

A NOTCH ABOVE? EXAMINING THE BOND RATING INDUSTRY

HYBRID HEARING

BEFORE THE
SUBCOMMITTEE ON INVESTOR PROTECTION,
ENTREPRENEURSHIP, AND CAPITAL MARKETS
OF THE
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A NOTCH ABOVE? EXAMINING THE BOND RATING INDUSTRY

Wednesday, May 11, 2022

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INVESTOR PROTECTION,
ENTREPRENEURSHIP, AND CAPITAL MARKETS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Brad Sherman [chairman of the subcommittee] presiding.

Members present: Representatives Sherman, Maloney, Scott, Foster, Vargas, Gottheimer, Axne; Huizenga, Wagner, Hill, Emmer, Davidson, Gonzalez of Ohio, Steil, and Taylor.

Ex officio present: Representative Waters.

Chairman SHERMAN. The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will come to order.

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time. Also, without objection, members of the full Financial Services Committee who are not members of the subcommittee are authorized to participate in today's hearing, pursuant to committee rules.

Today's hearing is entitled, "A Notch Above? Examining the Bond Rating Industry."

I will now recognize myself for 4 minutes for an opening statement. I will then recognize the ranking member of the subcommittee, Mr. Huizenga, for 5 minutes, followed by the Chair of the full Financial Services Committee, Chairwoman Waters, for 1 minute.

Each year, roughly \$3 trillion worth of money flows based upon the ratings of the bond rating agencies, in commercial paper, asset-backed securities, and corporate bonds. If the rating is good, the interest rate is low and the project can go forward. If the rating is low, well, it doesn't pencil out. It is like when you get a bad credit score and you don't buy a home, or, in this case, a business doesn't build a factory.

Earlier this year, S&P Global Ratings, the largest of the rating agencies, came up with a proposal which triggered these hearings, and that proposal was described as, "notching," because the bond rating agencies play two roles: they rate the insurance companies that buy the bonds; and then, they rate the bonds the insurance companies buy. And the notching proposal, in effect, told insurance companies that if you buy bonds that weren't rated by S&P, that

when S&P went to grade your insurance company, you could be notched downward. That is what triggered this hearing.

And I am pleased to say that this is the most successful hearing I have had as Chair of this subcommittee, because S&P, just 2 days before the hearing, announced that they were withdrawing the proposal. Thank you for being here, thank you for doing that, but I still believe that we should pass legislation to prohibit notching. Current statutes prohibit notching with regard to asset-based securities, and we now need to extend that to corporate bonds and other issues.

There are other issues that this hearing will also deal with, one of which is relatively new to our subcommittee, and that is whether our bond rating agencies should be allowed to rate the bonds of Russia or Belarus, and whether we should allow our issuers to pay for bond ratings from foreign bond rating agencies that choose to continue to provide services, that is to say, whether we should impose secondary sanctions designed to prevent the rating of Russian and Belarusian bonds.

Another issue is whether the bond rating agencies will be forced to do something that they haven't chosen to do, which is to speak English to the 320 million Americans who don't understand that the 12th highest rating, Ba2, unless the 12th highest rating is BB, which, I might add, is better than B+/2 ratings. There are those who think that maybe we should tell people what is the highest rating, what is the second-highest rating, what is the third-highest rating, et cetera. There are others who believe that bond rating agencies ultimately paid for by the American people should speak in a language understandable to those not initiated to Wall Street.

A final issue comes up, and that is the incentives for the bond rating agency to give the rating that the people who select the bond rating agencies, the issuers of the bond, prefer. This is the only game where the umpire is selected by one of the teams. Trust me, if the Dodgers got to pick the umpire, Kershaw would never throw another ball. So, whether or not bond rating agencies should continue to be the only professionals in our society not subject to professional liability for malpractice, and at the same time, should be selected by the issuer, which means all of the incentives are to please the issuer and there is no risk of liability for giving too strong a rating, those are the issues that this hearing will address, in addition to whatever other issues Members wish to bring up.

I now recognize the ranking member of the subcommittee, Mr. Huizenga, for 5 minutes.

Mr. HUIZENGA. Thank you, Chairman Sherman. While the title for this morning's hearing, "A Notch Above? Examining the Bond Rating Industry," gets an A for creativity, I sadly have to give the subcommittee's work and agenda a failing grade. Unfortunately, hearings for the subcommittee have become very rare in leaving precious time and resources to focus on issues that are actually timely. In fact, Democrats have failed to hold a meaningful hearing on our capital markets in over a year. I know that it is called the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets. I have seen a lot of discussion about investor protection, a little bit of conversation about entrepreneurship, not a whole lot, and it has been a big fat zero on the capital markets

side. So, let me be very clear. I have my own concerns about S&P's recently-rescinded proposal, but to hold yet another hearing on our nation's credit rating agencies is, at the very least, misguided.

Earlier this week, as you noted, Mr. Chairman, S&P pulled back on proposed changes to the risk-based adequacy methodology for insurers, which begs the question, why is this hearing moving forward in this fashion? At the very least, pushing Congress to engage on this issue seems premature, given that stakeholder input had seemed to move that ball. So, let us be clear: Our capital markets are under attack. Since the gentleman from California has become Chair, the SEC released a rulemaking agenda that contains nearly 60 far-reaching proposals. And what is even more alarming from that list is that the Agency has proposed 16 rules in the first quarter, the first 3 months of this year alone, often leaving a scant 30-day window to comment.

So, since the start of the calendar year, the only time Democrats have cared to comment on the SEC's agenda was to congratulate them on their proposed climate disclosure rule. A 500-page rule, I might add, which, SEC's own analysis, will cost billions of dollars to comply, with most of that cost being passed down to hard-working Americans. In contrast, Republicans have continued to sound the alarm on a number of these harmful proposals. So, let me ask the question: What will prompt Democrats on this committee to get serious about oversight? In the 116th Congress, with a Republican in the White House, Chairwoman Waters held a hearing with the entire SEC Commission, but has repeatedly ignored requests from myself and Ranking Member McHenry to hold one this year. Why is that? Are they hiding something?

Given the breadth of issues before the Commission, and given the size and importance of our markets, I am sure Members on both sides of the aisle would appreciate a hearing to understand the Commission's ongoing deliberations, given their aggressive agenda. I would hope my Democrat colleagues would also appreciate a hearing to explore why the Commission is ignoring its mission to facilitate capital formation. If you don't want to bring the full Commission in to testify, how about an oversight hearing with the the SEC's Division of Enforcement? Last month, the SEC acknowledged a very significant breach in protocols between the SEC's adjudicatory and enforcement functions, with potential ramifications regarding the fairness over prior SEC enforcement actions. How about a hearing on digital assets?

Last week, the SEC announced an expansion of its crypto enforcement team, which nearly doubled the size of the unit. Why is this significant and timely? Well, given the Chair's inability to provide clarity and transparency to the \$3 trillion digital asset ecosystem, I would be interested in knowing what prompted his decision to move forward on that. To quote Commissioner Hester Peirce, "The SEC is a regulatory agency with an enforcement division, not an enforcement agency." So, why are we leading with enforcement in crypto? What about a hearing on the impact of the bipartisan Jobs Act, which just had its 10th anniversary last month, or maybe we could focus on legislative proposals to help fuel capital and growth on Main Street? Just because the SEC has zero capital

formation items on its agenda, doesn't mean we can't focus on it; it does not mean we should be ignoring our job.

These are the timely topics for the hearings, and, by the way, ones that Republicans held while we were last in the Majority, yet, again, today's hearing topic is not. So this subcommittee, and we as lawmakers, should focus and prioritize issues that will expand opportunity for retail investors and promote capital formation for small businesses, all while we are protecting those investors. I look forward to hearing from our witnesses today in how we can best accomplish that.

Mr. Chairman, I yield back.

Chairman SHERMAN. Without objection, I will put in the record a letter dated April 14th, signed by 13 Democratic Members of this committee and 9 Republican Members of the Full Committee, asking the SEC to intervene to stop the anticompetitive S&P notching proposal, which was withdrawn just 2 days ago.

Without objection, it is so ordered.

And with that, I will now recognize the Chair of the Full Committee, Chairwoman Maxine Waters, for 1 minute.

Chairwoman WATERS. Thank you so very much, Chairman Sherman, for holding this very timely hearing. I am so pleased with the leadership that you are providing for this subcommittee, and I am so pleased today that we have oversight on bond rating agencies, and that what you have done has caused them to pull back something that would have been grossly unfair, and so you have done a great job. And as for the gentleman from Michigan, I think he does not understand that we are in charge, and I am the Chair of this committee. You are one of the subcommittee Chairs. He does not dictate to us what our agenda is. We develop that agenda, and if he is trying to draw attention away from the oversight on bond rating agencies, that is not going to happen.

Mr. HUIZENGA. It will be remembered.

Chairwoman WATERS. I have long called for robust oversight of the bond rating agencies, particularly after Wall Street's and the financial market's overreliance on the often-erroneous credit ratings of just three agencies directly contributed to the 2008 financial crisis. It has been my goal to empower investors and other market participants with an abundance of accurate information, and anti-competitive practices, like the S&P's latest proposal, run counter to those—

Mr. HUIZENGA. Mr. Chairman—

Chairwoman WATERS. While S&P may have withdrawn this proposal, I am concerned it and other credit rating agencies—

Mr. HUIZENGA. Mr. Chairman, we are 30 seconds over time.

Chairwoman WATERS. —have other anti-competitive practices that, if allowed to fester—

Mr. HUIZENGA. Mr. Chairman, we are 30 seconds over time.

Chairwoman WATERS. —will harm our market and the American public investing their hard-earned dollars.

Mr. HUIZENGA. [Inaudible].

Chairwoman WATERS. Thank you for holding this hearing, and I yield back the balance of my time.

Chairman SHERMAN. Today, we welcome the testimony of our distinguished witnesses.

I now recognize our first witness, Yann Le Pallec, who is the executive managing director and head of global ratings services for S&P Global Ratings. You are recognized for 5 minutes.

STATEMENT OF YANN LE PALLEC, EXECUTIVE MANAGING DIRECTOR AND HEAD OF GLOBAL RATINGS SERVICES, S&P GLOBAL RATINGS

Mr. LE PALLEC. Mr. Chairman, Mr. Ranking Member, Madam Chairwoman, and 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, and 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 1 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 testify as part of today's hearing.

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. As opinions, credit ratings are not fungible, meaning that there are true analytical differences among the credit ratings and credit ratings' methodologies on different credit rating agencies. And just like how opinions evolve, 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. We consider comments received from the market, and we make those comments publicly available upon the publication of our final criteria. By SEC regulation and S&P policy, employees participating in developing or approving our procedures and methodologies used for determining credit ratings cannot be influenced by sales or marketing considerations. And we maintain a strict separation between analytical and commercial activities within S&P Global Ratings.

On December 6, 2021, we published a request for comment, or RFC, on certain proposed changes to our methodology and assumptions for analyzing the risk-based capital adequacy of insurance companies. 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. Our RFC process gives the market the opportunity to provide feedback and voice any concerns about our proposals prior to the finalization and implementation of our final criteria. We thank market participants for the extensive engagement and high volume of comments they have provided in response to our December 2021 RFC. We take the market's comments and feedback seriously.

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 experience since our last update of our insurance capital model criteria in 2010. However, 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 parts of the proposed approach and we are considering alternatives. While we believe certain of the criticisms made to date in the press misconstrued our proposal and are unfounded, we have heard the markets' concerns.

My submitted testimony goes into more depth on the proposed application and the intent of the withdrawn sections of our RFC, but I am happy to address any questions you may have on these issues. As I mentioned, 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 subsequent RFC and then will finalize the criteria article in its entirety, consistent with our criteria development process.

Throughout our RFC process, we have engaged in high levels of transparency and interaction with the market, and we are committed to maintaining that transparency and interaction as we move forward to the next phase of our process. Thank you, and I look forward to your questions.

[The prepared statement of Mr. Le Pallec can be found on page 41 of the appendix.]

Chairman SHERMAN. Thank you. Next, we have Angela Liang, who is the general counsel at the Kroll Bond Rating Agency.

STATEMENT OF ANGELA LIANG, GENERAL COUNSEL AND EXECUTIVE COMMITTEE MEMBER, KROLL BOND RATING AGENCY (KBRA)

Ms. LIANG. Thank you. Chairman Sherman, Ranking Member Huizenga, Chairwoman Waters, and distinguished members of the subcommittee, thank you for the opportunity to testify today. I am Angela Liang, KBRA's general counsel and Executive Committee member. I am grateful for the subcommittee's strong bipartisan interest in issues being discussed today. This hearing is particularly critical and timely given the impact of S&P's proposed risk-based capital methodology. While S&P temporarily withdrew certain sections of its methodology a mere 2 days before this hearing, the proposal caused immense concern and confusion among market participants in all sectors as they grappled with the likely negative effects of the proposal and decreased competition among nationally recognized statistical rating organizations (NRSROs).

KBRA was founded in 2010, and it is a full-service credit rating agency. It is one of the five largest rating agencies globally, and the largest rating agency established after the 2008 financial crisis. Mr. Chairman, we believe that KBRA's entry into the market has been extremely positive for investors. We offer a diverse perspective and have restored transparency and analytical rigor to credit analysis. However, we and other small and medium-sized NRSROs continue to face barriers to competition. Despite KBRA's success over the past 12 years, the Big Three still command approximately 95 percent market share and are woven into the fabric of our finan-

cial system. For example, many investor guidelines still refer to only the incumbent NRSROs. Certain key bond indices require that its security be rated by at least one of the Big Three. Government regulations and recent government facilities still reference the largest NRSROs by name, rather than all NRSROs.

I would also like to highlight the importance of bond indices. Many investors benchmark to the S&P Bond Index or Bloomberg's Fixed Income Indices and, therefore, are not able to purchase bonds not rated by the Big Three because they are not index-eligible. We believe that the continued lack of open competition is by far the biggest problem facing the credit rating industry today. KBRA has been successful because of its relentless focus on transparent, thorough research and investor feedback, but it has not been easy.

In our view, entrenchment of the Big Three disadvantages the financial markets, investors, and the public writ large. The impact that a mere proposal had on the market demonstrates S&P's significant market power and its ability to impede competition using that power. While S&P withdrew for the time being the anti-competitive sections of its proposal, we are concerned that S&P will continue to consider approaches with similar anti-competitive effects.

In addition to already-significant systemic barriers to competition, S&P's proposed methodology would have allowed S&P to notch down KBRA's ratings from AAA to as low as CCC. If S&P's methodology had been implemented, it would have further reinforced S&P's position as the most-dominant credit rating agency by establishing disparate and arbitrary treatment of non-S&P ratings on bonds across all asset classes held in S&P-rated insurance company portfolios.

The negative market reaction to S&P's proposal was swift, clear, and widespread. We are aware that many diverse market participants submitted comments and provided feedback to S&P beginning in early January. In addition to the concerns raised by this committee, the Department of Justice submitted a comment identifying potential violations of antitrust laws stemming from S&P's proposal, and yet it took S&P 5 months to withdraw the problematic sections of the proposal.

What can we do to prevent the aversion of fair competition among NRSROs? Mr. Chairman, in our view, many components of the NRSRO provisions of the Dodd-Frank Act have been highly successful and have meaningfully improved the credit rating industry. The requirement that NRSROs publicly post their methodologies and substantive changes to them allows investors to analyze methodologies in advance of implementation. This requirement was key in S&P's withdrawal of proposed changes that would have had further negative effects on the market and NRSRO competition. Still, we believe there is room to strengthen Federal law to bolster competition and increase disclosure. We support current legislative efforts to prohibit notching and to prohibit credit rating agencies from taking actions that have an anti-competitive effect while maintaining credit rating agencies' ability to determine their rating methodologies.

We encourage Congress, the Department of Justice, and the SEC to continue to scrutinize S&P's proposed methodology, and to take

swift and decisive action to prevent anti-competitive behavior such as notching, or any feature that includes disparate treatment of other NRSROs.

