



Testimony

Before the U.S. House Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets
Hearing on “A Notch Above? Examining the Bond Rating Industry”

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May 11, 2022

Chair Sherman, Ranking Member Huizenga, and distinguished members of Subcommittee on Investor Protection, Entrepreneurship and Capital Markets, my name is Jennifer Schulp, and I am the Director of Financial Regulation Studies at the Cato Institute’s Center for Monetary and Financial Alternatives.

I thank you for the opportunity to take part in today’s hearing entitled, “A Notch Above? Examining the Bond Rating Industry.”

The focus of my testimony is on the regulation of Nationally Recognized Statistical Rating Organizations (NRSROs) and competition within the bond rating industry.

There are currently nine NRSROs approved by the Securities and Exchange Commission (SEC), which is tasked with their oversight by Section 15E of the Securities Exchange Act of 1934.¹ In conjunction with Section 15E, Rules 17g-1 through 17g-10 govern registration and oversight of NRSROs. The Commission’s authority is limited, however, as Section 15E prohibits the Commission from regulating “the substance of credit ratings or the procedures or methodologies by which any nationally recognized statistical rating organization determines credit ratings,” and explicitly recognizes that these prohibitions should not “modify, impair, or supersede” the operation of antitrust law.²

Recognizing the importance of competition within the industry to the quality of ratings, Section 15E directs the Commission to issue final rules prohibiting “any act or practice” relating to the issuance of credit ratings by an NRSRO that the Commission determines to be “unfair, coercive, or abusive.”³ The Commission’s rules prohibit, among other things, an NRSRO from “[c]onditioning or threatening to condition the issuance of a credit rating on the purchase by an

¹ Office of Credit Ratings, Securities and Exchange Commission, “Current NRSROs,” available at <https://www.sec.gov/ocr/ocr-current-nrsros.html>.

² 15 U.S.C. § 78o-7(c)(2).

³ 15 U.S.C. § 78o-7(i).

obligor or issuer...of any other services or products” of the NRSRO and “[i]ssuing or threatening to issue a lower credit rating, lowering or threatening to lower an existing credit rating, refusing to issue a credit rating, or withdrawing or threatening to withdraw a credit rating, with respect to securities or money market instruments issued by an asset pool or as part of any asset-based securities transaction, unless all or a portion of the assets within such pool or part of such transaction are also rated by the [NRSRO], where such practice is engaged in by the [NRSRO] for an anticompetitive purpose.”⁴

The state of competition within the bond rating industry is a perennial question, so much so that the Commission is required to make an annual report to Congress that addresses, among other things, its views on the state of competition among NRSROs.⁵ The Commission’s most recent report describes an NRSRO industry that remains concentrated, with the three largest NRSROs accounting for approximately 95% of all outstanding ratings as of the end of 2020.⁶ But, such top line statistics can be deceiving when looking to understand the true state of competition in the ratings industry.⁷ As the Commission points out, smaller NRSROs appear to have increased their total number of ratings outstanding and have increased their ratings share with respect to some ratings categories.⁸

Drawing conclusions from these numbers alone is difficult, particularly when understanding the industry over time. For example, academics have identified a number of factors that may explain the long-term tendency for the ratings industry to be comparatively concentrated.⁹ In addition, and importantly, regulatory barriers also account for decreased competition among NRSROs. For example, the requirement that an applicant provide written statements from investors who have used the agency’s credit ratings for at least three years may block new entrants to NRSRO status.¹⁰ The costs associated with complying with the Dodd-

⁴ 17 C.F.R. § 240.17g-6.

⁵ Credit Rating Agency Reform Act of 2006, Section 6, Pub. L. No. 109-291, 120 Stat. 1327 (Sept. 29, 2006).

⁶ Office of Credit Ratings, Securities and Exchange Commission, Staff Report (January 2022) at 24, available at <https://www.sec.gov/files/2022-ocr-staff-report.pdf> (2021 OCR Report).

⁷ *Id.* at 21-40.

⁸ *Id.* at 21.

⁹ See, e.g., Lawrence J. White, “The Credit Rating Industry: An Industrial Organization Analysis,” NYU Working Paper No. EC-01-02 (February 2001), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1292667; Emily McClintock Ekins and Mark A. Calabria, “Regulation, Market Structure, and Role of the Credit Rating Agencies,” Cato Institute Policy Analysis No. 704 (August 1, 2012) at 19, available at <https://www.cato.org/sites/cato.org/files/pubs/pdf/PA704.pdf>; U.S. Securities and Exchange Commission, Annual Report on Nationally Recognized Statistical Rating Organizations, March 2012, at Section IV.C, available at <https://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0312.pdf>.

