

WRITTEN TESTIMONY OF YANN LE PALLEC

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HEARING BEFORE THE UNITED STATES HOUSE SUBCOMMITTEE ON INVESTOR
PROTECTION, ENTREPRENEURSHIP AND CAPITAL MARKETS

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Mr. Chairman, Mr. Ranking Member, Members of the Subcommittee, good morning. My name is Yann Le Pallec. I am an Executive Managing Director and Head of Global Ratings Services at S&P Global Ratings (“S&P Global Ratings” or “S&P”). I am also a member of the S&P Global Ratings Operating Committee. I oversee a group of approximately 1,400 credit analysts present in 28 countries and covering more than one million outstanding ratings on entities and securities across a wide range of sectors including governments, corporations, financial institutions and structured finance. I appreciate the opportunity to provide this statement as part of today’s hearing.

Overview of S&P Global Ratings

S&P Global Ratings is committed to providing the financial markets with timely, transparent, and high-quality credit ratings. Credit ratings are forward-looking opinions about the ability and willingness of debt issuers, like corporations or governments, to meet their financial obligations on time and in full. Our ratings provide market participants with a basis for comparison of the relative credit risk associated with different securities within and across asset classes. As forward-looking opinions, our ratings take into account, on a continuing basis, relevant changes in market conditions, issuer-specific credit factors, and other events that could affect credit risk. As a result, our credit ratings and our credit rating methodologies can and do evolve over time.

By regulation and S&P policy, we publish all new proposed rating methodologies and proposed material updates to our in-use methodologies in advance so that market participants can review and comment on our proposals. As a credit rating agency, we compete on analytical excellence. We strive to provide the market with high quality opinions based on sound, defensible analytics. Accordingly, we want to know if a market participant disagrees with any methodology we propose or any assumption within that methodology. We consider comments received from

the market during our criteria development process and we make those comments publicly available upon the publication of our final criteria.

To ensure the independence and impartiality of our credit ratings, we also maintain a strict separation between analytical and commercial activities within S&P Global Ratings. By regulation and S&P policy, employees participating in determining or monitoring credit ratings, or developing or approving procedures or methodologies used for determining credit ratings cannot be influenced by sales or marketing considerations.

S&P has always supported the objective of increasing the number and diversity of high-quality credit rating opinions in the marketplace. We welcome the opportunity to compete with other rating agencies on analytical excellence. Increased competition was in fact one of the primary goals of the Credit Rating Agency Reform Act of 2006 (“CRARA”), a statute that S&P supported. Since the implementation of CRARA, there are nine credit rating agencies currently registered as NRSROs with the SEC.

Our Proposed Methodology and Assumptions for Insurer Risk-Based Capital Adequacy

On December 6, 2021, we published a request for comment on certain proposed changes to our methodology and assumptions for analyzing the risk-based capital adequacy of insurance companies (the “Request for Comment” or “RFC”).¹ An insurer’s risk-based capital adequacy considers the amount of capital that an insurance company may need to cover any losses across its different exposures and is one of the key factors in our framework for rating all insurers.

As set out in our RFC publications, our proposed methodology change was intended to improve our ability to differentiate risk, enhance the global consistency of our methodology, improve the transparency and usability of our methodology, and account for more recent data and

¹ <https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/2805856>.

experience since our last update of our insurance capital model criteria in 2010. As further explained in those publications, based on our testing, we estimated that the proposed criteria, if adopted, could lead to credit rating actions on up to 10% of our ratings in the insurance sector, with the majority involving rating actions of one notch and with more upgrades than downgrades.

One aspect of our proposed methodology has received some attention. Given the nature of some of the concerns raised in the comments that we received through our RFC process, on May 9, 2022, we announced to the market that we have withdrawn this aspect of the proposed approach and we are considering alternatives.² While we will not be moving forward with this part of the proposal, I would still like to address certain criticisms that have been made publicly that, in our view, misconstrue and mischaracterize this aspect of our proposed methodology. I'd like to take this opportunity to explain the application and intent of our proposal.

To rate an insurance company, we believe we have to understand the credit quality of the assets held by the insurance company. Specifically, in assessing an insurance company's capital adequacy, we consider and apply capital charges to all major sources of credit risk at the insurance company, including the insurer's bond and loan holdings. Our capital model will apply capital charges based on, among other factors, a credit rating or other credit risk assessment on the given bond, loan or other credit exposure. In instances where we maintain our own credit rating on the bond or loan, we can use that rating as the input to our capital model. However, where we do not rate the bond or loan, another credit quality assumption must be used instead.