Mr. Chairman, I thank the subcommittee for the opportunity to testify today, and I look forward to your questions.

[The prepared statement of Ms. Liang can be found on page 51 of the appendix.]

Chairman SHERMAN. Now, I recognize Ian Linnell, the president of Fitch Ratings.

STATEMENT OF IAN LINNELL, PRESIDENT, FITCH RATINGS

Mr. LINNELL. Chairman Sherman, Ranking Member Huizenga, and distinguished members of the subcommittee, I appreciate the invitation to appear before you to discuss the anti-competitive practice called notching, and how S&P is, in our view, using this practice in its proposed insurer capital adequacy methodology to further its market dominance.

While we are pleased that on Monday, S&P effectively admitted that they had no basis for the proposed methodology, we hope that both S&P and Moody's will now consider alternatives to notching in local government investment pools, money market funds, bond funds, and collateralized loan obligations (CLOs), which fund U.S. small companies where either one or both of them are currently engaged in this behavior.

In 2006, Congress passed the Credit Rating Agency Reform Act to foster accountability, transparency, and competition in the credit rating agency industry. Although the Reform Act addressed the notching conducted by both S&P and Moody's in the period before its passage, both agencies have continued to engage in this activity, and the SEC has failed to stop it.

Fitch Ratings is a global rating agency located in over 25 countries. During the last 3 decades, Fitch has become the only credible challenger to the duopoly of Moody's and S&P in the credit rating industry. Credit ratings play an important role in the efficient allocation of capital by providing the financial markets with an independent view of credit risk. Any measure that reduces competition in the credit rating agency industry hurts the marketplace.

S&P's methodology is fundamentally anticompetitive because it incorporates the practice of so-called notching into S&P's assessment of insurer capital adequacy. Notching occurs when an agency either insists on rating most, if not all, of the assets owned by an entity and/or significantly reducing the ratings that other agencies have assigned to assets that they have not rated.

The proposed methodology applies significant haircuts to all non-S&P-rated investments held by insurance companies. As a result, securities held by an insurer rated AAA by Fitch or Moody's could have their credit rating lowered to AA- by S&P, while securities rated AAA by other agencies or by the National Association of Insurance Commissioners (NAIC) could 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 use its dominant market position in insurance to increase its market share in the securities com-

monly purchased by insurers, including areas where S&P has a low market share.

S&P's ratings are hardwired into many insurers' broker systems and brokers typically have criteria for recommending insurers to clients that only refer to S&P or AM Best ratings. This market power gives S&P a monopoly on insurer financial strength ratings and makes insurers hostages to S&P. As insurers are focusing on maintaining their S&P ratings, they would be discouraged from purchasing securities in those sectors where S&P rates relatively few securities. Insurers and the issuers of securities that insurance companies purchase would select S&P to avoid the punitive notching of the methodology and the negative impact on insurance financial strength ratings.

Fitch was not alone in criticizing the methodology. Many market participants have condemned S&P's proposals. In addition, the Department of Justice recently commented that S&P's methodology has the potential to suppress competition from rival rating agencies.

S&P and Moody's have been engaging in notching for over 20 years. It is time for Congress to ban notching in all market sectors and for the SEC to start enforcing this ban.

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

[The prepared statement of Mr. Linnell can be found on page 61 of the appendix.]

Chairman SHERMAN. Next, we have Mariana Gomez-Vock, who is the senior vice president for policy development at the American Council of Life Insurers.

STATEMENT OF MARIANA GOMEZ-VOCK, SENIOR VICE PRESIDENT, POLICY DEVELOPMENT, AMERICAN COUNCIL OF LIFE INSURERS (ACLI)

Ms. GOMEZ-VOCK. Good morning. Thank you, Chairwoman Waters, Chairman Sherman, and Ranking Member Huizenga, for having me here today. My name is Mariana Gomez-Vock, and I am proud to be here today representing the American Council of Life Insurers. Before I dive too much into the details, I would like to briefly touch on the big picture, because I think it demonstrates why we care about this issue so much.

The big picture is that 90 million American families, people you represent, depend on the life insurance industry to protect their financial future. Life insurance annuities, disability insurance, paid medical leave, and other products make certain that they can care for themselves and their loved ones in good times and bad. Our policies often stay with families for decades, and our promise to them is that we will be there no matter what, and we are. When the pandemic hit, life insurers were there. The pandemic hit many industries hard—retail, restaurants, airlines—but we were the industry that was writing checks and paying out to families. We were there when the worst came for too many. Benefits paid in 2020 were the highest in history. The industry paid over \$90 billion in life insurance benefits, and it is our long-term investments that are the bedrock of our commitments to be there when we are called.

We invest \$7.4 trillion in the U.S. economy. That is \$572 million every day. That makes life insurers one of the largest sources of investment capital in the nation, and our investments do more than protect policyholders. They drive economic growth in every corner of the country. Steady slow-growth investments make it possible to keep our promises while providing business owners, farmers, school systems, and communities with the working capital that they need to open their doors, fund infrastructure, and grow their workplace. That is the big picture. Now, let us dig deeper.

Insurer capital models like the one proposed by S&P are so critical to insurers that they will often shape their long-term investment and capital management strategies to align with them. When a rating agency notches an investment, it is signaling that it believes the asset has a higher risk of loss or default, and the insurer should hold more capital against it. S&P has proposed a notch, and, in some cases, disregarded credit ratings from competitors and designations from the NAIC Securities Valuation Office. In some cases, the notching would assign a 100-percent capital charge to an investment-grade asset without any clear reason for the notching, other than it is rated by an S&P competitor. We appreciate S&P's decision to revisit that part of their proposal because notching assets just because they are rated by a competitor will compromise the integrity of financial strength ratings and could disrupt capital markets. That is a bad outcome for consumers and the economy.

Before I conclude, I would like to make three brief points. The first is that ACLI supports robust competition. Competition and diversity among the NRSROs benefits the insurance industry, the economy, and ultimately, consumers.

The second point is that automatic notching is not harmless. It creates a fundamental disconnect between the asset's value and the asset's charge. Large swathes of insurance bond portfolios would have been notched, and structured products not rated by S&P would have been treated as junk under the S&P's original proposal.

We look forward to exchanging views with S&P on the appropriate treatment of NAIC-designated securities. The proposal's disregard of these designations is counterintuitive, given that the NAIC designations are designed for and overseen by State regulators whose mission is to preserve the solvency of insurers and protect consumers. There is no conflict of interest there. Automatic notching essentially inflates asset charges. It would force insurers to choose between holding artificially-inflated levels of capital or to avoid high-quality, high-yield assets just because they are rated by a competitor. Both outcomes are bad.

The third point addresses the proposal's impact on the competitive global insurance market. Some of the changes were designed to promote global consistency, an understandable goal, but some elements of the proposal appear to disadvantage American regulatory and accounting regimes. This could disadvantage U.S. insurers' ability to offer key products to consumers, like variable annuities and whole life. We look forward to continuing the dialogue on this issue.

One final observation. Much of this is highly technical, but the details matter. They matter because individuals and families all across this country are seeking certainty, and we are in the busi-

ness of providing certainty. We are there for our policyholders when they need us. We are there for communities who rely on our economic investments in our towns, suburbs, and cities so they can feel America's commerce and ingenuity. A change by the world's largest rating agency will have an impact. Those changes should be transparent and supported by data. We urge you to think of those details and the impact that they will have.

Thank you for the opportunity to share our view. I look forward to answering any questions you may have.

[The prepared statement of Ms. Gomez-Vock can be found on page 32 of the appendix.]

Chairman SHERMAN. And finally, we will hear from our last witness, Jennifer Schulp, the director of financial regulation studies at the Cato Institute.

STATEMENT OF JENNIFER J. SCHULP, DIRECTOR, FINANCIAL REGULATION STUDIES, CENTER FOR MONETARY AND FINANCIAL ALTERNATIVES, CATO INSTITUTE

Ms. SCHULP. Chairman Sherman, Ranking Member Huizenga, and distinguished members of the 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. Thank you for the opportunity to take part in today's hearing.

The state of competition within the bond rating industry is a perennial question. The Security and Exchange Commission's most recent report to Congress describes the concentrated NRSROs industry, with the three largest NRSROs accounting for approximately 95 percent of all outstanding ratings as of the end of 2020, but such broad statistics can be deceptive. As the Commission points out, smaller NRSROs have increased their total number of ratings outstanding, and have increased their share in some ratings categories. Moreover, drawing conclusions about competition from these numbers alone is difficult. A number of factors may explain the long-term tendency for the ratings industry to be comparatively concentrated. And, importantly, regulatory barriers can decrease competition. Legislative solutions should focus on lowering regulatory barriers and decreasing the artificial demand for NRSRO ratings.

The subject of today's hearing relates to a recent proposal now withdrawn by S&P Global Ratings to notch down ratings of non-S&P-rated securities when applying its methodology to rate life insurers' investment portfolios. While such notching may raise concerns about its effect on competition, legislative action is premature.

First, the proposal has been withdrawn in response to critical comments. S&P has indicated that it will issue a new request for comment which may ameliorate any potential anti-competitive concerns or raise different ones. It would be prudent to delay consideration of potential legislative action until the issue becomes more clear.

Second, other laws already prohibit anti-competitive behavior. In addition to the antitrust laws that apply without regard to indus-

try, Section 15E of the Exchange Act, and the Commission's rules, prohibit unfair, coercive, or abusive NRSRO behavior. Additional legislation may not be required.

Finally, rushing to judgment on the methodology change proposed may itself harm ratings quality by limiting NRSROs from considering the creditworthiness of instruments rated by another agency, or by substantively regulating credit ratings and rating methodologies.

Given this committee's hearing on NRSROs less than a year ago, I respectfully suggest that there are other issues more suited to the investment of this committee's limited resources. For example, the Commission's agenda may be the most ambitious in its history. It is being undertaken at breakneck speed and with an unprecedented disregard for the importance of public comment to the rule-making process. While short comment periods have the potential to limit public comment 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.

The Commission's recent announcement that it would extend the time period for its climate risk disclosure proposal, and 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. 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. 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 has declined to discuss. The Commission has instead chosen to lead with enforcement actions over rulemaking in this space.

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 at this time on NRSRO regulation. Thank you, and I welcome any questions that you may have.

[The prepared statement of Ms. Schulp can be found on page 67 of the appendix.]

Chairman SHERMAN. Thank you. We have heard from our witnesses. I will now recognize myself for 5 minutes for questions.

This is known as the Capital Markets Subcommittee. Our last hearing was on the stock markets. This hearing is about the most critical part of the bond markets. It is hard to say that we are not focusing on our capital markets. Though as a philatelist, I believe that perhaps we are leaving out the market for collectible stamps.

So, we are covering the bond market. We are covering the stock market.

The critical role that the bond rating agencies play is exemplified by the fact that if you are putting together a portfolio, and you generate a 5.7 percent return on bonds rated either AA or AAA, you look good compared to somebody else who puts together a portfolio meeting the same requirements, who is only getting 5.6 percent. The fact is, whether you are putting together a portfolio for an insurance company and trying to please your boss there, or whether you are putting together a portfolio for a mutual fund, the ratings determine what you need to put into that portfolio.

As to the problem that is focused on in this hearing, we are being told by some that it is not an important problem. Nine Republican Members signed the letter urging that this problem be dealt with, and I think our witnesses have illustrated how important this problem is. And as I say, I think this subcommittee hearing was remarkably effective and that the proposal has been withdrawn, but that raises the question for our witness from S&P, Mr. Le Pallec, is this proposal dead or just sleeping for a while?

Mr. LE PALLEC. Thank you, Mr. Chairman, and I appreciate you giving me the opportunity to give more information on the ongoing request for comment process. On Monday, the 9th of May, we published a FAQ that announced the withdrawal of one particular section that was describing the way we were proposing to deal with a fairly complex technical issue, which is how to assess the thousands of securities held by insurers.

Chairman SHERMAN. I am going to interrupt you there. We have an anti-notching statute that deals with asset-based securities. Is there any reason we shouldn't extend that to all bond issuances?

Mr. LE PALLEC. I have no particular view about that. What I am trying to say is that—

Chairman SHERMAN. Well, that is the major proposal being considered by this subcommittee, and on our list of proposals, and the fact that you aren't here to oppose that proposal commends it to all of our colleagues.

Mr. LE PALLEC. We have an open request for comment that continues. We will continue to take in comments. There were serious concerns raised. We took them into account. It is out there for everyone to see.

Chairman SHERMAN. I thank you for doing that, and knowing that this issue could come up in the months and years ahead, I think that we need legislation. Why don't I ask the gentleman from Fitch? One proposal before us is that we prevent the bond rating agencies of the United States from rating any new instruments coming out of Russia and Belarus more particularly, or we might limit it to certain state-affiliated firms. We could go further with secondary sanctions and turn to the foreign-based bond rating agencies and say, if they rated such bonds, they could not rate bonds here in the United States, or at least American issuers couldn't pay them to do so. What effect would denying bond ratings to all future issuances by Belarus and Russia have on their ability to raise capital? Mr. Linnell?

Mr. LINNELL. For us, in Russia, the ship has already sailed. We announced the suspension of commercial operations in Russia on

March 7th. We announced on March 23rd our intention to withdraw the ratings in Russia. Towards the end of March, several banks—

Chairman SHERMAN. Thank you. I will ask the gentleman from S&P, Mr. Le Pallec, are you still rating Russia?

Mr. LE PALLEC. No, we don't. We withdrew all our ratings on Russian entities—

Chairman SHERMAN. Are foreign-based bond rating agencies rating them, the Japanese, the Europeans? You don't know?

Mr. LINNELL. I'm sorry to just interrupt. The EU passed a law that for any rating agency based in Europe that endorses international ratings, they have to withdraw their ratings by April 15th.

Chairman SHERMAN. Okay. Next, I will ask our representative from Kroll, Ms. Liang, we have a system of different ratings. Instead of saying first-best, second-best, third-best, fourth-best, all the way up to 18th-best, we have weird combinations of plus and minus signs, and capital and small letters, which are absolutely unintelligible. What would be the harm to the bond rating agency if you just said, first-best, second-best, third-best? Would it be a great harm to our society if my constituents could understand what you are saying?

Ms. LIANG. Thank you for your question, Chairman Sherman. I don't think it would be any harm to your—

Chairman SHERMAN. I see that my time has expired. I am going to ask you to respond for the record.

Ms. LIANG. Okay.

Chairman SHERMAN. I now recognize the ranking member of the subcommittee, the gentleman from Michigan, Mr. Huizenga, for 5 minutes.

Mr. HUIZENGA. Thank you. Ms. Schulp, the pace and substance of the SEC rulemaking is unlike anything I have seen as well in the 6 terms that I have been here doing this. And as you had pointed out, coupled with those short comment periods, they are releasing rules really without articulating how they are going to interact or potentially contradict some of their other proposals. For instance, SEC securities lending, short disclosure, and swaps rules impact similar markets without specifying how the rules will interact with one another. Do you believe that the SEC has clearly articulated how these rules are supposed to work together?

Ms. SCHULP. No, I don't believe they have. A similar problem exists with respect to the 10b5-1 plans and the share repurchase disclosure as well.

Mr. HUIZENGA. Okay. And you have sort of articulated this in your opening statement. You would agree that the common effect of all of their rules really isn't understood by the Commission, much less those that they are actually regulating, correct?

Ms. SCHULP. Correct.

Mr. HUIZENGA. Okay. It should be noted that these rules are being released during a period of extreme market volatility as well. And I am curious, in your view, do you think these rules could be potentially adding to some of that volatility that we are currently seeing?

Ms. SCHULP. It is difficult to say what exactly is adding to the market's volatility, but the uncertainty caused by these rules can

be disruptive, both to the economy, as well as the financial industry generally.

Mr. HUIZENG. We have lots of reasons to talk to the SEC and other regulators. I guess we will have to get to those hearings in about 7 months, but trust me, it is going to be busy, so buckle up and hang on everybody.