¹⁰ See Testimony of Jim Nadler, President and CEO of Kroll Bond Rating Agency, U.S. House Committee on Financial Services, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets, “Bond Rating Agencies: Examining the ‘Nationally Recognized’ Statistical Rating Organizations,” July 21, 2021, available at <https://financialservices.house.gov/uploadedfiles/hhrg-117-ba16-wstate-nadlerj-20210721.pdf>; see also Jay Cochran, III, “An Economic Analysis of the SEC’s Nationally Recognized Statistical Rating Organization (NRSRO) Standard,” Working Papers in Regulatory Studies, Mercatus Center, George Mason University (August 15, 2005) at

Frank Act and its related rules, in addition to the costs inherent in being subject to Commission oversight, may also erect barriers to entry for potential NRSROs.¹¹

Which brings me briefly to the nominal subject of today's hearing, "notching." Notching itself is a general practice by credit rating agencies to give different credit ratings to particular obligations or debts of an issuing entity or closely related entity. This practice is well-established, but the particular question at hand relates to a recent proposal—now withdrawn—by S&P Global Ratings to "notch" ratings of non-S&P rated securities when applying its methodology to rate life insurers' investment portfolios.¹² S&P had proposed updating its Insurer Risk-Based Capital Adequacy Methodology and Assumptions to allow it to notch down the rating of non-S&P rated securities held by the insurance company: for Moody's or Fitch-rated securities, the rating would be lowered one to three notches, and for securities rated by any other credit agency, the security may be notched all the way down to junk status, depending on the asset class and country.

While such "notching" may raise concerns about its potential effect on competition,¹³ it is premature to take any legislative action in response to S&P's proposal. First, the proposal was merely a proposal, which has now been withdrawn in response to critical comments received.¹⁴ Such comments included a letter from the Department of Justice citing concerns that "penalizing insurers that purchase securities rated by S&P's competitors has the potential to raise barriers to entry and expansion by competitors, insulate S&P from competition, or otherwise suppress competition from rival rating agencies."¹⁵ Similarly, a bipartisan group of legislators sent a letter to the Commission regarding S&P's proposal.¹⁶ S&P has indicated that it will issue a new request for comment, incorporating proposed alternatives for the withdrawn elements, after it has had sufficient time to consider the comments received.¹⁷ Because S&P's

8, available at <https://www.mercatus.org/publications/monetary-policy/economic-analysis-secs-nationally-recognized-statistical-rating>.

¹¹ See 2021 OCR Report at 42.

¹² S&P Global Ratings, Request for Comment: Insurer Risk-Based Capital Adequacy – Methodology and Assumptions, available at <https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/2805856>.

¹³ See Fabian Dittrich, "The Credit Rating Industry: Competition and Regulation" *SSRN* (June 4, 2007) at 153, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=991821 (noting that the economic analysis as to anticompetitive behavior on notching and tying is "ambiguous").

¹⁴ See, e.g., S&P Global Ratings, "S&P Global Ratings Withdraws Rating Input Approach From Proposed Insurer Risk-Based Capital Adequacy Criteria," Press Release (May 9, 2022) (S&P Press Release); "KBRA Releases Commentary on S&P's Proposed Updates to Its Insurer Risk-Based Capital Adequacy Methodology and Assumptions," available at <https://www.yahoo.com/now/kbra-releases-commentary-p-proposed-190700785.html>; "Deadline Nears for Comments on S&P Capital Sufficiency Methodology," available at <https://www.jdsupra.com/legalnews/deadline-nears-for-comments-on-s-p-1724713/>.

¹⁵ Comments of the Antitrust Division of the United States Department of Justice, Comment re: Insurer Risk-Based Capital Adequacy – Methodology and Assumptions (April 29, 2022).

¹⁶ Letter to Gary Gensler, Chairman of Securities and Exchange Commission from 26 Members of Congress, re: "Anticompetitive Concerns Regarding 'Notching' in the S&P Proposal" (April 14, 2022).

¹⁷ S&P Press Release.

response may ameliorate any potential anticompetitive concerns—or raise different ones—it would be prudent to delay consideration of any potential legislative action until the issue becomes more clear.