Our proposal laid out a multi-step process for determining the appropriate credit quality assumption to use as an input to our capital adequacy model:

² <https://www.spglobal.com/ratings/en/research/articles/220509-s-p-global-ratings-withdraws-rating-input-approach-from-proposed-insurer-risk-based-capital-adequacy-criteria-12371141>.

First, to the extent we have already formed a credit view on the asset through the issuance of an S&P credit rating, our proposal provided that we would use that S&P rating as the input to our capital model.

Second, if we have not rated the asset, our proposal would have allowed us to use any other alternative measure of credit quality determined by S&P Global Ratings. An example would be an S&P Global Ratings credit estimate.

Third, if no S&P rating or S&P credit estimate is available, our proposal provided that we would use the corresponding rating from another rating agency for which S&P has determined a “mapping” is possible as determined by our mapping analysis. A “mapping” is a statistical analysis used to map or match S&P’s credit rating scale to that of another rating agency. In other words, mapping allows us to translate another rating agency’s ratings into our own measure of credit risk. In mapping another NRSRO’s ratings, we apply our published mapping criteria. To properly translate the rating scale of another rating agency to our own, we need a statistically significant sample of bonds for which there are both ratings from S&P and the other rating agency. The mapping generates the most robust results when we have a large number of pairs upon which to calculate ratings relationships; if we do not have a large number of pairs, the standard error of this statistical exercise will increase.

Finally, if none of the options described above are available to us, the proposal provided that we determine the rating input assumption by considering factors such as the average rating and lowest average rating in the relevant sector or, in the case of structured finance, assuming the unrated exposures relate to the most junior tranches of a securitization and using a ‘CCC’ rating input in our capital model. Notably, in applying this last step, the proposal provided that we could adjust the credit quality assumption up or down by one rating category (*e.g.*, from ‘CCC’ to ‘B’)

if additional information indicates that the credit quality assumption for the unrated asset is, in our view, materially higher or lower than the assumption provided for in the proposed criteria.

Again, this multi-step process was just one aspect of our proposed methodology and, as we repeatedly made clear, we wanted to know what the market thought of it. We first published our proposed methodology in December 2021 and solicited market comment. We specifically asked the market to address, among other questions:

- What are your views on the methodology and assumptions we have outlined in this article?
- Do you believe we are appropriately capturing capital and risks for insurers, including asset risk for bond insurers, and agree with the manner in which we propose to assess them? If not, what alternative(s) would you propose?

Since our December 2021 publication, we twice extended the period for comments to allow the market additional time to review and comment on our proposal. We also offered webinars and published additional commentary to help market participants better understand our proposal.

The expiration of our comment period is not the end of our criteria development process. The next phase would be a period of detailed review and further consideration of the proposal, including comments received from the market. As part of this phase, we would consider whether changes to the proposed criteria are merited based on the feedback we received. Following any revisions, the draft criteria would then need to be reviewed by our independent criteria validation function and then reviewed and approved first by our Criteria and Models Governance Committee and then the Criteria & Models Committee of the S&P Global Ratings U.S. Board of Managers. Only after each of those steps were completed and approvals obtained could the criteria be finalized and become effective.

In this instance, however, given the volume and nature of the comments we received about this aspect of our proposal, we decided to withdraw our proposed approach for determining rating inputs of bonds and loans, reinsurance counterparties, and deposits with credit institutions. We are considering alternatives for the withdrawn elements of the proposed criteria. After we have had sufficient time to consider the high number of comments received, we intend to issue a new request for comment. After this further request for comment is completed, we will finalize the criteria proposal in its entirety, consistent with our criteria development process. The current criteria remain in effect until such time as any new criteria are issued and made effective.

S&P's Response to Recent Criticisms of Its Proposal

As I mentioned above, our proposed process for determining the credit quality inputs to our capital adequacy model has been the subject of some recent criticism. Again, while we have decided to withdraw certain elements of our proposal, we believe the criticisms made to date in the press misconstrued our proposal and are unfounded. For example, in applying our proposed multi-step process, we would not be, as some critics have claimed, lowering or “downgrading” the ratings of other credit rating agencies. Nor could we. Rather, we were addressing a very specific analytical issue: how to evaluate internally the risk presented by an asset held by an insurance company in the process of rating that insurance company when S&P has limited, if any, information about the asset.

