

Statement of Ian Linnell
President
Fitch Ratings
before a hearing of the United States House Committee on Financial Services,
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets
on
"A Notch Above? Examining the Bond Rating Industry"
May 11, 2022

Chairman Sherman, Ranking Member Huizenga, and distinguished members of the Subcommittee, I appreciate the invitation to appear before you to talk about the anti-competitive practice called "notching" and how S&P Global Ratings ("S&P") is, in our view, using this practice in its proposed insurer risk-based capital adequacy methodology ("Methodology") in an attempt to further its market dominance. As S&P initially proposed the Methodology, it would have undermined competition in the credit rating agency industry and adversely impacted insurance companies and other industry participants, resulting in the misallocation of capital throughout the economy and harm to both consumers and businesses.

We are pleased to see that on Monday S&P effectively admitted they have no basis for the proposed Methodology after resounding objections from the market and the Department of Justice to their proposal. We hope S&P will now "consider alternatives" for the identical position they take for local government investment pools (LGIPs) and that both S&P and Moody's will also reevaluate the positions they take relating to Money Market Funds, Bond Funds, and collateralized loan obligations. At the very least, both S&P and Moody's should provide the statistical data that justifies their current notching of Fitch in these other market sectors. We believe it is time that local governments and fund managers are allowed to choose the securities they buy without anti-competitive pressure from S&P or Moody's.

In 2006, Congress, with extensive bipartisan support, passed the Credit Rating Agency Reform Act of 2006¹ (the "Reform Act") with the stated aim of fostering "accountability, transparency, and competition in the credit rating agency industry." The Reform Act includes a provision to prohibit conduct in the structured finance sector identical to what S&P now proposes in the insurance sector². Although the Reform Act addressed the anti-competitive behavior engaged in by both S&P and Moody's in the period leading up to its passage, both S&P and Moody's have continued to engage in the prohibited conduct, and the Securities and Exchange Commission ("SEC") has made no effort to stop its practice. S&P sought to extend this anti-competitive activity to the insurance sector.

Fitch Ratings and the credit rating industry

Fitch Ratings ("Fitch") is a global credit rating agency ("CRA") with a presence in over 25 countries. Over the past three decades, Fitch has become the only credible challenger to the dual monopoly of Moody's Investor Services ("Moody's") and S&P in the credit rating industry. During this period, Fitch has raised its share of the overall market for credit ratings in the US to 13%, compared to 32% for Moody's and 50% for S&P³.

Credit ratings play an important role in efficient capital allocation by providing the financial markets with an independent view of credit risk. We believe that investors benefit from the various analytical perspectives of the CRAs. The variety of CRA opinions – and the diversity of their analysis – offer valuable insight to the investor attempting to purchase securities. Any measure that reduces competition in the CRA industry is detrimental to the marketplace. Investors will have fewer materially different opinions to weigh when evaluating the credit risks of a particular securities issuance. The dominance of one firm or view also potentially increases systemic risk in the financial system.

¹ Pub. L. No. 109-291, 120 Stat. 1327 (2006).

² *Ibid.*, § 4

³ See U.S. Securities and Exchange Commission, *Office of Credit Ratings Staff Report On Nationally Recognized Statistical Rating Organizations* (January 2022), available at <https://www.sec.gov/files/2022-ocr-staff-report.pdf>

S&P Methodology and Notching

S&P's proposed Methodology is anti-competitive because it incorporates the practice of "notching" into S&P's assessment of insurer risk-based capital adequacy. Notching occurs when a CRA (i) insists on rating most, if not all, of the assets owned by an entity, such as an insurance company, or underlying an asset pool, such as in a structured finance transaction, and/or (ii) significantly reduces the ratings, often by many categories, that other CRAs have assigned to the assets in the portfolio that they have not rated. Both S&P and Moody's have engaged in notching for over 20 years and across many different asset categories, including the rating of Local Government Investment Pools, Money Market Funds, Bond Funds, and Collateralized Loan Obligations.