Second, other laws already work to prohibit anticompetitive behavior by NRSROs. In addition to the antitrust laws that apply without regard to industry, Section 15E of the Exchange Act and the rules promulgated to by the Commission pursuant to it, prohibit unfair, coercive, or abusive NRSRO behavior. Rule 17g-6 identifies specific prohibited conduct that may be applicable to anticompetitive notching. To the extent that current law addresses any anticompetitive concerns raised, additional legislation is not required.

Finally, a rush to judgment on type of methodology change offered by S&P’s initial proposal may itself harm the quality of ratings to the extent that it limits the ability of NRSROs to consider the creditworthiness of instruments rated by another agency and forces the agency to simply accept another agency’s ratings at face value.¹⁸

Other than the potential “notching” issue—which is no longer being proposed by S&P—little else has changed since this Committee last held a hearing on NRSROs less than a year ago.¹⁹ Legislative solutions to increase competition in the ratings industry should focus on lowering regulatory barriers to competition or decreasing the artificial demand for ratings conducted by an NRSRO (including by examining the necessity of the designation).²⁰ These aims are not met by legislation like the draft “Commercial Credit Rating Reform Act,” which would assign agencies to provide ratings, thus eliminating the benefits of competition.²¹ Over the long

¹⁸ See, e.g., Leah Nylen, “S&P Global ‘power grab’ sparks congressional pushback,” *Politico*, February 25, 2022, available at <https://www.politico.com/news/2022/02/25/s-p-insurance-power-grab-sparks-rival-congressional-pushback-00010344> (quoting Lawrence J. White, professor at New York University’s Stern School of Business: “I don’t like the idea that this is raising a rival’s cost and may put a little more pressure on bond issuers to get an S&P rating...But I don’t see a good alternative.”); see also Dittrich at 113-114 (differentiating between “notching” and “punitive notching” and finding that market forces make “punitive notching” a limited threat and warning against restricting notching because it would be a “direct influence on the rating methodology”).

¹⁹ See Hearing, “Bond Rating Agencies: Examining the ‘Nationally Recognized’ Statistical Rating Organization,” U.S. House Committee on Financial Services, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets, July 21, 2021, available at <https://financialservices.house.gov/events/eventsingle.aspx?EventID=408110>.

²⁰ Ekins and Calabria at 23-32; Cochran at 7-9.

²¹ The effects of government assignments of ratings may have broader impacts on investors as well. See Testimony of Jim Nadler, President and CEO of Kroll Bond Rating Agency, U.S. House Committee on Financial Services, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets, “Bond Rating Agencies: Examining the ‘Nationally Recognized’ Statistical Rating Organizations,” July 21, 2021, available at <https://financialservices.house.gov/uploadedfiles/hhrg-117-ba16-wstate-nadlerj-20210721.pdf> (“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.”).

term, such an assignment system would remove the market incentives to produce high quality ratings and to innovate both in methodology and products.²²

Given the prematurity of considering legislative solutions for any “notching” issue and the recent attention given to the ratings industry more generally, I respectfully suggest that there are other areas more suited to the investment of this Committee’s limited resources.

For example, the Commission is currently undertaking what has been referred to as “one of the most ambitious agendas in the SEC’s 87-year history.”²³ That agenda is being undertaken at breakneck speed and with an unprecedented disregard for the importance of public comment to the rulemaking process. The short periods allowed for the public to comment on proposed rules are anomalous and are particularly problematic given the number of rule proposals pending simultaneously.²⁴ While short comment periods have the potential to limit public input on proposed rules—particularly where those rules are complex—public input is limited even further when commenters are unable to analyze the interrelationship of a large number of proposed rules, including their unintended consequences.²⁵ The Commission has received widespread criticism for this practice, including market participants and industry stakeholders and a bipartisan group of House Members.²⁶ The Commission’s recent announcement that it would extend the time period for its climate-risk disclosure proposal and

²² See, e.g., Testimony of Michael R. Bright, Chief Executive Officer of The Structured Finance Association, U.S. House Committee on Financial Services, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets, “Bond Rating Agencies: Examining the ‘Nationally Recognized’ Statistical Rating Organizations,” July 21, 2021, available at <https://financialservices.house.gov/uploadedfiles/hhrg-117-ba16-wstate-brightm-20210721.pdf>; Written Statement of S&P Global Ratings, U.S. House Committee on Financial Services, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets, “Bond Rating Agencies: Examining the ‘Nationally Recognized’ Statistical Rating Organizations,” July 21, 2021, available at <https://www.spglobal.com/assets/images/ratings/pdf/sp-global-ratings-written-statement.pdf>.

