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United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

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RANKING MEMBER

May 6, 2022

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: May 11, 2022, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets Hearing entitled, "A Notch Above? Examining the Bond Rating Industry."

The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, "A Notch Above? Examining the Bond Rating Industry" on Wednesday, May 11, 2022, at 10:00 am in room 2128 of the Rayburn House Office Building and on the Cisco Webex platform. There will be one panel with the following witnesses:

- **Yann Le Pallec,** Executive Managing Director, Head of Global Ratings Services, S&P Global Ratings
- **Angela Liang**, General Counsel and Executive Committee Member, Kroll Bond Rating Agency
- **Ian Linell**, President, Fitch Rating
- **Mariana Gomez-Vock**, Senior Vice President of Policy and Legal, American Council of Life Insurers
- **Jennifer J. Schulp,** Director of Financial Regulation Studies, Cato Institute

Overview

Bond or credit rating agencies are Securities and Exchange Commission (SEC) registered and regulated entities that assign creditworthiness ratings to public and private institutions and the individual debt instruments these institutions issue. Market participants, including retail and institutional investors, commonly use credit ratings to determine whether to invest in bonds and other debt instruments. The three largest Nationally Recognized Statistical Ratings Organizations (NRSROs)— S&P, Moody's, and Fitch—collectively provided 95% of all available ratings outstanding as of December 31, 2020[1] and employ an "issuer pays" model wherein the rating agencies are compensated by the issuers of the securities that they rate. This model has been criticized as a source of significant conflicts of interest that may contribute to biased ratings because rating agencies have an incentive to provide issuers with favorable ratings to ensure they remain customers.[2] Such perceived and actual conflicts contributed to the 2008 financial crisis.[3]

[1] CRS using data from SEC, *Staff Report on Nationally Recognized Statistical Rating Organizations*, Jan. 2022, available at https://www.sec.gov/files/2022-ocr-staff-report.pdf.
[2] For example, *see* Samuel B. Bonsall, Jacquelyn Gillette, Gabriel Pundrich, and Eric So, "Conflicts of Interest in Subscriber-Paid Credit Ratings," *SSRN*, Apr. 2022, available at http://dx.doi.org/10.2139/ssrn.3931024. Egan-Jones is a NRSRO whose business model entails being paid by subscribers to its rating results, not the entities who issue the rated securities. This is known as the subscriber-pays model and is often praised as an alternative rating agency business model without the inherent conflicts found in the issuer-payer structure. Examining corporate bonds rated by Egan-Jones, this study found that the rater "optimistically bias[ed] their ratings to bolster subscriber revenue, which allows institutional clients to invest in riskier bonds with higher expected returns…. [It concluded that this] suggest[s] that the emergence of subscriber-paid rating agencies as an alternative to more traditional issuer-paid agencies is unlikely to resolve problems arising from conflicts of interest."
[3] For example, *see* Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, Jan. 2011, available at https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

Congress has also enacted legislation to address some of these conflicts and increase the number of rating agencies by expanding NRSRO eligibility.[4]

Overseen by the SEC's Office of Credit Ratings, NRSROs are statutorily subject to, among other things: (1) various reporting and examination requirements; (2) required disclosure of their ratings methodology; (3) requirements that their analysts pass qualifying examinations; (4) potential deregistration by the SEC; and, (5) prohibitions on engaging in certain unfair, coercive, or abusive practices to the extent they are practiced with an anticompetitive effect. [5] NRSROs are also subject to rules on managing certain conflicts of interest and rules that provide outright prohibitions on other conflict of interest scenarios.[6]

The S&P Proposal

In December 2021, S&P published a request for comment regarding its proposed methodology for analyzing the risk-based capital (RBC) adequacy of insurers and reinsurers ("S&P Proposal"), including a controversial proposal for how it would use the ratings from other NRSROs of securities owned by insurers and reinsurers.[7] In general, when providing ratings for insurance companies, S&P analyzes the credit risk (i.e., risk of default) by reviewing the individual risks of the assets owned by the insurer, including bonds, loans, credit derivatives, mortgages, and counterparty credit exposure relating to reinsurance contracts, deposits, and over-the-counter derivative contracts.