The proposed Methodology extends the anti-competitive notching behavior of S&P to insurers, re-insurers, and any securities they purchase. S&P intends to apply "mapping criteria" and automatic notching haircuts to all non-S&P rated investments held by insurance companies. S&P's Methodology significantly reduces the rating of securities rated by either Fitch or Moody's. Furthermore, S&P intends to apply a deeply "junk" credit rating to securities rated by any of the other CRAs and to securities rated by the National Association of Insurance Commissioners. As a result, securities held in the portfolio of an insurer rated "AAA" by Fitch could have their credit rating lowered to "AA-" by S&P in its assessment of the creditworthiness of that insurance company. Meanwhile, securities rated "AAA" by another CRA would be rated "CCC."

We believe that S&P withdrew the Methodology, and continues to fail to explain its Methodology, because no explanation exists. The Methodology was a pretext by S&P to leverage off its dominant position in insurance to increase its market share in the securities commonly purchased by insurers, including areas where S&P has a low market share. Credit rating performance data does not support S&P's proposed notching. Average annual default and transition rates for at least the last 30 years demonstrate that arbitrary and automatic haircuts, including notching, are not supported by the available evidence. In contrast, credit

rating performance data, sensitivity analyses, and comparability studies conducted by Fitch, Moody's, S&P, and other financial market participants show that the ratings of these three CRAs are comparable. This data is freely available on CRAs websites and submitted to regulators including the SEC.

Damage to CRA Competition

S&P's proposed notching would damage the competitive environment of the credit rating industry. S&P has a dominant market share in the financial strength ratings of insurance companies (Insurer Financial Strength Ratings) compared to either Fitch or Moody's⁴. S&P ratings are hard-wired into many insurance brokers' systems, and brokers typically have criteria for recommending insurers to clients that only refer to S&P and AM Best ratings, and not to Fitch and Moody's ratings. This market power gives S&P a virtual monopoly on insurance company financial strength ratings and makes insurers hostages to S&P. Only AM Best, which has no meaningful market share outside of insurance, presents significant competition to S&P in financial strength ratings.

As insurance companies seek to maintain their S&P Insurer Financial Strength Ratings, they would clearly be discouraged from purchasing securities in those sectors where S&P rates relatively few securities and other CRAs rate relatively more. Insurers, and the issuers of securities that insurance companies purchase, would select S&P not because of the quality or predictability of its ratings but to avoid the punitive notching of the Methodology and the negative impact on insurers' financial strength ratings. The inevitable consequence is, over time, S&P would increase its market share in those asset classes where the CRAs are currently competitive (e.g., commercial and residential mortgage-backed securities)⁵, while maintaining its position in those areas where it is already dominant.

⁴ Based on data from S&P's SNL Insurance dataset

⁵ See Commercial Mortgage Alert website, available at <https://www.greenstreet.com/news/library/commercial-mortgage-alert> and Asset-Backed Alert website, available at <https://www.greenstreet.com/news/library/asset-backed-alert>.

Fitch was not alone in its criticism of the Methodology. Investors and other capital market participants have condemned S&P's proposal. In addition, the Department of Justice's Antitrust Division has recently commented that S&P's Methodology, "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."⁶.

The Methodology's Impact on the Markets

In addition, the Methodology could have a significant impact on the financial markets by distorting the investment decisions of insurers. For example, the Methodology's severe degree of notching might theoretically motivate an insurer to purchase a bond rated 'BB' by S&P over a bond rated 'AAA' by another CRA (a five-category difference) since the AAA-rated bond would be considered riskier and have a higher imputed capital charge under S&P's Methodology. Moreover, the Methodology could lead to overly conservative, unjustified risk assessments on insurance companies' investment portfolios, resulting in unnecessary increases in funding costs to various sectors of the capital markets and negative impacts on the economy. Finally, as insurance companies sought to maintain their S&P corporate ratings, they might change their investment criteria, thereby impacting consumers and businesses by reducing the substantial investor base currently available to them.

Conclusion

S&P and Moody's have been engaged in "notching" for over twenty years, despite laws in the books to the contrary. S&P sought to extend this anti-competitive practice to the insurance sector in order to tighten its grip on the credit rating industry. Congress must amend existing legislation to ban notching, not only in structured finance, but also in all other market sectors, and the SEC must start enforcing this ban.

⁶ See Antitrust Division of the United States Department of Justice, *Comment re: Insurer Risk-Based Capital Adequacy* (April 29, 2022), available at <https://www.justice.gov/atr/page/file/1497956/download>

Thank you for your time and your attention to this critical matter. I welcome any questions that you may have.