



Testimony of Amy Copeland McGarrity, Chief Investment Officer

Colorado Public Employees' Retirement Association

before the

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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.hsgac.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.hsgac.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/2013-2013-83htm>; 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/rtf06maehlmann.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.