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 Sub-Committee, 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

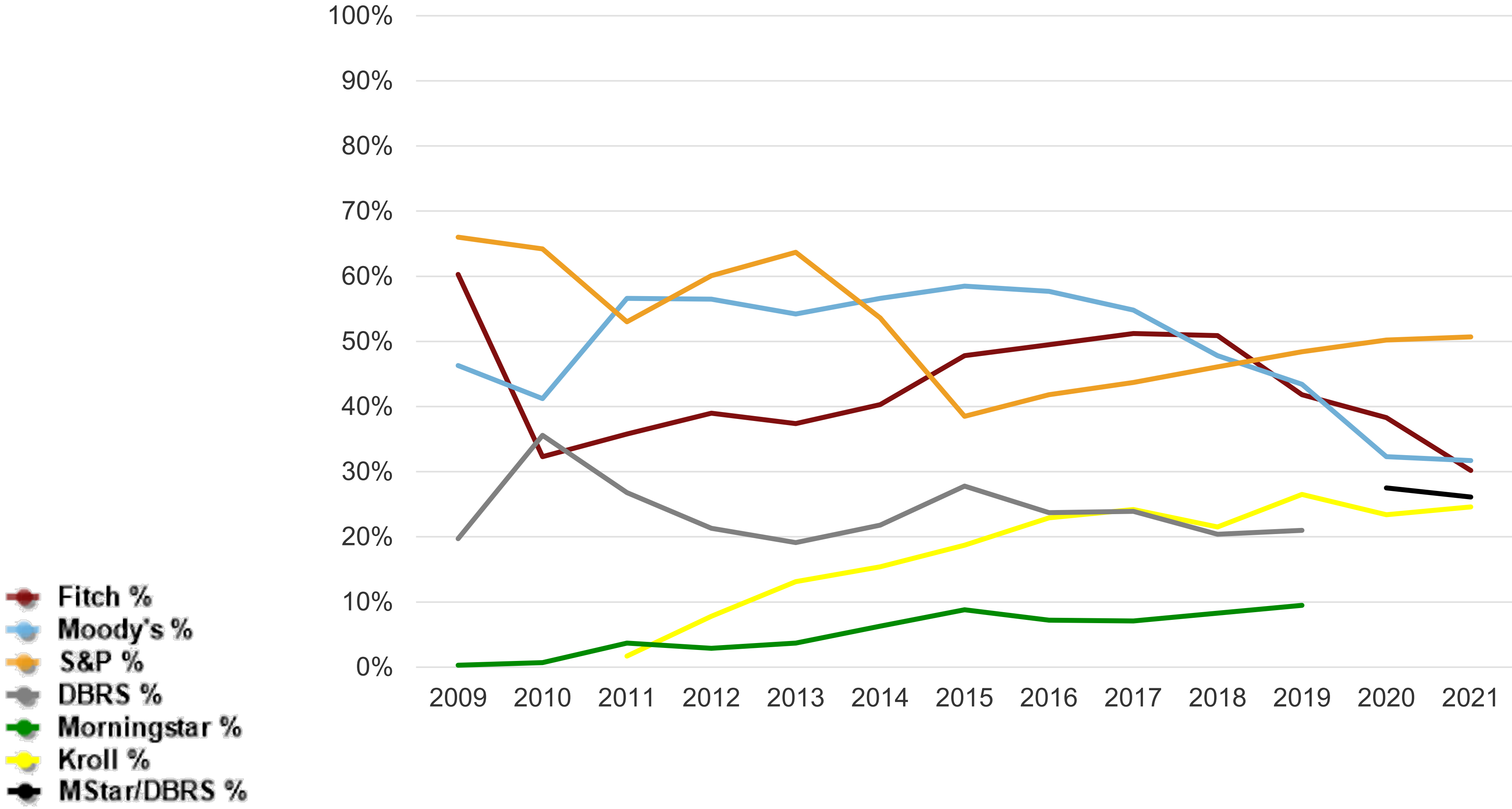
Furthermore, we understand that some members may be contemplating a legislative proposal to require the Federal Reserve Bank, the US Treasury, and other agencies that use ratings in a program to accept the ratings of all NRSROs, regardless of their level of expertise or historical ratings performance. 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