

**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 share<sup>1</sup>, 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.<sup>2</sup>

*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.<sup>3</sup> 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 be by its

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<sup>1</sup> 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.

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

<sup>3</sup> 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 in 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 misrepresented 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