Ms. GOMEZ-VOCK, one of the overreaching criticisms of the S&P proposal is that it diverges significantly from the U.S. regulatory framework. As I noted in my opening remarks, some of my original concerns remain, and I certainly would like to see S&P address those in any forthcoming proposals. My concern is that the divergence from the U.S. system will have material impact on insurers and their products that they offer in the financial marketplace. For instance, it appears that long-term guarantee products, such as variable annuities, which our U.S. companies offer, will be especially impacted by this proposal, unnecessarily raising costs, limiting availability, et cetera, and I am just wondering if you could comment on that?

Ms. GOMEZ-VOCK. Yes, products like variable annuities and their availability, accessibility, and affordability, which help people live and retire with predictable income, could be particularly impacted. And we are concerned with the S&P's proposal, the fact that it does diverge significantly.

Mr. HUIZENG. What is the management issue there? What is going to make it more difficult to manage that and put you at a competitive disadvantage?

Ms. GOMEZ-VOCK. I think there are a number of different reasons, given the complexity of the actual formula itself. But the big-picture issue is that for insurers, it is very difficult, if not impossible, to manage two different capital standards, and the U.S. system is the NAIC risk-based capital system. It is a book value-type approach that uses reserves and is more cash flow-based. The S&P global capital model is more similar to Solvency II and the ICS. It is more of a market-consistent framework which tends to be unfriendly to long-term products.

Mr. HUIZENG. Okay. Thank you. Mr. Le Pallec, I would like to take a moment and discuss S&P's recent decision to publish ESG indicators for U.S. States. Do you agree that these ratings, whether they are done by S&P or, frankly, any other credit rating agency, should be based solely on financial indicators within the State and items that are material to the creditworthiness of the rated entity, or are you looking at something else?

Mr. LE PALLEC. We have taken into account ESG risks in credit ratings all along, whenever those risks have had an impact on creditworthiness, and we have published that in our rating rationale—

Mr. HUIZENG. Let me stop you right there. So, materiality.

Mr. LE-PALLAC. The indicators that you are talking about are an additional element of transparency and disclosure that we have been publishing on corporations, financial institutions, and more—

Mr. HUIZENG. Is that for everybody, whether it is material or not?

Mr. LE PALLEC. That is for all entities we rate, because investors for the past 2 years around the world have been asking us con-

stantly the same question, tell us whether ESG risks have had an impact on creditworthiness or if they have, and why? And those indicators—

Mr. HUIZENG. How about D&I? How about D&I issues or some of those other, maybe not the “E” side of the ESG? Is diversity and inclusion now also part of how you rate a company or—

Mr. LE PALLEC. To the extent that it has an impact on creditworthiness, we have to take any ratings—

Mr. HUIZENG. Again, only if it is material.

Mr. LE PALLEC. The “S” would typically be aging population in any municipality or State that has an impact on cash flows—

Mr. HUIZENG. My time has expired. I appreciate it. Thank you.

Chairman SHERMAN. The Chair of the Full Committee, Chairwoman Waters, is recognized for 5 minutes.

Chairwoman WATERS. Thank you very much. Mr. Le Pallec, shortly after this hearing was announced, S&P withdrew a controversial proposal that many market observers have suggested was anticompetitive. In fact, S&P was warned by the Justice Department that the proposal would violate antitrust laws. S&P deserves no praise, however, for withdrawing a proposal it never should have put forward. Notably, this wasn’t the first time S&P proposed notching down its competitors’ ratings. In 2007, just before the financial crisis, S&P was trying to increase the market’s reliance on its own ratings by similarly proposing to undermine its competition. One positive outcome of S&P’s latest proposal has been to draw attention to other anti-competitive practices by the largest bond rating agencies.

Before the 2008 economic crisis, for example, it was a common practice among the largest two rating agencies, S&P and Moody’s, to stipulate that they would only provide a credit rating for collateralized loan obligations (CLOs), and bond insurers if they also rated all of the underlying securities issued by that CLO or the bond insurer, aiming to prevent smaller rating agencies from rating any of the underlying securities. A decade later, does S&P’s rating criteria still stipulate that S&P will only provide ratings for bond insurers if S&P also rates every underlying issuance of that bond insurer? Yes or no?

Mr. LE PALLEC. No, we don’t.

Chairwoman WATERS. I beg your pardon?

Mr. LE PALLEC. We don’t.

Chairwoman WATERS. Ms. Liang, as a smaller rating agency, what is the effect of this policy on KBRA and your ability to rate securities?

Ms. LIANG. Thank you, Madam Chairwoman. The effect on KBRA as a smaller and medium-sized NRSRO would be the same as what S&P proposed recently. I will note that the CLO market and the bond insurer market is smaller, and so the effect may not be as great as it would be in the insurance industry, but the effect would be anticompetitive in practice.

Chairwoman WATERS. Thank you. In 2015, Moody’s, whom we invited to today’s hearing but declined to come, drew criticism when a Wall Street Journal article reported that after a Pennsylvania bank contracted with KBRA for a rating, Moody’s threatened to release an unsolicited rating that was lower than the KBRA rating.

Ms. Liang, from your perspective at KBRA, what was the effect of this action by Moody's?

Ms. LIANG. Thank you, Madam Chairwoman. At the time, we had just started rating community banks, and Moody's and the larger rating agencies were not rating that space because their methodology had a size bias and did not permit the rating of the smaller banks. And so, when we published our rating and heard that Moody's was going to publish an unsolicited rating with a lower rating, we took that to mean that they were trying to discourage our entry into the market and also to undercut the viability of KBRA as a rating agency.

Chairwoman WATERS. More recently, S&P purchased IHS Markit, which at the time was one of the largest data and analytical firms in the world, for \$44 billion. Rating agencies need data to conduct their analysis. Some have raised concerns that now that S&P is in control over IHS Markit, it may limit the provision of this data to its competitors.

Mr. Linnell, do you share these concerns about S&P owning such a trove of data and analytical capabilities?

Mr. LINNELL. I think there is a broad benefit from groups having and offering a broader range of credit and risk products. It does indirectly help their core ratings business, but I don't think you can draw a line one-for-one saying that this reinforces their duopoly. I think the issue on the table today around notching and anti-competitive practices is more important, and it is a shame you didn't ask the colleague from S&P about their CLO bond fund money market funds. The reinsurance sector is not really a big sector anymore.

Chairwoman WATERS. I have only asked you about a few of these practices, but the list is longer. For example, S&P's exclusion of non-S&P-rated securities from its mixed-income indexes, S&P's notching practices in money market funds, S&P's and Moody's heavy engagement with institutional investors to maintain investment guidelines that favor S&P and Moody's, among others. Investors need a diversity of ratings opinions, and I am glad that this committee is shining a light on how incumbent large rating agencies employ various anti-competitive practices—

Chairman SHERMAN. Thank you.

Chairwoman WATERS. I yield back the balance of my time.

Chairman SHERMAN. Yes. The gentlelady from Missouri, Mrs. Wagner, is recognized for 5½ minutes.

Mrs. WAGNER. Thank you, Mr. Chairman. I hope you can watch the clock a little more closely here in respect to everyone, our witnesses and our Members.

Ms. Schulp, does the Commission's rulemaking agenda include any proposals to help facilitate capital formation? And further to that, why should the SEC be focused on reducing burdens for companies to access capital?

Ms. SCHULP. First, the Commission's agenda does not have a specific rulemaking or capital formation agenda items on it. And, in fact, I am concerned, because many of the agenda items that are on the Commission's agenda go towards putting additional burdens on capital formation themselves, such as the ESG disclosure rules.

Mrs. WAGNER. And what else? Please elaborate.

Ms. SCHULP. The ESG disclosure rules are private fund disclosure rules where the SEC is beginning to insert itself further into private markets, where the SEC has previously not done so before, which puts additional costs on capital formation in those spaces as well. There are a number of places where the SEC's proposed rules can harm entrepreneurship and harm the efficient allocation of capital.

Mrs. WAGNER. And certainly, one would think that we should be focused, at the SEC in particular, on reducing those burdens to capital formation, correct?

Ms. SCHULP. I agree. Part of the SEC's tripartite mission, as they are happy to say, is to facilitate capital formation.

Mrs. WAGNER. We will get to that. Our priorities in this committee should be, I think, as I stated, reducing the cost of capital for companies, and helping investors, our retail investors, real people out in Missouri's 2nd Congressional District who are trying to make both ends meet, helping those investors grow their savings, especially during these very difficult inflationary times. Instead, I have to say that committee Democrats and the Commission are focused on climate disclosure requirements for public companies and other initiatives, as you have outlined some, Ms. Schulp, that will ultimately discourage companies from going or staying public, which means fewer investment options for Main Street Americans.

Ms. Schulp, there has been much discussion surrounding the impact of the SEC's short comment periods, especially when it comes to the multitude of potentially interconnected proposals. Will you discuss the impact that short comment periods have on market participants and how these historically short comment periods impact the Commission's rulemaking process as its ability to uphold the three-part mission as you meant—

Ms. SCHULP. First, I think it is important to clarify that market participants really mean all of us, when we are talking about market participants here, all the way down from your retail investor who might have opinions about how the SEC should be regulating here, all the way up through your largest Wall Street banks. Your largest Wall Street banks may very well have an army of lawyers who can spend their time reading through these proposals. But even at that, being able to determine how these proposals interrelate, to really sit down and think about the unintended consequences of these proposals, short comment periods, harm that. And they harm the SEC's ability to really understand and weigh the potential effects of the rules that they have proposed. Short comment periods also result in fewer comments. They likely result in fewer complicated comments that bring some of these deeper issues to light. That is less for the SEC to deal with when they are finalizing rules under the Administrative Procedure Act, and I think that is a negative. The SEC should be able to gather as much information as possible in order to create quality rulemakings that benefit the American people, benefit the markets, and will also be able to stand the test of time—

Mrs. WAGNER. And obviously, the smaller investors and the smaller capital formation companies are greatly hindered by this. Ms. Schulp, there has been no discussion on removing barriers for everyday investors from my Democrat colleagues. Are there any

regulatory barriers you see that we in Congress could work to remove today?

Ms. SCHULP. One of the easiest is to open up the accredited investor definition to more investors. In fact, that is on the SEC's agenda, but not with the intention of opening it up further, but rather taking a look at it again to close it down and to make private market investments less available to average individuals.

Mrs. WAGNER. Barriers, barriers, barriers, when we have to be concentrating on growing capital, capital formation, and helping our investors grow their savings. I thank you for your input, and I yield back the balance of my time.

Chairman SHERMAN. The gentleman from Georgia, Mr. Scott, who is also the Chair of the House Agriculture Committee, is recognized for 5 minutes.

Mr. SCOTT. Mr. Linnell, let me start with you. I am very concerned about competition in the credit rating agency industry and the impact that market domination could have on banks, insurers, financial companies, and other industry participants. And about the ratings market, there are some who feel that they should remain as they are, which really looks like an oligopoly where only a small number of participants compete in order to safeguard their reputations of the ratings. However, studies that have been brought to my attention have shown that competitive dynamics, even amongst a small number of rating agencies, can result in higher-quality ratings and potentially mitigate the inherent conflict of interest in the issue-payers model.

Mr. Linnell, tell me, how would you assess competition amongst the credit rating agencies, and how is this competition distinct from other markets?

Mr. LINNELL. I think since the passing of the Dodd-Frank Act after the financial crisis, competition in the rating agency industry in general has intensified. We are seeing more and more new entrants. I think a good example of that is what we are talking about today, really one aspect of it, which is the U.S. structured finance market. There, back around 2010, you really had the Big Three firms competing with each other: Fitch; Moody's; and S&P. But since then, you have had the new entrants. We have Kroll, and then you have had DBRS expanding with the merger with Morningstar, and their market share has increased significantly. They are up to about 20, 25 percent of the market each, while the Big Three have come down quite steadily to around about 45 percent, and we are about 30 percent.

What you have there is a market that has gone from three large players to one, where there are five agencies competing with each other, and there are new agencies coming up all the time. So I think competition is good, but there are still problems in the industry, and S&P and Moody's benefit from institutional barriers, but some due to their own policies which they have put in place, such as notching, which is what we are here to discuss today.

Mr. SCOTT. Okay. Do you believe that robust competition for the credit rating industry is the absolute best way to promote the continued integrity, reliability, and quality of their ratings?

Mr. LINNELL. Yes, as long as it is combined with transparency. As long as you have transparency around the performance of those

ratings, how those ratings have been developed, what analysis and what issues support those ratings, then, yes, absolutely, competition tends to produce—

Mr. SCOTT. How would you rate transparency in the industry right now?

Mr. LINNELL. I think it is pretty good. The agencies generally had a high level of transparency going into the financial crisis, but regulatory reforms around Dodd-Frank and similar regulations in Europe promoted a much greater level of consistency in the way that agencies provide information to the market. I think the level of transparency is—

Mr. SCOTT. Yes. I want to get to Ms. Liang with this question. Ms. Liang, you cited in your testimony how difficult it is to even enter the credit rating agency market, and highlighted the Securities and Exchange Commission's registration process as a barrier to new entrants. What specific changes would you suggest that the SEC consider making to increase the number of new credit rating agency registrants?

Ms. LIANG. Thank you for your question. Currently, the SEC regulation requires new entrants to the market to basically provide attestations from investors who have used that applicant rating agency's ratings for 3 years. This is a very difficult bar to achieve because most investors have little use for ratings from non-NRSROs. So, I think it might be helpful for the SEC to look at different ways that new entrants could enter the market. I leave it to them in their research on how best to do that, but I would be happy to continue the conversation.

Mr. SCOTT. Thank you, Ms. Liang. I am done with my questions, Mr. Chairman, relatively on time.

Chairman SHERMAN. Thank you. Relatively. I now recognize the gentleman from Arkansas, who is also the Republican lead on the Russia and Belarus Financial Sanctions Act, Mr. Hill, for 5 minutes.

Mr. HILL. First, let me thank the Chair for our collaboration together on economic cost, raising the economic cost on Putin and the Kremlin for their illegal invasion of Ukraine. And yesterday, we had excellent work on that on a bipartisan basis to send the signal to our transatlantic partners that the U.S. speaks with one voice on raising the economic, diplomatic, and military costs of Putin's illegal invasion. So today, thanks for having this hearing to talk about our rating agencies, and I couldn't help but notice a number of the bills that were noticed and attached to this hearing. One was of particular concern to me, which is the Commercial Credit Rating Reform Act, that proposes to change the rating assignment model process.

After the financial crisis, as we have talked about this morning, Dodd-Frank tasked the Democrat-led SEC at the time with implementing a ratings assignment model, which meant the creation of a quasi-governmental board to assign qualified rating agencies to provide ratings. The SEC thoroughly considered a range of business models, and many other market participants raised concerns that the writing assignment model's quasi-governmental board would hold significant influence over the capital markets by being the sole party to select and assign ratings for the entire market

rather than relying on market checks and balances, competition, and investors.

And after a thorough review and public feedback, the Commission decided not to mandate any structural changes to what is known as the issuer pay model. We have talked about this now for over a decade, and we certainly recognize that credit rating agencies have potential conflicts of interest, regardless of whether issuers, investors, or governments pay for those ratings or assign those ratings. Our goal as policymakers should be to ensure that these potential conflicts are managed and mitigated. That is the whole secret to the capital market system, is, of course, it has built-in conflicts of interest in it. And the whole question about public policy is, can those be transparent? Can they be managed in the right way? Can they be subject to the checks and balances of those market forces? So, despite those potential conflicts of interest, issuer pay produces a stronger and, I think, less biased signal for market participants. My thoughts are, we had these conflicts, and they are not going to be solved, in my view, by turning more power over to the government.

Let me start with you, Mr. Le Pallec, and I will, in turn, ask the other rating agencies present to comment. Would you agree that a rating assignment model would discourage independent competition and risk that would end up deteriorating the quality and future innovation in the credit rating industry?

Mr. LE PALLEC. Thank you for your question. Certainly, we have reservations about this proposal. We think it treats ratings as a commodity, and prevents investors from making their own choices. Investors may have very different use cases, and they rely on the diversity of view in the market, and we want the market to be competing on the quality of our ratings.