²³ Robert Schmidt and Ben Bain, “SEC Chief to Wall Street: The Everything Crackdown is Coming,” *Bloomberg Law* (October 8, 2021), available at <https://news.bloomberglaw.com/banking-law/sec-chief-to-wall-street-the-everything-crackdown-is-coming>.

²⁴ See Kevin Zambrowicz, Joe Corcoran and Sean Campbell, “The SEC’s Current Far-Ranging & Aggressive Rulemaking Agenda Will Raise Regulatory Uncertainty and Risks Unintended, Negative Consequences,” *SIFMA* (April 25, 2022), available at <https://www.sifma.org/resources/news/the-secs-current-far-ranging-aggressive-rulemaking-agenda-will-raise-regulatory-uncertainty-and-risks-unintended-negative-consequences/>; see also Center Forward, “The SEC’s Comment Periods for New Regulations,” available at <https://center-forward.org/the-secs-comment-periods-for-new-regulations/>; Jennifer J. Schulp and Nicholas Anthony, “The SEC Short-Changes Public Comment,” *Cato Institute* (January 14, 2022), available at <https://www.cato.org/blog/sec-short-changes-public-comment>.

²⁵ See, e.g., Hester M. Peirce, Statement, “Rat Farms and Rule Comments – Statement on Comment Period Lengths,” December 10, 2021, available at <https://www.sec.gov/news/statement/peirce-rat-farms-and-rule-comments-121021>.

²⁶ Letter to Gary Gensler, Chair of U.S. Securities and Exchange Commission, from 25 associations, “Re: Importance of Appropriate Length of Comment Periods” (April 5, 2022), available at <https://www.sifma.org/wp-content/uploads/2022/02/SEC-Joint-Trades-Comment-Period-Letter-4-5-2022.pdf>; Letter to Gary Gensler, Chairman of U.S. Securities and Exchange Commission, from 47 Members of the House of Representatives, “Re: Private Fund Advisers; Documentation of Registered Investment Compliance Reviews” (April 13, 2022), available at <https://www.investmentcouncil.org/47-bipartisan-lawmakers-urge-the-sec-to-increase-comment-periods/>.

reopen comment on two other proposed rules is welcome, but does little to alleviate broader concerns where short comment periods have predominated and continue to do so.²⁷ The ability of the public to comment on proposed rules, and the effect of limited public comment on the quality of rulemaking, should be of concern to this Committee.

The Commission's agenda also raises a number of issues relevant to this Committee's interests in "investor protection, entrepreneurship and capital markets," including the Commission's proposed rules on climate-risk disclosure and private fund disclosure.²⁸ What is missing from the Commission's agenda is also notable. There is little that arguably constitutes a plan for supporting capital formation, and many of the Commission's proposed rules and agenda items may operate to deter entrepreneurship. The Commission's agenda also lacks items relevant to the regulation of digital assets (except where rule proposals may have effects the Commission declined to discuss in the proposal), choosing instead to lead with enforcement actions over rulemaking in this space.²⁹

These are just a few of the issues in connection with the Commission's current agenda that are more deserving of this Committee's time and attention than additional focus on NRSRO regulation.

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Thank you for the opportunity to provide this information, and I welcome any questions that you may have.

²⁷ U.S. Securities and Exchange Commission, "SEC Extends Comment Period for Proposed Rules on Climate-Related Disclosures, Reopens Comment Periods for Proposed Rules Regarding Private Fund Advisers and Regulation ATS," Press Release (May 9, 2022), available at <https://www.sec.gov/news/press-release/2022-82>.

²⁸ Jennifer J. Schulp, "The SEC's 'Daddy' Issues," *National Review (Online)* (September 24, 2021), available at <https://www.cato.org/commentary/secs-daddy-issues>.

²⁹ Charlie Innis, "SEC Proposals May Harm Digital Asset Space, GOP Reps. Say," *Law360* (April 18, 2022), available at <https://www.law360.com/securities/articles/1484988/sec-proposals-may-harm-digital-asset-space-gop-reps-say>; Kia Kokalitcheva, "Crypto Industry takes on SEC's proposed new 'exchange' definition," *Axios* (April 21, 2022), available at <https://www.axios.com/2022/04/21/crypto-industry-takes-on-secs-proposed-new-exchange-definition>; Dave Michaels and Paul Kiernan, "SEC to Hire More Crypto Cops to Fight Digital Frauds," *Wall Street Journal* (May 3, 2022), available at <https://www.wsj.com/articles/sec-to-hire-more-crypto-cops-to-fight-digital-frauds-11651568403>.