Affordability		n.a.	n.a.
Customer Welfare - Fair Messaging, Privacy & Data Security		Data security; vehicle safety	Brand Positioning; Profitability
Labor Relations & Practices		Impact of labor negotiations and employee (dis) satisfaction	Cost Structure; Profitability
Employee Wellbeing		n.a.	n.a.
Exposure to Social Impacts		Cities' focus on promoting less vehicle ownership; shift in consumer preferences toward cleaner energy	Profitability

Governance (G)

General Issues	G Score	Sector-Specific Issues	Reference
Management Strategy		Strategy development and implementation	Management and Corporate Governance
Governance Structure		Board independence and effectiveness; ownership concentration	Management and Corporate Governance
Group Structure		Complexity, transparency and related-party transactions	Management and Corporate Governance
Financial Transparency		Quality and timing of financial disclosure	Management and Corporate Governance

The analyst assigns a score from 1 to 5 for each of 5 general risk issue categories for environment, 5 categories for social and 4 or 5 categories for governance (depending on the template). The scores provide a detailed observation at an entity, transaction or program level of how an individual ESG factor has, or hasn't, impacted the credit rating decision. The scores assigned represent the following:

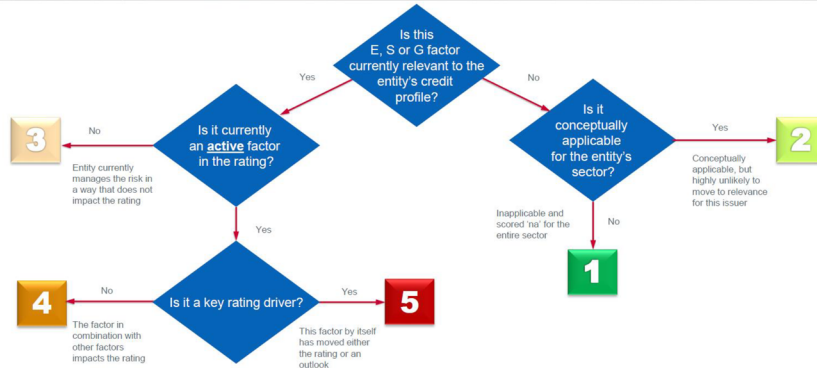
How Are We defining Relevance - Issuer Scoring Scale



Source: Fitch Ratings

The scores are based on the credit rating decision of the committee and are important as they provide a clear indication as to whether individual E S or G factors have had a material impact on the rating decision. As they are based on the forecasts that are used for the credit rating decision they are completely aligned with the credit rating, and clearly and transparently display whether there was any perceived credit impact from ESG in the credit rating derived from the forecasts.

A Decision Tree to Show How We Define Relevance & Materiality to Credit



The scores are based purely on credit impact and are not subject to influence from ethical / moral / good or bad behavior, unless there is perceived to be a credit consequence to that behaviour which

could materialize within the forecast period. In this respect the scores highlight and illustrate where there are differences in credit consequences for entities in the same industry sector but based in different jurisdictions (eg electric utilities in Europe suffer greater consequences to credit profiles from environmental risk factors than in the US or Asia due to carbon pricing and regulation), as well as between entities in the same jurisdiction based on their operational and financial profiles.

This is important as it goes beyond a pure 'sector based view' and shows how exposure to different jurisdictions has different credit consequences at an entity and transaction level, as well as how company structures and operating practices can influence credit outcomes for different entities even if they experience the same type of risk.