Mr. HILL. Thank you

Mr. LE PALLEC. Also, in terms of the feasibility, particularly for the corporate market, it would be very important to consult with the corporate issuers. Apart from Treasuries, that is the biggest section of the market in the United States.

Mr. HILL. Right. Mr. Linnell, what do you think?

Mr. LINNELL. Just a moment ago, we talked about the benefits of competition, and what is the best way to provide high-quality credit ratings to the market. A board or some sort of selection process is essentially a government subsidy and just removes that incentive. We continue to think it is a bad idea. It just introduces new potential conflicts, new costs, and new bureaucracy, and isn't needed.

Mr. HILL. Good. Thank you. I would like to invite the other agencies here to send me a written answer to that question.

Let me switch gears to Ms. Schulp from Cato. Given the significant influence that this quasi-governmental board would have for a ratings assignment model, doesn't this approach in and of itself carry its own conflict of interest?

Ms. SCHULP. It absolutely does.

Mr. HILL. Tell me more. Tell me why you think that is just a bad idea in search of a challenge?

Ms. SCHULP. I think we have recognized, and as Congress has recognized before, by promoting and seeking to promote competi-

tion in the rating space, that competition is the way to keep these conflicts within check. And in order to encourage the additional development of new methodologies, refinement of methodologies, and continuing to innovate in the credit rating space, the government, a quasi-governmental board, or a governmental board assigning ratings in that way removes the incentives for all of that development and the focus on quality in the same way.

Mr. HILL. Thank you. And, Mr. Chairman, thank you for the hearing, and I yield back.

Chairman SHERMAN. Thank you. The gentleman from Texas, Mr. Taylor, is recognized for 5 minutes.

Mr. TAYLOR. Thank you, Mr. Chairman. I appreciate that. Mr. Linnell, I wanted to hear from you about what changes have been made in your business model over the last decade since the financial crisis?

Mr. LINNELL. The business model itself is unchanged, the issuer pay model. But since the financial crisis, particularly after the passing of Dodd-Frank, we put in a number of different changes to reflect the legislative requirements but also just to continue to invest and grow and improve our own risk management infrastructure.

The Dodd-Frank Act, in particular, introduced a formalizing control framework around the determination of ratings, formal legal attestation around those controls being adequate to manage those risks. It requires the board now to independently approve all criteria. It created a formal compliance officer role and also strengthened the regulatory oversight of the rating agencies for the creation of the credit ratings unit within the SEC. And it also encouraged greater transparency and disclosure around things like key rating drivers and standardization, of how agencies talk about key risks in their ratings. And these regulations, which, as we all know, run many hundreds of pages, are echoed as well in the EU regulation around the credit rating issue, Directives Number 2 and 3.

So, there has been a significant strengthening of the control infrastructure, all designed to more effectively manage this conflict of interest that we all talk about. And then, in addition, disclosures have been significantly stepped up across the industry. And I think there is a general acceptance, or at least that is what I hear, that disclosure standards are pretty robust.

Mr. TAYLOR. And in terms of your underwriting, how has that changed over the last decade?

Mr. LINNELL. Essentially, we are trying to predict the future with credit ratings, right? Is the company going to honor their obligations in 10, 15, 20 years' time? We continue to think about new ways of how we can analyze risks, how we can look at new and emerging risks. There is a discussion on ESG risks but cybersecurity risks, conduct risk, all new risks are starting to come and play a greater prominence.

We continue to strengthen things like different access to information, the way that we look at data and using new technologies around machine learning, artificial intelligence, and also strengthening internal control functions, such as our credit policy group, which is not aligned to any particular group. It is an independent internal task force, if you like, that looks at the quality of our rat-

ings. And we continue to think about how we can improve our methodologies and criteria to reflect the ever-changing risk environment in which we operate. And I think overall, you can see that in the performance of the ratings that continue to be very strong since the financial crisis.

Mr. TAYLOR. Ms. Schulp, just to switch to you, are there any regulatory barriers that you think could be removed, that would help improve the markets?

Ms. SCHULP. Sure, and it has been discussed before, but I think the—

Mr. TAYLOR. Why don't you just add on new information—

Mr. SCHULP. Yes. The registration, the letters from investors for 3 years in order to become an NRSRO has been cited time and again as a barrier to entry into the NRSROs space. And regulations and legislation across the government that recognize particular NRSROs for recognition for investment and other purposes itself creates an anti-competitive environment where the smaller ratings agencies are disadvantaged. I think those are places to focus on.

Mr. TAYLOR. Okay. Thank you. Mr. Chairman, I yield back the balance of my time.

Chairman SHERMAN. Thank you. I now recognize the gentleman from Wisconsin, Mr. Steil, for 5 minutes.

Mr. STEIL. Thank you very much, Mr. Chairman. Ms. Schulp, as we have discussed today, the SEC has been rushing out new significant rulemakings and setting unusually short comment periods. I am concerned with the substance of many of these rules, but I am also worried about the SEC's pace, that is designed to limit substantive public comment. I know you have authored multiple public comments for rules. Is this correct?

Ms. SCHULP. Correct.

Mr. STEIL. How long does it typically take to draft substantive comments on a significant rule proposal?

Mr. SCHULP. Quite a bit of time. It depends on the rule proposal, but it is a solid—

Mr. STEIL. Give me a range.

Ms. SCHULP. A couple of weeks' work for me, while I am not focused on other things—

Mr. STEIL. So from the moment you start, it is a couple of weeks of full-time work, from the moment you start to getting those rules out. In that context, if you have other things going on, which most people do, when we have unusually short periods of time, it makes it incredibly difficult for individuals, companies, and stakeholders to provide substantive comments to SEC rules. Is that correct?

Ms. SCHULP. It does, and I will say that the pace has caused me to pick and choose what I would comment on in ways that I would otherwise not do.

Mr. STEIL. So you pick and choose, but it also limits others who are able to provide comments, meaning it limits those who might want to provide comments from providing those comments?

Ms. SCHULP. Absolutely.

Mr. STEIL. And what does it do to the quality of our regulations? Is the SEC at risk of having blind spots because they are not going to have the opportunity to receive comments from stakeholders?

Ms. SCHULP. I think that is true.

Mr. STEIL. Let me shift gears slightly. You wrote an article last year criticizing the SEC's paternalistic attitude. And in many ways, I share some of the concerns you put forward in that article, in particular as it relates to excessive restrictions and burdens on retail investors, reducing opportunities for millions of American families to be able to participate in our capital markets. And my colleagues are concerned about wealth inequality. I think one of the areas that we have an opportunity to push back on is some of the SEC rules and regulations we see being put forward in a paternalistic manner.

I would like you to just, tightly here because I want to jump to another question as well, identify some of the proposals or general beliefs that you think the SEC exemplifies with this paternalistic approach?

Ms. SCHULP. The ESG rules that are coming out, the climate risk disclosure rules, those in particular are problematic because they are going to encourage companies either to not be public or to go private as the situation depends. And that will remove the ability of average investors to invest in those companies that are having important roles in our economy.

Mr. STEIL. I think that is really important. So, your average mom-and-pop retail investor, when companies leave the public markets, go into the private markets, it gives an advantage to private equity firms. It gives an advantage to some of the biggest players on Wall Street, and removes the opportunity for Main Street mom-and-pop kind of investors to be able to invest and take advantage of U.S. capitalist structures.

Ms. SCHULP. Absolutely.

Mr. STEIL. Let me shift gears with you for a moment. I want to talk about one of the core principles of securities law that seems to continually come up in this hearing, or in this committee, and that is materiality. As you know, this principle underpins our disclosure-based system. And it served investors quite well for decades, and under current law, if information is material to investors, it needs to be disclosed. Is that correct?

Ms. SCHULP. Within the broad categories that the law already requires disclosure on, correct.

Mr. STEIL. Correct. And the SEC, in my opinion, appears to be moving away from this traditional interpretation of materiality, in particular as it relates to the climate disclosure rule that they are working on. SEC Chairman Gensler and Commissioner Lee have argued that there is an investor demand for climate disclosures, so the SEC should be required to act on that. Can you talk about how the SEC's interpretation of materiality in their argument supporting the climate disclosure rules differs from the traditional understanding of the term?

Ms. SCHULP. When looking at the climate risk disclosure rules, the connection between so many of the things that are disclosed and financial materiality is tenuous at best, and, in some cases, completely absent. What is also important to know is that investor demand can be a component of whether something is material to an investor. The SEC relies, in its climate risk disclosure rules, solely on demand from large institutional investors who have

worked climate risk into their modeling. While that is not unimportant, they are focused solely on the largest investors rather than on what the whole market and perhaps what individual investors might want in an investment.

Mr. STEIL. Thank you very much. Mr. Chairman, I remain concerned about where the SEC is headed as it relates to shifting away from materiality, and, in particular, the rush of some of these rulemakings. Cognizant of time, Mr. Chairman, I yield back.

Chairman SHERMAN. I now recognize the gentleman from Illinois, Mr. Foster, who is also the Chair of our Task Force on Artificial Intelligence, and has recently arrived from his important work at the Science Committee, and he is recognized for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman. The Dodd-Frank Act required SEC staff to study and publish a report, and one that the credit rating system would benefit from requiring NRSROs to adopt uniform rating scales and rating symbols. In the final report published in September of 2012, the Commission found that, "Standardizing credit rating terminology may facilitate comparing credit ratings across rating agencies and may result in fewer opportunities for manipulating credit rating scales to give the impression of accuracy." However, the SEC staff ultimately recommended the Commission not to take further action, to require increased standardization, primarily because of concerns over feasibility. A discussion draft attached to this hearing would direct the SEC to issue rules to require all NRSROs to use a uniform set of credit ratings for each of the 6 categories of credit ratings recognized under the Securities and Exchange Act.

So, Mr. Le Pallec, Mr. Linnell, Ms. Liang, all three of your firms use an identical set of rating symbols for corporate issuers. Do you feel that uniformity in your rating scales allows investors to more quickly and easily understand your ratings?

Mr. LE PALLEC. What we know from investors is that they benefit from a diversity of views, and we don't think that treating ratings with common definitions across the piece could lead to handling them like commodities, and would lead to convergence of methodologies, and would, therefore, limit competition on quality in the market.

Mr. LINNELL. Yes. I would just add that you have to differentiate between the two issues of the standardized criteria and the definitions of those ratings versus the actual nomenclature of the scale. You could, if you wanted to, propose and argue for a standard scale. In fact, there are some pieces the same at Fitch, and Moody's is pretty similar. It uses 21 gradations. And I figured that as an industry, we should be open to positive feedback or criticism that a common scale itself may be facilitate little transparency and comparability. But you don't want to undermine the independent integrity and the diversity these agencies have by putting and enforcing the same criteria across the agencies.

Mr. FOSTER. Yes. Ms. Liang? About those—

Mr. LIANG. Thank you. I would agree with my colleagues regarding preserving the diversity of perspectives, and better serving the market. Another way we could come at it is perhaps requiring more disclosure, because I have heard you and your colleagues talk about the difficulty in understanding rating scales, and perhaps in-

creasing disclosure on those rating scales might help with clarity and understanding.

Mr. FOSTER. Yes. Another mechanism that I have heard suggested is that a small fraction, say 1 percent, of all issuance would have to be rated by everyone, all major players in the market. So that, combined with standard ratings, and you could actually have an interesting discussion when you saw a wide divergence of ratings for a single issue. Is that something you would have any comments on as a possible way to get it part of the whole conflict-of-interest problem in this?

Mr. LINNELL. Maybe I will take a stab at that. It could be an interesting way of doing it. But I think in reality, if you look in most markets and you did the Venn diagram of coverage of the agencies and even at the new agencies, you probably have plenty of examples where they are already covering 1, 2, 5 percent of similar rating. You may already have that in play. And indeed, part of our approach has been to do unsolicited ratings where we believe our ratings are different from the existing ones of S&P and Moody's on some of the major issuers that are of interest to investors. Again, the competition between the agencies creates that comparability in many of the industries and sectors we are talking about.

Mr. FOSTER. So, when you issue an unsolicited rating, and in some sense you turn out to be right, does the market reward you for making a correct objection to one of your competitors' ratings?

Mr. LINNELL. I would hope, but I figure it is more in the long term. It is about building your reputation and your franchise for the quality of the work that you do, and that is what everybody should be striving for, to compete on the quality of their analytics and the quality of their ratings. Over the long term, you hope that kind of action would result in that benefit.

Mr. FOSTER. That is right. Of course, one of the big challenges is that you only see in times of distress, whose ratings are not as solid as they might have been.

Well, my time is up now, and when you figure all this stuff out, let me know. We have been struggling with it for a decade. Thank you, and I yield back.

Chairman SHERMAN. And longer. The gentleman from Ohio is recognized for 5 minutes.

Mr. GONZALEZ OF OHIO. Which one?

Chairman SHERMAN. Mr. Gonzalez.

Mr. GONZALEZ OF OHIO. Thank you, Chairman Sherman, and thank you to our witnesses for being here today. I want to start by echoing some of the comments of Mr. Huizenga and other colleagues expressing concern with the direction of the subcommittee. Just recently, the financial stability report came out from the Federal Reserve. This is the Capital Markets Subcommittee, and one of the things being highlighted is low liquidity and cash, Treasury securities, and equity-indexed futures. That is a major issue. If we have liquidity challenges, if the depths of our markets all of a sudden are impaired, the ability of the financial system to respond to large shocks is severely diminished. And I hope at some point, we will start taking up some of these, what I would consider more pressing issues, and certainly ones that could really harm the financial system.

That aside, Ms. Liang, I want to start with you. As part of this hearing, the Majority attached a discussion draft called the Commercial Credit Rating Reform Act. A provision within this legislation would establish a newly-created credit rating agency assignment board that would assign NRSROs to provide ratings for corporate issuers. Can you discuss some of the concerns that you have with this sort of approach?

Ms. LIANG. Absolutely. Thank you very much for the question. I think some of these topics have already been touched on, but I feel that an automatic assignment would be to guarantee business for rating agencies and would create a disincentive to provide quality research. I think, ultimately, the market investors, and the investing public at large would suffer from that lack of quality research.

Mr. GONZALEZ OF OHIO. Thank you. I couldn't agree more. I know that there are obviously some challenges in this particular market, but to just assign them at the Federal level, I think is a little bit absurd.

Mr. Le Pallec, earlier this week, S&P announced that it was going to withdraw the notching proposal, but said that, "We are considering alternatives for the withdrawal elements." Do you expect this alternative proposal to come out in 2022, and do you have any more information that you could share on what is being considered?

Mr. LE PALLEC. Thank you for your question. Yes, the request for comment process continues. As we said last Monday, we are going to go back to the market with proposals on how to handle the technical issue at hand, and we plan to come out with a final criterion by the end of this year. We will update the market as we know more and as we treat more comments. We want to maintain the same high level of transparency we have applied up until now, and we will continue to do so.

Mr. GONZALEZ OF OHIO. Thank you. I think that is very, very important.

Ms. Liang, back to you. In your testimony you, sort of related to the first question, discuss the importance of increasing competition in the NRSRO market. What are the key barriers this committee should further explore to promote that competition in the credit rating market?

Ms. LIANG. Thank you for your question. I highlighted a few instances where there continue to be systemic barriers to competition. Many investor guidelines still require the incumbent rating agencies by name, and certain Federal regulations and facilities require and refer to the larger NRSROs by name, rather than all NRSROs. I think taking a look at those references and requirements would be helpful in promoting competition, and certainly, I think that continued attention to S&P's proposed methodology would benefit competition in the credit rating industry.

Mr. GONZALEZ OF OHIO. Thank you. I couldn't agree more. Again, sort of basic stuff: more competition, more choice, deeper markets, less government dictating and interventions, I think, is usually the direction we want to go. This is certainly no exception. Again, I want to reiterate, I hope we spend more time on some more pressing issues than this, but with that, I yield back.