Notably, this analytical issue does not arise in connection with the vast majority of credit rating opinions we offer to the market. In other words, in most instances, we can and do offer opinions about a securities issuer or issue without the need to consider whether and how we might accept or incorporate the credit rating of another rating agency. However, in some limited

instances, including with respect to assessing the capital adequacy of an insurance company, we must consider the issue.

We cannot rate an insurance company—or any other credit—unless we have sufficient reliable information to do so. In assessing the capital adequacy of an insurance company, we believe that a robust rating analysis requires that we understand and have visibility into every major source of credit risk at the insurance company—both credit risks that are rated by S&P and those that are not. We believe the strength and reliability of our insurance ratings require that level of detailed analysis of the exposures of the rated insurance company.

Where we have not formed a credit view on a particular asset, we cannot simply substitute the work of another rating agency instead. This is because, as I will explain in more detail shortly, there are meaningful differences in the methodologies and definitions used by different rating agencies. Where we have some basis to translate another rating agency's rating into our own—*i.e.*, where we can map our ratings to the ratings of another rating agency in accordance with our criteria—we will do so. In other instances, we reserve the right to make an appropriate assumption to address the inherent uncertainty presented by an asset we have not reviewed or rated. Our intent in approaching this issue as outlined in our proposal was not to penalize competing rating agencies. Rather, it was to apply a level of conservatism into the rating process for an insurance company in instances where we do not have our own rating on, or sufficient visibility into the credit risk presented by, an asset held by an insurance company we are rating.

Some critics would have us short-cut our credit risk analysis of insurance companies and instead accept at face value the credit rating offered by any rating agency regardless of whether S&P agrees—or has any basis to agree—with that credit assessment. Some critics would have us blindly accept the credit rating of another agency notwithstanding that there may be important

differences in the criteria or methodology of the other rating agency, a lack of transparency about the other rating agency's methodology, or a lack of track record on the part of the other rating agency. Such critics effectively view credit ratings as a commodity and incorrectly presume that all ratings are of equal quality and utility.

However, as reflected in the various different criteria methodologies and the default and transition studies published by each rating agency, this is not a correct assumption. Moreover, these critics further ignore that not all ratings even speak to the same subject, *i.e.*, some rating agencies issue ratings that assess the relative likelihood of default regardless of any recovery after default and others issue credit ratings that include assessments of loss given default.

As I stated at the outset, S&P supports and welcomes competition in the rating agency industry. We believe the market benefits most when investors and other market participants have a choice across multiple, diverse views of credit risk by different rating agencies. Requiring a rating agency to use the work of another rating agency would in fact reduce competition in this regard and is, in fact, directly at odds with the very nature of the analytical independence at the core of the rating agency industry.³

In short, some critics would have us compromise our analytics with respect to insurance companies because of conjecture that our proposed methodology change might cause an insurance company to make (improperly, in our view) investment decisions solely by reference to our capital model, which might in turn reduce the demand for ratings of smaller rating agencies in certain asset classes. Let me be clear, that is not and has never been the intent of our proposed criteria.

³ Indeed, a major aspect of the rating agency reforms provided under the Dodd-Frank Wall Street Reform and Consumer Protection Act was the requirement that federal agencies remove references to NRSRO credit ratings from federal regulations to address any over-reliance on ratings by investors and other market participants. Yet, now some critics would have NRSROs blindly rely—as investors are specifically advised not to do—on the credit ratings of other rating agencies.

Market share or commercial considerations had no role and will have no role in our criteria development process as we move forward to the next phase of our process.

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In sum, S&P Global Ratings is committed to providing the financial markets with timely, transparent, and high-quality credit ratings. We believe we have in fact been transparent with the market at every step in connection with our proposed methodology. Although we have decided to withdraw certain elements of our proposal at this time, after we have had sufficient time to consider the high number of comments received to date, we intend to issue a new RFC. This would incorporate any proposed alternative for the withdrawn elements, along with any other changes to what we originally proposed. I appreciate the opportunity to testify here today and I am happy to answer any questions.