When an NRSRO is contracted to perform an analysis of a pool of securities or, for example an insurance or reinsurance company, it may incorporate the ratings other NRSROs assigned to the underlying assets into its own analysis of the pool's risk profile. Notching is a practice in which an NRSRO marks up or down those individual credit ratings by other bond rating agencies. SEC Rule 17g-6(a)(4) generally prohibits notching when it is engaged in for an anticompetitive purpose.[8] The rule reads:

> "A [NRSRO] is prohibited from engaging in any of the following unfair, coercive, or abusive practices... Issuing or threatening to issue a lower credit rating, lowering or threatening to lower an existing credit rating, refusing to issue a credit rating, or withdrawing or threatening to withdraw a credit rating, with respect to securities or money market instruments issued by an asset pool or as part of any asset-backed securities transaction, unless all or a portion of the assets within such pool or part of such transaction also are rated by the nationally recognized statistical rating organization, where such practice is engaged in by the nationally recognized statistical rating organization for an anticompetitive purpose."

Under the S&P Proposal, an insurer's assets rated by other NRSROs would be assigned lower credit ratings (that is, notched down) using a multi-step process:[9,10]

- If S&P has an existing rating or alternative method to determine the rating, the model will use those ratings and methods.

[4] Notable examples include the Credit Rating Agency Reform Act (P.L. 109-291) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act; P.L. 111-203).
[5] *See* generally, SEC, "Updated Investor Bulletin: The ABCs of Credit Ratings," available at https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/updated-8 (Accessed May 6, 2022).
[6] *Id*.
[7] S&P Global Ratings, *Request For Comment: Insurer Risk-Based Capital Adequacy--Methodology and Assumptions*, December 2, 2021, at https://www.spglobal.com/ratings/en/research/articles/211206-criteria-insurance-general-request-for-comment-insurer-risk-based-capital-adequacy-methodology-and-assum-12155699 (hereinafter S&P, *Request for Comment*).
[8] 17 C.F.R. § 240.17g-6.
[9] National Association of Insurance Commissioners, *NAIC Shares Letters with Congress Regarding S&P Global's Proposed Capital Model*, Mar. 9, 2022, available at https://content.naic.org/article/naic-shares-letters-congress-regarding-sp-globals-proposed-capital-model.
[10] S&P, *Request for Comment*, Paragraph 70.

- Absent internal ratings and methods, S&P would apply mapping[11] criteria on other NRSROs' ratings (if mapped) to determine the input rating.
- S&P would apply assumptions based on certain economic risk groupings for unrated securities other than structured finance instruments.
- For unrated structured finance instruments, S&P assumes a CCC rating[12] corresponding to the most junior tranches of a securitization.[13]
- If a rating cannot be determined by previous steps and S&P determines that a bond or a loan faces non-payment risk, it would assume a CCC rating for the asset.

Regarding mapping, as mentioned in the second bullet above, S&P specifies the following in the new proposal:[14]

> Suppose we have determined that a mapping is possible for a CRA (see our criteria for mapping a third party's internal credit scoring system). In that case, we may determine the corresponding rating input by applying the statistical analysis described in step 3 of our mapping criteria to the credit rating scale of the other CRA. All CRAs are eligible for consideration when assessing the underlying rating input. We have completed a mapping of Moody's and Fitch ratings in the scope of this section as of the date of publication. When we apply the criteria relating to other CRAs, we look to the long-term Moody's or Fitch issue rating and apply the following adjustments:
>
> - Corporate and government ratings: We lower the rating by one notch for investment-grade ratings and by two notches for speculative-grade ratings to determine the rating input. When both CRAs rate the issue, we use the lowest of all the notched ratings.
> - Structured finance ratings: We lower the rating, in general, by three notches if it is rated by only one of the two CRAs. When both CRAs rate the issue, we may lower the lowest rating by two notches.