Chairman SHERMAN. For the record, I believe the gentleman from New Jersey has asked that we waive him and go on to the next Member, unless that is incorrect. And so, we will go to the second gentleman from Ohio, Mr. Davidson, for 5 minutes.

Mr. DAVIDSON. Thank you, Mr. Chairman, and thanks for convening this hearing. I think it is useful. It is a good hearing, and of the fact, as you highlighted in your opening remarks, Mr. Chairman, part of the purpose was already achieved. I look forward to the discussion with our witnesses, and thank you for being here, but I really want to kind of join the urgency of getting the Securities and Exchange Commission here. We really need to weigh the weighty matters. And frankly, my colleagues, Mr. McHenry and Mr. Huizenga, sent a letter to Chairwoman Waters on May 5th. Since we weren't here in town, perhaps it has escaped notice. And, Mr. Chairman, I wouldn't want it to escape your notice, so I ask unanimous consent to submit that letter for the record.

Chairman SHERMAN. Without objection, it is so ordered.

Mr. DAVIDSON. What that calls for is a hearing of the full Securities and Exchange Commission, because it is very clear that Chairman Gensler is exceeding the authority that Congress has granted to the Securities and Exchange Commission. He is acting outside of the scope of the authority. And certainly, even within the authority, there has been some ongoing concern for regulation by enforcement and the harm that is causing to capital formation here in the United States. And, frankly, when they say they are protecting investors, obviously their view of protection sometimes means preventing investors from even participating in markets and owning certain assets, and there are huge consequences for that, no more so than in fintech and digital assets. I hope that, frankly, the letter will not just be submitted for the record, but that it will be read and fully supported, because this kind of accountability ought to be overwhelmingly bipartisan. It will certainly happen with a Republican Majority, but we might as well get it underway now.

Mr. Le Pallec, can you explain the process of mapping ratings given by other firms and factoring them into S&P ratings? How does it work?

Mr. LE PALLEC. Mapping is one of the options that we have to get to a view on the creditworthiness of assets held by insurers as per the withdrawal methodology, so we don't consider everything is junk. Actually, we do mapping by exception. And we do mapping for credit rating agencies for whom we have common ratings, a lot of ratings in common so that we can translate, if you will, their ratings into our own. This is what mapping tries to do.

Mr. DAVIDSON. Is it similar to crowdfunding, crowdsourcing—the wisdom of crowds, and to some, is it vulnerable to groupthink?

Mr. LE PALLEC. No. It is a statistical study that just looks at default and performance statistics published by all of the credit rating agencies. And wherever we have ratings in common, we translate their ratings into our own because, as we said, rating definitions differ from one credit rating agency to the other. This is what mapping tries to do.

Mr. DAVIDSON. It basically translates how you score versus somebody else?

Mr. LE PALLEC. It is a translation exercise.

Mr. DAVIDSON. Okay. I would like to ask an open-ended question to the three witnesses representing credit rating agencies today. The COVID-19 pandemic provided a real-world stress test within every aspect of the financial industry. This includes credit ratings, since access to Federal emergency lending facilities is tied directly to an applicant's credit rating—not in every case, but often. My question for the rating agencies is, of all the defaults that you saw among companies that you provided ratings for, what percentage of them were of speculative grade?

Mr. LE PALLEC. Most of those that defaulted were of speculative grade because the definition of a, "speculative rating," is that it is more likely to default than an investment-grade rating. But COVID was the biggest stress test for the industry that we had since the great financial crisis, and now, if you look at rating's performance through COVID, you will see that they are completely in line with rating definitions and expectations built in the rating. So we can say that, in our case, COVID pressure tested our ratings and they performed as expected, which, for us, makes us very proud.

Mr. LINNELL. Can I just add to that? Actually, I think the default way of companies is actually quite low and lower than what you would expect in a typical stress test. And the reason why was because of the unprecedented policy response by governments around the world, which offensively created a bridge from a stressed COVID world to a post-COVID world. And the performance of companies and, therefore, the performance of credit ratings benefited from that.

Mr. DAVIDSON. Thank you. Any other comments on that?

Ms. LIANG. I apologize. I don't have those statistics at my fingertips, but I would be happy to follow up with you and the committee on that.

Mr. DAVIDSON. Thank you, and we certainly hope that stress test is behind us, and hopefully, the lessons learned can help us in the future, so that we can keep pandemic risk and minimize the political risk. Governments around the world laid a pretty heavy hand on industry, certainly helpful in some cases, and so, thank you for highlighting that positive aspect.

My time has expired, and I yield back.

Chairman SHERMAN. I want to thank the Members and, particularly, the witnesses, for participating in this important hearing today.

The Chair notes that some Members may have additional questions for these witnesses, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing is now adjourned.

[Whereupon, at 11:41 a.m., the hearing was adjourned.]

A P P E N D I X

May 11, 2022



Statement for the Record

Submitted to the

U.S. House Financial Services Subcommittee on
Investor Protection, Entrepreneurship and Capital Markets

"A Notch Above? Examining Bond Rating Industry"

May 11, 2022

On behalf of

Mariana Gomez-Vock
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The American Council of Life Insurers appreciates the opportunity to share our views on S&P's proposed insurer risk-based capital adequacy methodology ("the proposal"). Life insurance companies have been part of America's economy for more than 175 years. Today, life insurers pay out \$2.4 billion to our customers every day, compared to the \$3 billion paid by Social Security each day. The business model that makes life insurance companies this sort of stalwart is founded on the certainty that life insurers will maintain the financial solvency to deliver on our promises now, and in the long run.¹

Mr. Chairman, 90 million families nationwide – people you and your colleagues in Congress represent – depend on the life insurance industry to protect their financial future, for whatever life brings. Life insurance, annuities, disability insurance, paid medical leave and other products make certain they can take time off if they're sick or injured, and care for themselves and their loved ones in good times and bad. Our policies often stay with families for decades, and our long-term investments underpin the promises we make to show up when it counts.

When the pandemic hit, life insurers were there. The pandemic hit many industries hard – airlines, retail, restaurants. We are the industry that was writing checks and paying out to families and loved ones during that time. We were there when the worst came for too many. Benefits paid out by life insurers in 2020 were the highest in history – \$90 billion were paid in individual and group life insurance benefits. The increase in claims over 2019, a 15.4 percent jump, was the largest year-to-year increase since the Influenza Epidemic of 1918.

Recognizing the financial hardship COVID-19 created for so many families, life insurers quickly established extended grace periods. We worked together with state officials so policyholders can make payments later and keep coverage now. Life insurers also actively worked to help families understand and obtain the relief provided by the Coronavirus Aid, Relief, and Economic Security ("CARES Act"), which expanded access to retirement funds and provided a critical lifeline to those struggling to make ends meet.

But life insurers do more than pay claims. Life insurers also invest \$7.4 trillion in the U.S. economy – \$572 million every day – making life insurance companies one of the largest sources of investment capital in the nation. Our investments do more than protect our policyholders. They drive economic and job growth in every corner of the country. Life insurers invest in agricultural loans, education bonds, residential and retail mortgages, and other foundational investments that help businesses and communities open their doors, fund infrastructure, and grow their workforce.

As the trade association representing a major source of long-term capital in the U.S., ACLI engages when something could adversely impact how our members invest. In December 2021, S&P issued a request for comment ("RFC") on an extensively revised insurer risk-based capital adequacy methodology ("the proposal" or "the capital model"). Changes to financial strength rating

¹ Strict state laws govern solvency and capitalization, and companies make sure they always have sufficient funds to pay claims without assistance from state or federal governments. Key to this process is the investment of premiums received on policies, annuity contracts and other products, and setting aside assets in reserve to meet obligations whenever they arise.

methodologies are highly important to our members because they are an opinion of whether a life insurer can honor its promises now and in the future.

Financial strength ratings are so critical that insurers will often shape their long-term capital investments and capital strategies to conform with rating agency capital model requirements. Furthermore, given the role of life insurers as one of the largest sources of investment capital in the United States, a significant change in how the world's largest rating agency treats insurers' investments could reverberate through the U.S. economy. As such, any proposed capital model changes should be transparent and supported by objective, empirically supported data. This is especially true if a proposed methodology diverges significantly from the U.S. regulatory framework or would result in the notching of broad swaths of insurers' portfolios. The former requires vigilance to ensure long-term products remain available and accessible to American families, and the latter could jeopardize competition in the rating industry.

To be clear, ACLI is not opposed to rating agencies updating their capital models or asset charges. ACLI recognizes the need for rating agencies to periodically review and update their capital adequacy methodologies. ACLI supports several of S&P's stated objectives in the RFC, including the desire to improve the transparency and usability of the insurer capital adequacy methodology. ACLI submitted comments and we appreciate S&P's willingness to thoughtfully consider feedback on the proposal. We welcome S&P's announcement to withdraw portions of the RFC related to notching and mapping. We look forward to continuing a constructive dialogue with S&P regarding their proposed insurer capital model. Below, we have highlighted a few of our concerns to share with the subcommittee.

1. Permitting Nationally Recognized Statistical Rating Organization's ("NRSROs") to automatically notch securities without empirical evidence could jeopardize financial strength ratings, harm capital markets, and restrain competition.

S&P's original RFC would have automatically notched or disregarded credit ratings from other NRSROs, as well as the NAIC Securities Valuation Office ("SVO") on non-S&P rated assets, when determining the appropriate amount of risk-based capital that insurers should hold against bonds or securities on their balance sheets. When an asset on an insurance balance sheet is "notched" by S&P, the insurer must hold additional capital against the asset. In some cases, the proposed notching would result in an investment-grade asset being assessed a 100-percent capital charge without any clear reason for the notching, other than the fact it was not rated by S&P.

a. Asset-risk charges should be empirically supported

Asset-risk charges should reflect a data-driven analysis of the assets' credit quality and other intrinsic factors. An independent, third-party review of available data indicates that the proposed notching of non-S&P rated assets was not supported by available data.² Absent further empirical support for the notching, it appears that the notching would have introduced non-economic factors that were unrelated to the asset's credit risk into the insurer capital

² Investment Bank Research, "Analysis of Historical NRSRO Ratings Data," received March 2022.

model. Introducing non-economic factors would potentially compromise the integrity of life insurer financial strength ratings.

ACLI does not oppose treating an asset as lower-quality than its rating by another NRSRO if it is justified by the underlying economic facts - such as the probability of default. However, ACLI disagrees that it is appropriate to notch an asset, or in the case of a structured product, apply a BB or CCC charge, solely because the product was not rated by a particular NRSRO.

b. ACLI supports competition among NRSROs

ACLI supports competition among NRSROs, as well as the development of processes to reconcile any significant differences in ratings between different NRSROs, where they exist. Rating agencies should, as a rule, use complete mapping schemes in capital models. Failing to map to all NRSROs and lumping the NAIC Securities Valuation Office in with non-mapped NRSROs, would impair competition among NRSROs.³

Competition and diversity between NRSROs benefit the insurance industry, capital markets, and the economy. Effectively forcing insurers to acquire securities in asset classes rated by a particular NRSRO would reduce bond-issuers freedom to choose among NRSROs based on price, quality and efficiency. There are also some attractive asset classes that certain NRSROs may not invest in the staff and resources needed to develop a particular methodology or expertise in rating. But competition in the marketplace has created opportunities for other NRSROs to focus these asset-classes.⁴ S&P's notching proposal raises the question of whether insurers will continue to have the same access to these assets.⁵ Such a result would be contrary to the goals of the 2006 Credit Rating Reform Act,⁶ in which Congress sought to increase transparency and competition among NRSROs.⁷

³ Mapping is the process of establishing a correspondence table that can be used to statistically map assets rated by another rating agency to the S&P Global ratings scale.

⁴ This is understandable given that each NRSRO is a business and needs to make decisions on where to allocate its scarce resources. For example, an NRSRO may decide not to rate an asset class because it is too small to justify the investment or because a competing NRSRO already has differentiated expertise.

⁵ Examples of these asset classes include: (i) Private credit in the form of private placements (Reg D) and directly sourced financing arrangements with privately owned companies or public companies that do not seek out public ratings - this category also includes the growing category of impact investments; (ii) Community banks, capital securities issued by community banks, and trust preferred (TRUP) CDOs (*i.e.*, securitizations of community bank securities); (iii) Securitizations of an ongoing stream of consumer loans originated by a given lender that might ramp up over time as loans are made according to defined set of credit rules. A large portion of the loans to U.S. consumers are financed through these vehicles; (iv) Firms that originate consumer loans through a bank partnership model (*e.g.*, Affirm, Upstart, etc.); (v) Ginnie Mae early buyouts; (vi) Certain assets supporting the clean energy transition (*e.g.*, solar or PACE assets); (vii) Whole business securitizations of restaurants and other businesses.

⁶ Credit Rating Agency Reform Act, Pub. L. 109-291 (2006).

⁷ On 3/5/2021, now-SEC Chair Gary Gensler [wrote to the Senate Banking Committee](#) stating that "Promoting competition in the credit ratings agencies . . . is critically important to the SEC's mission" and that "[w]eaknesses at credit rating agencies contributed to the 2008 financial crisis as the 'issuer pays' model led to conflicts and potentially misaligned incentives." Similarly, in 2016, the European Securities and Markets Authority [noted that](#) "[o]ne of the objectives of the EU's regulation of credit rating agencies . . . is to stimulate competition in the credit rating industry."

c. Automatic notching would distort financial strength ratings, disrupt markets, and ultimately harm consumers.

Automatic notching is not harmless. If it is applied without consideration to the quality of the underlying asset it could distort financial strength ratings, disrupt markets, and harm the economy by potentially disrupting a portion of the \$7.4 trillion invested by life insurers. In its original form, the proposal would have notched large swaths of bond portfolios, and deemed structured products not rated by the three largest NRSROs, as no better than CCC.⁸

This type of notching potentially harms both insurers and consumers by requiring insurers to choose between holding artificially elevated levels of capital or to forgo yield on high-quality assets because they were rated by one of an NRSROs competitors. This may disrupt markets and impair liquidity and asset valuations, because it is reasonable to assume that insurers may feel compelled to sell or avoid investment-grade assets to avoid the threat of onerous capital charges. That, in turn, would have encouraged issuers to seek out S&P ratings, increased S&P's market share and potentially eliminated the checks and balances created by competition in the NRSRO market.

Other additional considerations include:

- Insurers play a significant role in financing vast segments of the economy through the investment debt markets. These segments include corporate bonds and loans, residential and commercial real estate loans, and consumer credit offerings (e.g., credit cards, car loans, etc.). The notching proposal would have artificially dampened insurers' interest in assets rated by other NRSROs. If adopted as proposed, this would ultimately drive higher funding costs for borrowers as the market reprices assets not rated by S&P – and not because the assets are implicitly riskier, but because these assets, post-notching, would consume much more capital on insurers' balance sheets.
- If the original notching proposal was adopted, it would have an outsized effect on fixed income structured products. In 2021, approximately 58 percent of North American issuances of asset-backed securities and mortgage-backed securities were not rated by S&P (per Green Street [here](#)).
- As noted above, S&P's original proposal would likely reduce the universe of high-quality fixed income assets that would receive appropriate capital charges, making it harder for insurers rated by S&P to achieve target yields. This creates a real risk that life insurers would have to offer less attractive long-term insurance products, or even limit product availability and offering. It could also reduce the diversification of assets held by insurers, if insurers concentrate on assets and asset classes rated by a particular NRSRO to avoid unduly onerous asset charges.

⁸ S&P's definition of a "CCC" security is "[a]n obligation [that] is currently vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation."

