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

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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.