Under S&P's Proposal, although all NRSROs are eligible for consideration, S&P plans to only apply the mapping of Moody's and Fitch (with some downward adjustments for RBC calculations) at the time the when the Proposal was released. The Proposal does not specify the reasons why S&P plans to notch down so significantly the ratings of its medium- and small-size competitors. This has led some NRSROs to interpret the Proposal to mean that S&P intends to not accept the ratings of some of S&P competitors. For example, KBRA (*aka* Kroll Bond Rating Agency), one of the NRSROs whose ratings are not mentioned in the Proposal, interpreted the Proposal as follows:[15]

> [T]o the extent an insurance company holds a security rated by S&P, that rating will be taken at face value when S&P calculates the insurance company's capital charge associated with such security; (2) if the security is rated by Moody's and/or Fitch, the rating will be lowered one to three notches; and (3) if the security is rated

[11] *Ratings mapping* is essentially creating a table or a schedule that shows the correspondence of ratings between two (or more) rating agencies based on likelihood of credit loss. For example, the table would show that an "Aa1" rating by Moody's correspondence to an "AA+" rating issued by S&P Ratings.
[12] A "CCC" rating by S&P signals a "below investment grade", "non-investment grade," or "speculative-grade" and assumes "very vulnerable" financial condition of the issuer. For bonds, a S&P rating of CCC are known as junk bonds.
[13] S&P, *Request for Comment*, Table 38.
[14] *Id.* at Paragraph 187.
[15] KBRA, "KBRA Releases Commentary on S&P's Proposed Updates to Its Insurer Risk-Based Capital Adequacy Methodology and Assumptions," *Business Wire*, Apr. 18, 2022, available at https://www.businesswire.com/news/home/20220418005486/en/KBRA-Releases-Commentary-on-SP%E2%80%99s-Proposed-Updates-to-Its-Insurer-Risk-Based-Capital-Adequacy-Methodology-and-Assumptions.

> by any other credit rating agency (CRA), the security will be notched down to as low as CCC, depending on asset class and country."

According to a J.P. Morgan Asset Management study of the proposal, amongst the assets reported by insurance companies, around 11% of the assets did not have S&P ratings but did have either Moody's or Fitch ratings.[16] It also estimates that 2% of assets have ratings from NRSROs other than Moody's, S&P, and Fitch.[17] About 68% of assets had an S&P rating and about 19% had no public rating at all.[18]

Policy Considerations Related to S&P Proposal

The practice of notching and S&P's Proposal regarding insurance company rating methodology has attracted much debate, including a recent comment from Department of Justice's Chief of Antitrust Division, stating that S&P's actions "could raise significant concerns that the Sherman Act has been—or will be—violated and warrant additional scrutiny by the Antitrust Division."[19] As noted above, SEC Rule 17g-6(a)(4) generally prohibits notching in structured products when it is engaged in for an anticompetitive purpose. But in practice, the rule is difficult to implement because although notching clearly has anticompetitive *effects*, it is difficult to demonstrate that the *purpose* of notching is anticompetitive.[20] Because the credit rating of a company would affect its cost of financing, critics of notching postulate that the S&P Proposal appears to view the assets rated by other NRSROs as less creditworthy, thus incentivizing asset issuers to obtain ratings from S&P.[21] This practice potentially challenges the accuracy of securities pricing and could directly interfere with other NRSROs business operations, and their ability to compete and develop market share. Although the methodologies of all SEC-registered NRSROs are publicly available (and the process of setting these methodologies (but not the content) are regulated and examined by the SEC), and the ratings (and the performance of these ratings) are publicly available, S&P staff have briefed the Committee that S&P still lacks adequate visibility into and confidene in the ratings of their competitors, particularly the medium and smaller NRSROs. In any case, the reasons why S&P plans to significantly mark down or notch down the ratings of its medium- and small-size competitors are not described in the Proposal.

Random Assignment Rating Agency Mechanism

In an attempt to help remedy the perceived issuer-payer model conflict of interest biases, the Dodd-Frank Act directed the SEC to study alternative approaches to NRSRO compensation. After the study, the SEC was authorized to do rulemaking for a system that randomly assigned NRSROs to do initial credit ratings and then provide subsequent ratings monitoring for structured finance products. The ensuing 2012 SEC staff study found that the random assignment model could mitigate issuer-payer conflicts but also might fail to do so because issuers could continue "rating shopping" and hire other NRSROs to provide supplemental credit ratings.[22] Since then, the SEC has opted not to pursue any rulemaking on the random assignment mechanism.