- The proposed application of a “CCC” rating input for structured securities rated by certain NRSROs and the NAIC SVO appears to be rooted in S&P’s reluctance to complete a full mapping of all NRSROs and the NAIC SVO. Instead, the original proposal replaced certain NRSROs ratings with a “CCC,” as an apparent stand-in for a completed mapping process.⁹ ACLI believes there is sufficient data available for S&P to complete a full mapping. If S&P finds the available data lacking, they could consider utilizing well-accepted and commonly used analytical frameworks provided by third parties. Alternatively, they could also consider consulting with Canada’s Office of the Superintendent of Financial Institutions (“OSFI”) and/or the Joint Committee of the European Supervisory Authorities (European Banking Authority, European Securities Market Authority and European Insurance Operations and Pension Authority), both of whom successfully completed a recent mapping exercise that included a variety of credit rating agencies, including new market participants.^{10,11}

d. The notching’s disregard of state insurance regulators expertise and oversight is troubling.

The ACLI is highly concerned about the original proposal’s treatment of securities that are otherwise unrated by an NRSRO, but have undergone a comprehensive evaluation by the NAIC Securities Valuation Office (SVO) and received an appropriate designation category (e.g., private placements, certain asset-backed securities, etc.).¹² These assets would have received a severe notching and a correspondingly punitive capital charge.¹³ The application of CCC or BB capital charges for instruments deemed very high quality by regulators – whose primary interest is to preserve the solvency of insurers and protect consumers – is counterintuitive. The SVO is an established part of the regulatory framework in the United States; insurers are required to adhere to its designations (comparable to ratings) and set aside capital on securities based on the risk-based factors assigned to these designations.

⁹ The December 21 proposal mapped S&P ratings to the two other large NRSROs and mentions the possibility of mapping to a third NRSRO in the future but does not include any plans to complete a full mapping of all NRSROs. Instead, S&P is using a “CCC” as a placeholder for structured securities rated by unmapped NRSROs and the NAIC SVO.

¹⁰ See OSFI [Capital Adequacy Requirements \(CARI\) Chapter 4 – Credit Risk – Standardized Approach](https://osfi-bsif.gc.ca/en/capital-adequacy-requirements-cari) (osfi-bsif.gc.ca) 171, section 4.2.3.1. The CAR requirements apply to banks (including federal credit unions), bank holding companies, federally regulated trust and loan companies (retrieved May 7, 2022).

¹¹ The Joint Committee (JC) of the European Supervisory Authorities (ESAs) is mandated under Article 136(1) of the CRR to provide a correspondence (“mapping”) between relevant credit assessments of ECAs and Credit Quality Steps (CQS). The [JC’s latest report](https://www.esa.europa.eu/sites/default/files/document_library/Publications/Reports/2021/JC_Final_Reports_on_the_draft ITS ECAs mapping /1014540/JC_2021_38_%28Final_Report_Amendment ITS ECAs mapping CRR art 136%29.pdf), which was updated to include mapping for a new European Credit Assessment Institutions (ECAI) demonstrates the achievability of a transparent mapping process for all NRSROs. Available at https://www.esa.europa.eu/sites/default/files/document_library/Publications/Reports/2021/JC_Final_Reports_on_the_draft ITS ECAs mapping /1014540/JC_2021_38_%28Final_Report_Amendment ITS ECAs mapping CRR art 136%29.pdf (retrieved May 7, 2022).

¹² The NAIC SVO performs several key functions on behalf of regulators, including the evaluation of securities that have not received an NRSRO rating, and to assign appropriate risk-based capital charges based on NAIC designations.

¹³ Consider the potential treatment of an otherwise unrated structured security that has undergone a rigorous analysis and review by the NAIC SVO and been designated as an NAIC SVO Category 1. A NAIC SVO category 1 designation has traditionally mapped to an “AAA” charge. However, the initial S&P proposal declined to map to the NAIC SVO and instead proposed assigning a “CCC” capital charge to such securities, which corresponds to a 100% capital charge. An otherwise unrated fixed interest bond designated as Category 1 by the NAIC SVO would have received a BB charge under the initial proposal, regardless of the NAIC SVO designation.

The NAIC was also troubled by this approach, as noted in its letter to House Financial Services Chairwoman Waters and Ranking Member McHenry:

*"[F]or those investments not otherwise assigned a rating by the NRSRO's (e.g., private placements, certain asset backed securities, etc.), the NAIC SVO staff do conduct a detailed analysis to evaluate the risk and develop an appropriate NAIC designation for use by state insurance regulators. This, coupled with investment oversight laws, give state regulators comfort to allow or disallow such investments and ensure they are backed by sufficient capital for claims paying purposes. This is a critical regulatory function that allows the insurance sector to invest its substantial resources in a diverse cross section of the U.S. economy while prioritizing the strength of insurers to pay claims. We are troubled that S&P's proposal lumps NAIC designations assigned by the SVO staff, designed by and for regulators, in with NAIC designations derived from ratings provided by S&P and its for-profit competitors, with no input from SVO staff. Doing so could disrupt a critical source of diversification and investment for the U.S. insurance sector. We urge S&P to reevaluate that approach."*¹⁴

2. The methodology's potential impact on consumers and the competitive global insurance market merits additional evaluation.

The RFC explained that some changes to the methodology were made to "enhance global consistency." The desire for globally consistency is understandable. It is also a goal that international standard setting bodies have sought – and struggled with – for years because of differences between regulatory, accounting, and valuation frameworks across jurisdictions. These differences make it extremely challenging to apply identical factors across regimes without penalizing jurisdictions or products because of their regulatory, accounting or valuation framework. Well-intended methodologies also sometimes fail to recognize how key features of certain products can vary in different markets.

Some elements of S&P's proposed capital model may not reflect key differences among regimes and products. Other elements of the model may benefit from additional analysis because of their impact on long-term products. These issues were not addressed by the recent partial withdrawal of the RFC and may merit additional consideration by S&P. We have highlighted several examples below:

- The model's calculation of Total Adjusted Capital ("TAC") disadvantages companies using U.S. statutory reporting compared to those using GAAP/IFRS when assessing capital adequacy.¹⁵

¹⁴ NAIC letter to House Financial Services Committee and Senate Banking Committee, available at <https://content.naic.org/sites/default/files/government-affairs-letter-s%26p-proposed-capital-model-house-financial-services-cmte-030922.pdf> (retrieved March 18, 2022).

¹⁵The calculation of TAC under the S&P's current methodology provides some benefit for insurer's dividend liability in order to put GAAP/IFRS and statutory filers on the same footing. Under the current methodology, statutory filers could include 50 percent of their dividend liability in TAC – which matched the same treatment of dividend liabilities under GAAP/IFRS. The proposal now eliminates the inclusion of dividend liabilities for statutory filers – but does not eliminate it for GAAP/IFRS filers. This puts U.S. statutory reporting insurers at a disadvantage compared to those using GAAP/IFRS in capital adequacy assessments, because GAAP includes 50 percent of the dividend liability within GAAP equity.

- Some changes in the S&P capital model are particularly impactful with respect to certain long-term financial protection and retirement security products, like variable annuities (“VAs”), that American families rely on to supplement income in retirement, pay for college, cover medical expenses, or handle unexpected expenses. Life insurers pay \$1.1 billion a day in annuity payments. The treatment of VAs within the proposed capital model adds unnecessary complexity and will make capital management practices more difficult.
- The proposed calculation of TAC does not appropriately address differences in reserve calculations that are required by different jurisdictions. Most insurance regulatory regimes require insurers to hold reserves which include a margin above the amount estimated to pay future insurance obligations. U.S. regulators have determined, and ACLI agrees, that reserves should cover “moderately adverse” conditions. This allows for the inevitable ebbs and flows of claims payments over time. The amount of margin in reserves can vary by regime. Other regimes do not require moderately adverse amounts to be held in their reserves. This does not mean that U.S. insurers are necessarily better capitalized than insurers domiciled in other regimes, like Solvency II, but it does mean that a TAC calculation that ignores this fact could understate the amount of “available capital” in regimes where a portion of loss-absorbing resources reside in the reserves.
- The assumptions in the interest rate calculation also impact similar products differently - depending on where they are sold. The interest rate risk charges appear to take a punitive approach to long-term products sold in the United States. It assumes an immediate, permanent, and extremely severe shock to both assets and liabilities.¹⁶ The assumptions in the interest rate risk calculation appear more reasonable for companies operating under a European regulatory framework, which focuses more on market-values, rather than cash flows, like the U.S. The effect is that it would penalize U.S. insurers with strong liquidity and cashflow profiles.

The differential impact of the interest rate risk calculation across jurisdictions demonstrates how an element of the proposal can include reasonable assumptions for products designed under some regulatory regimes, like Solvency II, and still be ill-suited for similar products issued under the U.S. regime.

Consider how the assumptions in the calculation work for participating policies in the U.S. and E.U. Participating policies in both jurisdictions issue policyholder dividends. But in the U.S., policyholder dividends are discretionary. They are only paid when the company is profitable – with no mandatory minimums, which means policyholders are sharing the rewards and the risks with the U.S. insurer. U.S. insurers can cut or pause the dividends in times of severe economic stress.¹⁷ In contrast, in the E.U., participating policyholder dividends are mandatory and fixed. Companies cannot decrease them in times of severe stress. From that lens, S&P’s proposed interest rate risk assumptions appear more reasonable for European participating products. Cash flows for those participating policies are

¹⁶ The S&P’s proposed interest rate risk approach uses an extreme stress over a 1-year period that assumes fixed cash flows and a duration floor that is unfair for participating products that are long-term, have adjustable cash flows, and can have minimal duration mismatch.

¹⁷ Companies have exercised the right to cut dividends before – the latest example of this occurred during the 2008 financial crisis.

fixed - they cannot be adjusted in times of stress. The same is not true in the U.S.¹⁸ This illustrates how an apparently reasonable assumption, applied identically across different regulatory constructs, without adjustments, can result in calculations that don't reflect the economic reality.

We would expect that a credible standard would assess the capital model's performance under different circumstances and regulatory regimes to ensure it is fit for purpose. Otherwise, the capital model could penalize a large segment of the global insurance industry and discourage insurers from issuing products Americans rely on. Likewise, a transparent assessment of any capital model's treatment of long-duration products is also important to ensure that these important products remain available and affordable for all American families. We look forward to discussing these issues in greater detail with S&P.

Conclusion

Much of this is highly technical, but the details matter. They matter because individuals and families across this country are seeking certainty. And life insurers are in the business of certainty. We are there for our policyholders when they need us. We are there for communities who rely on our economic investments in their towns, suburbs, and cities, so they can fuel America's commerce and ingenuity.

A change by the world's largest rating agency in how they treat insurers' \$7.4 trillion of investments will always be impactful, therefore any changes should be transparent and supported by data. We appreciate S&P's decision to withdraw portions of the RFC, as well as S&P's thoughtful consideration of comments on the RFC. We hope they will continue to consider the impact that changes to their insurer capital model may have on the long-term investments that support the U.S. economy and that make it possible for insurers to offer long-term products that Americans depend on. We look forward to continuing this dialogue and serving as a resource to S&P and this subcommittee. Thank you for this opportunity to share our views.

¹⁸ For example, if interest rates fell to 0 percent, an insurer that issues whole life participating products in the U.S. would have the flexibility to decrease or temporarily suspend policyholder dividends (i.e., decrease the cash outflow), which would provide a buffer to the company's capital levels. S&P's proposed interest rate risk assumptions - that cash flow is fixed - doesn't match with the economic reality of U.S. participating products. In contrast, an insurer who issues whole life participating products in Europe would have less flexibility to react to the interest rate shock, because under the European regulatory framework, the insurer lacks the ability to decrease or stop policyholder dividends, even in times of stress.

WRITTEN TESTIMONY OF YANN LE PALLEC

HEAD OF GLOBAL RATINGS SERVICES
S&P GLOBAL RATINGS

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

MAY 11, 2022

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.

* * * * *

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.

**Written Testimony of Angela Liang
General Counsel and Executive Committee Member
Kroll Bond Rating Agency**

**Hearing – “A Notch Above? Examining Bond Rating Industry”
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets
House Committee on Financial Services
May 11, 2022**

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) in my capacity as the firm’s General Counsel and Executive Committee Member.

KBRA is a global, full-service rating agency established in 2010 after the financial crisis 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, valuable information, and thorough research to market participants. 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 approximately 450 employees in five offices across the United States, Europe and the UK and has issued more than 56,000 ratings representing \$3 trillion in issuance. KBRA has rated nearly 950 transactions as the sole rating agency, and more than 1,100 transactions where KBRA is one of two rating agencies providing a rating.

I am especially grateful for the subcommittee’s strong bipartisan interest in these issues. This hearing is particularly critical and timely given the impact that S&P’s proposed Insurer Risk-Based Capital Adequacy – Methodology and Assumptions (“S&P’s Proposed Methodology”) has had on the markets. While S&P temporarily withdrew certain sections of this methodology two days before this hearing, it is important to note the proposal caused an immense amount of concern in the markets, and we have seen KBRA-rated transactions put on hold as a direct result of concern about the outcome of S&P’s proposal.¹ Despite the temporary withdrawal of certain features of the S&P Proposed Methodology, KBRA believes it is still crucial to have a robust discussion concerning competition among NRSROs and proposed legislation to level the playing field.

Barriers to Competition in the NRSRO Market

Notwithstanding KBRA’s success over the past 12 years, we still experience barriers to fair competition. It is widely acknowledged that concentration in the credit rating space 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.

¹ S&P, [Request for Comment: Insurer Risk-Based Capital Adequacy–Methodology And Assumptions](#), Dec. 6, 2021.

Not much has changed. The three largest NRSROs, or “the Big Three,” still command approximately 95 percent market share, only slightly down from over 98 percent pre-2008 crisis.² We believe that the continued lack of open competition is *by far* the biggest problem facing the credit rating space today. KBRA has been successful because of our relentless focus on transparent and thorough research and investor feedback – but it has not been easy. There are myriad ways in which the Big Three are still woven into the fabric of our financial system, as noted below. In our view, this entrenchment disadvantages the financial markets, investors, and the public writ large.

- *Investor Guidelines.* As one example, many institutional investors, including public and private pension funds, require the use of one or more of the largest NRSROs *by name* in their investment guidelines. Many of those guidelines were established decades ago, before other rating agencies existed, and this has become a very significant barrier to competition today. KBRA appreciates the success we have had in assisting investors in changing some of these legacy guidelines, but it will take many more years to change the market sufficiently for 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.
- *Government Regulations and References to NRSROs.* During the height of the pandemic, new barriers to competition emerged 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 because the facilities used the language from the 2008 financial crisis, before KBRA existed. 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, regulators amended the NRSRO requirements with respect to certain 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 or guidance and should use their authority to require supervised entities to do the same. The Department of Labor recently finalized the agency’s approach to 939A.³

- *Additional Structural Barriers to Competition.* Another market dynamic that provides S&P with enhanced market power is the fact that certain key indices require that a security be rated by at least one Big Three credit rating agency before being listed. For instance, the S&P Bond Index requires that a bond have a rating by S&P, Moody’s or Fitch to be index eligible.⁴ Similarly, the Bloomberg Fixed Income Index Methodology requires that a bond be rated by two of the Big Three agencies to be index eligible.⁵ Notably, many insurance companies benchmark to the Bloomberg index for investment purposes and thus will not purchase a non-Big Three rated bond.

² Office of Credit Ratings, Securities and Exchange Commission, [Staff Report on Nationally Recognized Statistical Rating Organizations](#), January 2022.

³ [87 CFR § 12985](#) (March 8, 2022).

⁴ S&P, [S&P 500 Bond Index Methodology](#), Oct. 2021.

⁵ Bloomberg, [Bloomberg Fixed Income Index Methodology](#), Aug. 24, 2021.

- *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.⁶ 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 effectively blocks new entrants. We encourage reconsidering certain registration requirements to allow new competitors to enter the credit rating agency market.

On top of these significant existing systemic barriers to competition, S&P's Proposed Methodology would have further entrenched its position as the most dominant credit rating agency by establishing disparate and arbitrary treatment of non-S&P ratings on bonds across all asset classes held by insurance companies.

S&P's Proposed Methodology and how it Creates Barriers to Competition

Insurance companies are large purchasers of rated debt, and S&P's Proposed Methodology would penalize any S&P-rated insurance company that did not buy S&P-rated debt, to the detriment of insurance companies, the market sectors in which insurance companies invest, and other credit rating agencies.

Why Insurance Companies Purchase Securities. For context, in 2021, US insurance companies invested approximately \$4.9 trillion in bonds alone, which represents an increase of 5.1% compared to 2020.⁷ Insurance companies must maintain large investments of highly rated securities to match their liabilities and meet capital adequacy requirements, or risk-based capital ("RBC"), imposed by insurance regulators. Insurance regulators use RBC requirements to determine the amount of capital an insurer must maintain to support its operations and pay policyholder claims.

An insurance company's credit rating reflects the likelihood that the company will have funds to pay a policyholder's claims, including during economic downturns and catastrophic events that result in large numbers of significant claims. An insurer's credit rating directly affects its ability to expand existing business or obtain new business, to raise capital efficiently and to hedge its financial exposure through reinsurance. Further, an insurer's credit rating is significantly influenced by the risk profile of the bonds and other securities that it holds in its investment portfolio.

S&P's Proposed Methodology. Because of S&P's historical market dominance, the insurance industry has long regarded S&P's capital model as critical to their credit rating and as such, many insurance companies manage their capital to S&P's capital model. S&P's Proposed Methodology represents a significant departure from S&P's current practices by (i) formalizing notching in the insurance company rating sector and (ii) notching down securities not rated by S&P to as low as CCC (the equivalent of unrated securities).

S&P's Proposed Methodology creates a three-tier scale for rating the riskiness of the bonds and loans on an insurance company's balance sheet based on which credit rating agency issued the rating (and

⁶ 15 USC § 78o.

⁷ NAIC, [Capital Markets Special Report, "U.S. Insurance Industry's Cash and Invested Assets Surpass \\$8 Trillion at Year-End 2021"](#), May 4, 2022.

not based on an independent analysis of creditworthiness of the bonds or loans or on the particular insurance company's portfolio performance or track record).⁸

- If bonds or loans are rated by S&P, the rating is taken at **face value**.
- If the bonds or loans are rated by Moody's or Fitch (or both), S&P will notch down the Moody's or Fitch ratings by **one to three notches**, depending on the scenario and asset class.
- If the bonds or loans are rated by non-Big Three agencies, S&P will automatically notch down the ratings to as low as CCC – in some cases that could be up to eighteen notches (or AAA to CCC) – which is the equivalent of a risky "junk", or near default, investment.

The notching is *solely* based on which credit rating agency issued the rating on the securities, and not on the creditworthiness of the securities themselves. As a result, S&P's treatment "overrules" the credit opinions of all other NRSROs.

S&P's Proposal is not Supported by the Market

S&P's Proposed Methodology has been widely derided by the market writ large for its potential harm to the capital markets, failure to consider available data, and its anti-competitive effect.

Lack of Data. A number of the largest investment banks have publicly released research reports refuting S&P's reported claims that there is not sufficient data to complete a mapping analysis of credit rating agencies other than Moody's and Fitch. In fact, many of these investment banks performed their own analyses based on publicly available data and concluded that there is a high correlation between S&P's ratings and those of other credit rating agencies: "Fitch, Moody's, DBRS and Kroll all have ratings that are highly correlated with S&P ratings."⁹ This calls into question the decision to notch other credit rating agencies' ratings at all.

Insurance Companies and Industry Groups Object to S&P's Proposal. We are aware that at least eight industry groups and multiple insurance companies have submitted comments to S&P concerning the lack of data supporting S&P's approach, the potential harm to the credit markets and the anti-competitive effect of S&P's proposal. In particular, one securities industry organization cited serious concerns with key elements to the proposal and the considerably adverse ramifications those elements could have on insurance companies, the capital markets, and important sectors of the economy. It also stated that its members unanimously agree that the proposed methodology, in its current form, has embedded fatal flaws.¹⁰ An insurance industry organization stated that S&P's use of a global methodology impairs the RBC formula's ability to assess risk effectively across different jurisdictions and diminishes the methodology's transparency and credibility. It continues to say that specific changes suggested by S&P, as well as their overall approach, may also have unforeseen effects on the U.S. and global insurance markets.¹¹

⁸ See *supra*, note 1.

⁹ Morgan Stanley, "[Analysis of Historical NRSRO Ratings Data](#)," Feb. 2022.

¹⁰ Structured Finance Association, [Response to S&P Global Ratings' Request for Comment: Insurer Risk-Based Capital Adequacy](#), April 29, 2022.

¹¹ American Property Casualty Insurance Association, [Response to S&P Insurer Risk-Based Capital Adequacy-Methodology and Assumptions](#), April 28, 2022.

Government Reaction. Members of this Committee have also sounded the alarm about S&P's Proposed Methodology and its potential effects on the market, and we thank them for this swift action. In addition, at least two attorneys general from Nebraska and Iowa have submitted public comments to S&P concerning the potential anticompetitive effect of the proposal, stating "[w]e are particularly concerned about the effect this may have on the market because of the existing market concentration among the large NRSROs, along with the industry's historic failures to provide accurate risk assessments in the case of Enron and the 2008-2009 financial crisis, which caused significant economic turbulence."¹² The National Association of Insurance Commissioners (NAIC), in a letter signed by NAIC CEO Mike Considine and leaders from the states of Idaho, Missouri, Connecticut, and North Dakota, sent a letter on behalf of all fifty US state insurance commissioners to Chairwoman Waters and Ranking Member McHenry expressing concern over the S&P proposal. Specifically, NAIC wrote that "...it has been suggested by some that NAIC's concern and workplan in this area is either an implicit or explicit endorsement of S&P's proposal which, in essence, treats the work of its competitors as less rigorous than its own. This is an egregious misrepresentation of our views."¹³

Moreover, on April 29, 2022, the Department of Justice issued a press release which states:

Based on the information provided by S&P, it appears that S&P is proposing to automatically lower its ratings for assets in insurance company investment portfolios rated solely by S&P's competitors. Such changes may affect the incentives of companies to use rating agencies other than S&P or invest in assets rated by agencies other than S&P.

The Antitrust Division suggests that S&P carefully consider whether 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. Such actions could raise significant concerns that the Sherman Act has been—or will be—violated and warrant additional scrutiny by the Antitrust Division.¹⁴

Importance of Competition in the NRSRO Market

Mr. Chairman, the potential negative effects of the S&P Proposed Methodology are significant, and bring to light the importance of open competition to investors and the broader economy. Although S&P has publicly withdrawn the sections relating to mapping and notching, it is important to note that S&P's market power is so great that they are able to cause disruption in the market merely with a proposed methodology. KBRA was founded on the premise that open competition protects investors and provides access to ratings to worthy issuers that may be overlooked by the largest incumbent rating agencies. KBRA has discussed this with this subcommittee in the past and it remains true – open and fair competition among NRSROs is the best way to expose investors to a diversity of ideas and information.

¹² Attorneys General of the States of Nebraska and Iowa, [Public Comments from the Attorneys General of Nebraska and Iowa in Response to Standard and Poor's Global Ratings Request for Comment Regarding Insurer Risk Based Capital Adequacy—Methodology and Assumptions](#), April 29, 2022.

¹³ NAIC, [Letter to House Financial Services Committee Re: S&P Global Ratings Request for Comment Regarding Insurer Risk Based Capital Adequacy—Methodology and Assumptions](#), March 9, 2022.

¹⁴ US Department of Justice, [Comments of the Antitrust Division of the United States Department of Justice Re: Insurer Risk-Based Capital Adequacy](#), April 29, 2022.

The more voices that can provide clear, transparent research, the more choices investors have to make well-informed decisions.

Community Banks. One powerful example is in the community bank space. KBRA began researching community banks in 2013. Other rating agencies historically demonstrated a bias based on size of the institution and only rated banks with a certain minimum revenue, while failing 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 and their close connection to their customers. Based on this study, KBRA devised a bank rating methodology that recognized the strength of management which allowed previously unrated 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 sector, the incumbent rating agencies followed suit and for the first time began rating community banks as well. KBRA's ratings have enabled community banks to access capital they had unfairly struggled to access in the past. The strength of our ratings is demonstrated by the fact that these markets are as liquid as those for the larger banks. Facilitating the creation of liquidity in the community bank market will benefit institutions and consumers alike. When banks do not have access to reasonable and affordable financing options, they are more likely to pass on those costs to customers in the form of higher interest rates and fees, making them less competitive with larger banks. As evidenced by the community bank example, competition among NRSROs can facilitate the creation of efficient capital sources for issuers, and keep costs lower for consumers.

Anti-Competitive Effect of S&P's Proposed Methodology

Mr. Chairman, we cannot speak to S&P's intent in notching in this methodology, but it is clear that S&P's proposal will harm competition among NRSROs, which in turn will harm investors and consumers.

New Barriers to Competition. S&P's Proposed Methodology will create artificial barriers to competition that will solely serve to reinforce S&P's already dominant market position. Insurance companies with an S&P rating are likely to solely invest in S&P-rated bonds and loans to ensure their investment portfolio does not result in a lower S&P rating on the insurance company itself. Additionally, companies issuing bonds and other securities will need to obtain an S&P rating to attract critically important insurance company investors, which, as noted above, need to purchase a large quantity of securities to fulfill their promises to policyholders, match their liabilities, and meet regulatory capital requirements. Moreover, because issuers pay for their financial strength rating and ratings on assets, and only one rating is necessary for state risk-based capital purposes, the S&P methodology will act as a powerful incentive for insurance companies to solely purchase S&P ratings to meet their rating needs. In other words, insurers would be pressured to exclusively purchase S&P-rated investments if this methodology were finalized as proposed, because otherwise they would risk being forced to hold higher levels of capital to preserve their S&P rating, even where assets rated by other NRSROs would be treated as high-quality and satisfactory for state regulatory capital purposes.

S&P Will Gain More Market Share. Another damaging result of S&P's Proposed Methodology will be that S&P will gain – and other credit rating agencies will lose – market share, further damaging the future of competition among NRSROs. Instead of using other NRSROs for ratings that are solely used for RBC purposes, insurance companies will be forced to require issuers to obtain S&P ratings to create the best possible outcome for their own ratings. This means that in those asset classes where insurance companies are key investors, but S&P does not currently provide ratings or is not a leader (e.g., marketplace lending, solar asset-backed securities (ABS) and commercial real estate (CRE)

collateralized loan obligations (CLOs)), issuers will have to obtain S&P ratings to allow the insurance company investors to meet their own requirements. This will allow S&P to rate asset classes in which it has no history or limited experience, force S&P's expansion into those asset classes and sideline those rating agencies with history and experience – none of which serves investors or the market. This gain in market share will create concentration risk in the credit rating agency space – the same risk the Dodd-Frank Act was designed to disarm.

An example of an asset class in which S&P is not currently a leader is conduit commercial mortgage-backed securities (CMBS). S&P was once a market leader in this asset class, but after S&P agreed to a ban on rating conduit CMBS transactions from January 2015 to January 2016 as part of an SEC settlement related to misrepresentations it made with respect to its conduit CMBS methodology application, S&P did not regain the market share it had prior to the ban. It seems an irrational result that under S&P's Proposed Methodology, any conduit CMBS security issued during S&P's 2015 ban from the sector and still held in an insurance company's portfolio would automatically be notched down even though it was *not even possible* for an insurer to invest in an S&P-rated CMBS security during that time due to a regulatory ban.

Mr. Chairman, as I mentioned earlier, we are already seeing the chilling effect on competition among credit rating agencies and have already seen some transactions that have been put on hold pending the outcome of S&P's Proposed Methodology. Indeed, market participants and observers have recognized the likely anti-competitive effects of S&P's Proposed Methodology:

- "It could certainly push someone toward S&P."¹⁵
- "S&P's new methodology uses higher capital charges for fixed income instruments that it does not rate. . . . Capital treatment is particularly punitive for securities without ratings from S&P, Moody's, and Fitch."¹⁶
- "It's an overuse of their market power," [John Huff] said of S&P. "It will have a negative impact on ratings for the Bermuda market without any reasonable justification or market changes. It is clearly anticompetitive."¹⁷

Policy Ideas to Support Competition

The Dodd-Frank NRSRO Provisions Work Well in Many Regards. Mr. Chairman, in our view, many components of the Dodd-Frank Act NRSRO provisions have been highly successful. The requirement that NRSROs publicly post their methodologies and substantive changes thereto allows investors to familiarize themselves with and scrutinize methodologies in advance of their implementation, and this requirement played a direct role in S&P's withdrawal of changes that would have had a negative effect on the market and NRSRO competition.

¹⁵ Leah Nylen, POLITICO, "S&P Global 'power grab' sparks congressional pushback" Feb. 25, 2022, available at: <https://www.politico.com/news/2022/02/25/s-p-insurance-power-grab-sparks-rival-congressional-pushback-00010344>.

¹⁶ Barclays Credit Research, *S&P's Proposed Capital Model Causes a Stir*, Feb. 25, 2022.

¹⁷ THE ROYAL GAZETTE, "Abir: S&P proposals are onerous and disruptive," April 22, 2022, available at: <https://www.royalgazette.com/re-insurance/business/article/20220422/abir-sp-proposals-are-onerous-and-disruptive/>.

In addition, other provisions in Dodd-Frank regarding NRSROs have served to improve outcomes for investors, including the creation of the Office of Credit Ratings (OCR) at the SEC, the SEC's rules requiring the development of internal controls, and supervision and annual examination. 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 the Dodd-Frank Act, in 2014 the SEC issued rules to prevent an NRSRO's sales and marketing considerations from influencing their credit ratings. This division between business development and analytics, one that must be certified by the CEO on an annual basis, has been highly effective in focusing our analysts on producing the highest quality, transparent and thorough research for investors.

Strengthening Competition. As I noted earlier, the lack of competition is the single largest problem in the credit rating space today. We believe there is room to strengthen federal law to help bolster competition and increase disclosure. We support the notching amendments being discussed here today that would prohibit actions taken by credit rating agencies that have an anti-competitive effect and to prohibit notching, while maintaining credit rating agencies' ability to determine its rating methodologies. We believe it is of the utmost importance for a credit rating agency to have the flexibility and freedom to create its own methodologies, but such methodologies must not have the effect of prohibiting competition. We also support efforts to encourage the SEC to undertake a mapping exercise – similar to that performed by Canadian and European regulators – to publicly disclose the correlation of ratings issued by credit rating agencies so that all market participants can compare the performance of an NRSRO's credit ratings for themselves. We believe increased availability of information can only be a positive for the market and the investing public.

Commercial Credit Rating Reform Act. I would also like to provide some input on the proposed Commercial Credit Rating Reform Act ("CCRRA"), which is being discussed today. We support efforts to improve competition and are grateful for your ongoing attention to that issue. However, we do have some concerns regarding potential unintended consequences of this legislation. While a government assignment of ratings would by its nature increase the market share of non-incumbent NRSROs, it could also discourage thorough research. If any NRSRO were assured of receiving steady, virtually guaranteed business via government panel rotation, this could act as a disincentive for some NRSROs to devote the resources necessary to produce in-depth analysis and solid research. That would ultimately be detrimental to investors, who would suffer from the lack of transparent and thorough information abundantly available to the market today from rating agencies like KBRA. *In our view, the Big Three enjoy virtually guaranteed business today by virtue of systemic barriers to competition and self-reinforcing market dominance. Our experience of NRSROs having virtually guaranteed business for any reason is that it can result in disincentives to produce high-quality research.*

Government assignment of ratings pursuant to the CCRRA would also restrict investor choice. 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 particular 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. This could also impair access to capital for market participants and have a trickledown effect for consumers through increased costs.

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.

NRSRO Exposure in Russia and Belarus. Mr. Chairman, we understand that some committee members may be concerned that medium- and smaller-sized NRSROs have not made clear their exposure to Russia or Belarus. We respect the work of this Committee on this issue, and while I cannot speak for the other medium or smaller NRSROs, I can assure you that KBRA has no outstanding Russian or Belarusian ratings, and any outstanding ratings with underlying assets that have exposure to those countries are being closely monitored. In addition, on March 22, 2022, KBRA announced a ban on registered website users located in Russia. We would welcome the opportunity to engage on this issue with members of your committee if additional information would be helpful.