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[16] J.P. Morgan Asset Management, *Proposed Changes to S&P's Insurance Capital Model—Getting Into the Details*, Mar. 24, 2022, available at https://am.jpmorgan.com/us/en/asset-management/institutional/investment-strategies/insurance/insights/s-and-p-proposed-capital-model-changes/#.
[17] Although J.P. Morgan also notes specifically that data limitations may have created underestimation for this share.
[18] *Id.*
[19] An Apr. 29, 2022 Letter from Jonathan Kanter, Assistant Attorney General, U.S. Department of Justice, Antitrust Division, available at https://www.justice.gov/atr/page/file/1497956/download (Accessed May 4, 2022).
[20] Herwig Langohr and Patricia Langohr, *The Rating Agencies and Their Credit Ratings: What They Are, How They Work, and Why They are Relevant* (John Wiley & Sons, 2010), p. 459.
[21] Leah Nylen, "S&P Global 'Power Grab' Sparks Congressional Pushback," *Politico*, Feb. 25, 2022, available at https://www.politico.com/news/2022/02/25/s-p-insurance-power-grab-sparks-rival-congressional-pushback-00010344.
[22] SEC, "Report to Congress on Assigned Credit Ratings As Required by Section 939F of the Dodd-Frank Wall Street Reform and Consumer Protection Act," Dec. 2012, available at https://www.sec.gov/files/assigned-credit-ratings-study.pdf.

Bond Rating Agencies Reaction to Russia's Invasion

While the largest bond rating agencies have announced[23] their intentions to suspend their business activities in Russia, there remains questions regarding the specifics of this withdrawal or the business exposures of the medium or smaller NRSROs. As part of its March 15, 2022 package of sanctions, the European Union required the largest three bond rating agency to withdraw from Russian markets, and the bond rating agencies had until April 15 to withdraw their ratings[24] but a similar announcement has not come from the SEC or U.S. government entities responsible for imposition of sanctions (beyond the blocked entities), and it is not clear whether the NRSROs are still doing business in Russia.

Legislation

- H.R.___, Notching Prohibition Act (discussion draft) : The bill would prohibit the practice of notching by SEC registered NRSROs. Notching is when an NRSRO refuses to rate securities issued by an asset pool or as part of any asset-backed or mortgage-backed transaction because it has not rated all the underlying portfolio assets.
- H.R.___, Commercial Credit Rating Reform Act (discussion draft) (Sherman): This bill would require the establishment of a credit rating agency assignment board within the jurisdiction of the SEC, which would be responsible for assigning NRSROs to provide ratings for corporate issuers and issuers of new asset-backed securities.
- H.R.___, No More Ratings For Russia and Belarus Act (discussion draft). The bill would prohibit all of SEC registered bond rating agencies from engaging in any new—and would require such agencies to terminate all—business with any Russia- or Belarus-related entities, including the governments (or any political subdivision or instrumentality) of Russian Federation and the Republic of Belarus.
- H.R.___, Credit Rating Liability Act (discussion draft). This bill would impose liability on NRSROs which commit gross negligence in issuing a credit rating which it consents to being referred to in an SEC registration statement.
- H.R.___, Credit Rating Standardization Act (discussion draft). This bill would direct the SEC to issue rules to require all NRSROs to use a uniform set of credit ratings for each of the six categories of credit ratings recognized under the Securities and Exchange Act.

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[23] *See* S&P's Mar. 21, 2022 announcement to withdraw ratings for Russia entities, *available* at https://www.reuters.com/business/sp-global-withdraw-all-outstanding-ratings-russian-entities-2022-03-21/; also, *see* Moody's March 5, 2022 announcements to "suspend commercial operations in Russia," *available* at https://www.businesswire.com/news/home/20220305005006/en/Moody%E2%80%99s-to-Suspend-Commercial-Operations-in-Russia; also, *see* Fitch Rating's Mar. 23, 2022, announcement to withdraw Russian entities' ratings, *available* at https://www.fitchratings.com/research/banks/fitch-ratings-to-withdraw-ratings-on-russian-entities-23-03-2022.

[24] *See* Reuters (Mar. 15, 2022) "EU Bans Top Credit Rating Agencies From Rating Russia and Russian Firms," *available* at https://www.reuters.com/business/eu-bans-top-credit-rating-agencies-rating-russia-russian-firms-2022-03-15/.