Other Policy Proposals to Support Competition Among NRSROs. Mr. Chairman, there is more work to do in requiring government and private market participants to support open competition among NRSROs, and we greatly appreciate your leadership in this area. 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 thank the members of this Committee for their support for this legislation. We strongly support broadening the emergency facilities legislation to prevent other federal government agencies from requiring ratings by specific NRSROs, as is currently the case, for example, with certain Federal Home Loan Banks and certain Freddie Mac requirements. We would welcome the opportunity to engage with Committee members regarding the specifics of governmental barriers to competition.

Liability Proposal. We have also read the proposal being discussed today regarding liability for NRSROs. We believe that the current SEC regulatory oversight provides the appropriate level of liability for NRSROs. Since the enactment of the Dodd-Frank Act, the SEC has had the ability to – and has exercised – its 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 anti-fraud 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 and could have a chilling effect on the diversity of views provided by NRSROs, which 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, but 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.

Mr. Chairman, in short, we are of the opinion that 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. We look forward to continued engagement on this issue with members of this subcommittee.

Standardization Proposal. We have also read the proposed Credit Rating Standardization Bill being discussed here today. We appreciate the opportunity to provide input but do have concerns that the legislation in its current form could unintentionally reduce the quantity and quality of information available to investors in making their investment decisions.

The great benefit of open competition in the credit rating agency market is that it allows more independent entities to conduct research and provide their views on credit and related information to the investing public. Credit rating agencies spend a great deal of time and effort conducting research on historical performance in various markets to develop their views on rating definitions. Each rating category has a specific definition as it is defined by that credit rating agency, based on the research conducted. Over time, credit rating agencies monitor rating performance of their own ratings and make adjustments to their methodologies to align with their rating definitions and rating scales. I believe that rating definitions and rating scales must be left to credit rating agencies to determine. It is our view that government involvement in the setting of rating categories and, as a result, rating definitions, would be akin to government interference in the determination of credit rating methodologies.

While we have concerns with this legislation in its current form, KBRA would support legislation requiring more transparency and easily accessible and comparable disclosure relating to how each credit rating agency has set its rating definitions and rating categories so that users of credit ratings can more easily compare those ratings.

Conclusion

Mr. Chairman, I am confident in KBRA's mission, our team, and our research and ratings. KBRA's entrance into this marketplace has enhanced the quality of research, opened markets, and improved outcomes for investors. I believe this is what the Dodd-Frank Act intended to do, and I encourage the development of stronger guardrails to enhance competition. I thank the subcommittee for the opportunity to testify today, and I look forward to your questions.



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.



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”

Jennifer J. Schulp
Director of Financial Regulation Studies
Center for Monetary and Financial Alternatives, Cato Institute

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-nadleri-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/hrg-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.

* * *

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>.



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STATEMENT FOR THE RECORD

by
 WILLIAM MICHAEL CUNNINGHAM
 and
 CREATIVE INVESTMENT RESEARCH

Submitted to the

Subcommittee on Investor Protection, Entrepreneurship and Capital Markets
 of the U.S. House Committee on Financial Services for a hearing entitled, "A
 Notch Above? Examining the Bond Rating Industry"

William Michael Cunningham and Creative Investment Research (CIR)
 submit the following statement for the record to the hearing entitled, "A
 Notch Above? Examining the Bond Rating Industry" on Wednesday, May 11,
 2022.

We thank the Committee for this opportunity. We urge the Committee to
 continue to get opinions from a culturally and economically diverse set of
 persons and feel this is especially important as you consider rating agencies.
 As the Committee noted,

"The three largest Nationally Recognized Statistical Ratings Organizations (NRSROs)— S&P, Moody's, and Fitch—collectively provided 95% of all available ratings outstanding as of December 31, 2020 and employ an 'issuer pays' model wherein the rating agencies are compensated by the issuers of the securities that they rate. This model has been criticized as a source of significant conflicts of interest that may contribute to biased ratings because rating agencies have an incentive to provide issuers with favorable ratings to ensure they remain customers. Such perceived and actual conflicts contributed to the 2008 financial crisis."

"Overseen by the SEC's Office of Credit Ratings, NRSROs are statutorily subject to, among other things: (1) various reporting and examination requirements; (2) required disclosure of their ratings methodology; (3) requirements that their analysts pass qualifying examinations; (4) potential deregistration by the SEC; and, (5) prohibitions on engaging in certain unfair, coercive, or abusive practices to the extent they are practiced with an anticompetitive effect."

Creative Investment Research
<http://www.minorityfinance.com>
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Mr. Cunningham notes that the SEC's Office of Credit Ratings excluded consideration of authentic African American viewpoints.¹

Given the fact that incompetence, discrimination and exclusionary practices based on race are prevalent², including at regulatory bodies, we decline to directly address the issues raised, having done so over the past 30 years. We contend that these exclusionary practices are inappropriate and note our answers to the credit rating agency issues posed by reference to the following:

Definition of Nationally Recognized Statistical Rating Organization. Monday, May 23, 2005. (File No. S/-04-05) <http://www.sec.gov/comments/s7-18-11/s71811-58.pdf>

Re-proposed Rules for Nationally Recognized Statistical Rating Organizations (large rating agencies). [Release No. 34-59343; File No. S7-04-09]. Apr. 8, 2009.
<https://www.sec.gov/comments/4-579/4579-9.pdf>

Also see: Social Performance Indicators for Banks, 2002.
<https://www.creativeinvest.com/SocialPerformanceIndicatorsfortheFinanceIndustry.pdf>

"Environmental Issues and Stock Returns." Our 2015 report quantifies the impact environmental issues have on company stock prices.
<https://www.eventbrite.com/e/how-environmental-issues-impact-stock-returns-tickets-2029288657>

The "proposed methodology for analyzing the risk-based capital (RBC) adequacy of insurers and reinsurers ('S&P Proposal') is a continuation of the inappropriate business practices we outlined in the comments above. Additional specific input would be futile.

Mr. Cunningham (WMC) has long been concerned with the failure of bank and financial institution regulatory agencies to protect the public interest.

We base this on the following:

- On July 3, 1993, WMC wrote to SEC Commissioner Mary Schapiro to notify the Commission about a certain, specific investing "scam." A timely warning was not issued to the investing public and members of the public were damaged. See: <https://www.creativeinvest.com/SECNigerianLetter.pdf>

¹ See Appendix B.

² See: "Viewpoint on Ukraine: Why African Wars Get Different Treatment." Published 6 March 2022. Online at: <https://www.bbc.com/news/world-africa-60603232>

- WMC designed the first mortgage security backed by home mortgage loans to low- and moderate-income persons and originated by minority-owned institutions. (See: Security Backed Exclusively by Minority Loans, at <https://www.creativeinvest.com/mbsarticle.html>)
- In October, 1995, the Washington Gas Light (WGL) Company retained WMC to create mortgage-backed securities (MBS) consisting of one to four family residential home loans originated by minority-owned financial institutions serving areas of high social need. Mr. Cunningham developed a completely original approach that involved geocoding and mapping, for the first time, the location of every loan in an MBS pool and tying that location to social data. A sample map WMC created in 1997 for this process is attached as Appendix A.
- On April 30, 1997, in Case 97-1256 at the US Court of Appeals for the DC Circuit, Mr. Cunningham opposed the merger of Citigroup and Travelers and the elimination of the Glass-Steagall Act.
- In November, 1997 and, again in December, 2003, WMC wrote to the Division of Market Regulation at the Securities and Exchange Commission, on behalf of WMC and Creative Investment Research to request that CIR be considered a nationally recognized statistical rating organization ("NRSRO"). WMC requested this status only with respect to rating securities issued by financial institutions owned by women and minorities. WMC never received a reply from the Commission. We have attached a copy of a letter sent to Ms. Nazareth, Director, Division of Market Regulation, Securities and Exchange Commission, as Appendix 1.
- On June 15, 2000, WMC testified before the House Financial Services Committee of the U.S. Congress on ways to improve the supervision and regulation of government sponsored enterprises, Fannie Mae and Freddie Mac. See: <https://www.creativeinvest.com/fnma/>
- In 2001, WMC designed an investment vehicle for victims of predatory lending. (See <https://www.creativeinvest.com/PropertyFlipping.pdf>)
- On Monday, April 11, 2005, WMC testified before Judge William H. Pauley III in the U.S. District Court for the Southern District of New York on behalf of the public at a fairness hearing regarding the \$1.4 billion-dollar Global Research Analyst Settlement. See: <https://creativeinvest.com/fairness.html>
- On December 22, 2005, WMC issued a strongly worded warning that system-wide economic and market failure was a growing possibility in a meeting with Ms. Elaine M. Hartmann of the Division of Market Regulation at the SEC.
- On February 6, 2006, statistical models created by WMC using the Fully Adjusted Return ® Methodology signaled the probability of system-wide economic and market failure. (See page 2: <http://www.sec.gov/rules/proposed/s71005/wcunningham5867.pdf>)
- On June 18, 2009, WMC testified before the House Ways and Means Select Revenue Measures Subcommittee at a joint hearing with the Subcommittee on Domestic Monetary Policy and Technology of the Financial Services Committee concerning ways to improve the New Markets Tax Credit Program. See: <https://www.creativeinvest.com/nmtctestimony.html>

Creative Investment Research

<http://www.minorityfinance.com>www.minoritybank.com<http://www.creativeinvest.com>

- On January 25, 2012, WMC submitted a "Friend of the Court" brief in a case before the United States Court of Appeals for the Second Circuit (Case 11-5227). As a friend to the Court, Mr. Cunningham provides an independent, objective and unbiased view in support of broad public interests. His education and experience uniquely positioned him to provide objective, independent research and opinions concerning the issues central to the case.
- Mr. Cunningham was in the pool of Corporate Governance Advisors and Diversity Investing Advisors to CalPERS. He is currently under contract for Portfolio Assistance (Non-Fiduciary) Investment Consulting Spring-Fed Pool 2020 to the fund. See: <http://www.creativeinvest.com/Calpers1.pdf> and <http://www.creativeinvest.com/Calpers2.pdf> and <http://www.creativeinvest.com/Calpers3.pdf>
- Creative Investment Research was one of the first signatories to the UN Global Principles for Responsible Investment (www.unpri.org). See: <http://www.creativeinvest.com/PRINews2009land.jpg>

Mr. Cunningham has a long track record of analyzing proposed regulatory agency rules:

- Our 2003 comments on proposed proxy voting rules that would, under certain circumstances, require companies to include in their proxy materials security holder nominees for election as director. <https://www.sec.gov/rules/proposed/s71903/wmccir122203.pdf>
- See: Comments on Proposed Rule: Internet Availability of Proxy Materials Release Nos. 34-52926 IC-27182 File No. S7-10-05. Confirmed that system-wide economic and market failure was a growing possibility. (See page 2: <http://www.sec.gov/rules/proposed/s71005/wcunningham5867.pdf>)
- Shareholder Proposals Relating to the Election of Directors. Release No. 34-56161 File No. S7-17-07 <https://www.sec.gov/comments/s7-16-07/s71607-495.pdf>
- We have requested that the U.S. Securities and Exchange Commission (SEC) develop mandatory rules for public companies to disclose high-quality, comparable, decision-useful information concerning BLM Pledge fulfillment. See: <https://www.sec.gov/rules/petitions/2021/petn4-774.pdf>

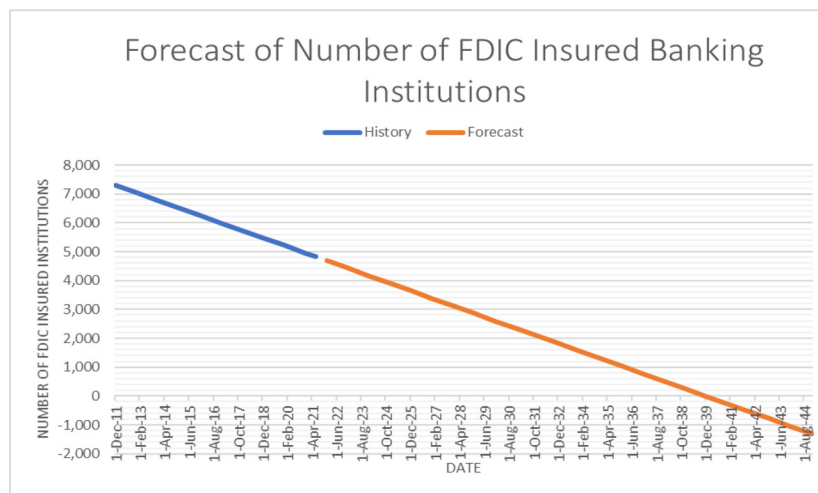
Mr. Cunningham has been concerned with using new financial technologies to maximize social and financial return.³ As his record shows, over the past 30 years, he has sought to protect the public by working with private sector and Federal regulatory agencies, including the Federal Reserve Board (FRB), the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), the Financial Crisis Inquiry Commission (FCIC), the U.S. Department of Justice (DOJ), the Consumer Financial Protection Bureau (CFPB), the Federal Housing Finance Agency (FHFA), the Department of Commerce (Minority Business

³ Bitcoin and Blockchain Explained IN 30 MINUTES FOR FREE. <https://www.udemy.com/course/bitcoin-explained/>

Development Agency) and the US Treasury, as an employee or as a contractor. Despite his education and experience, all offers to provide consulting services and all employment applications have been denied (due to age, racial and class discrimination.) Further attempts to work with these institutions would be futile. This leaves Mr. Cunningham no option but to appeal to this Committee in order to have his independent, objective technical knowledge and experience given consideration. Mr. Cunningham's interest in this matter stems from his role as an economist and an expert in marketplace ethics and rests upon his status as a citizen of the United States.

As Mr. Cunningham demonstrates, inadequate consideration of the public interest has clearly damaged the public and investors.⁴ Current regulatory practices protect the monetary interest of a narrow set of non-minority persons, fail to protect the interest of the general public, and damage the Country's long term economic prospects.

Industry Concentration Issues



⁴ For example, see: Fed Unveils Stricter Trading Rules Amid Fallout From Ethics Scandal. Jeanna Smialek, Oct. 21, 2021. The New York Times. Online at: <https://www.nytimes.com/2021/10/21/business/federal-reserve-trading-ethics.html> and Bankers Cast Doubt On Key Rate Amid Crisis https://www.wsj.com/articles/SB120831164167818299?reflink=desktopwebshare_twitter via @WSJ

Creative Investment Research

<http://www.minorityfinance.com>

www.minoritybank.com

<http://www.creativeinvest.com>

Regulatory ethical failings have real implications for the banking industry and for the public⁵. Regulators may have abdicated their responsibility to consider the public interest, if that interest includes maintaining a competitive industry. Our forecast indicates that by 12/31/2039, if current trends continue in a linear manner, the number of FDIC insured institutions will be approximately 1-2. Note that, with growing competition from fintech firms and alternatives, like bitcoin, this may imply the wholesale exit of banking institutions from both the FDIC and Federal Reserve systems. This would not be in the public interest.

See: Talk to the Government Blockchain Association on the Future of Money
<https://youtu.be/n1i4J8df0t0>

Statement for the Record on Crypto Inclusion Myths
<https://www.prlog.org/12899511-creative-investment-research-issues-statement-for-the-record-on-crypto-inclusion-myths.html>

Blockchain, Cryptocurrency and the Future of Monetary Policy
<https://www.prlog.org/12785779-blockchain-cryptocurrency-and-the-future-of-monetary-policy.html>

Is FedCoin, a US Government-issued cryptocurrency, feasible?
<https://www.prlog.org/12772509-is-fedcoin-us-government-issued-cryptocurrency-feasible.html>

Comments to the Reserve Bank of India on Blockchain, Crypto
<https://www.prlog.org/12765825-comments-to-the-reserve-bank-of-india-on-blockchain-crypto.html>

We include all linked documents by reference.

⁵ We note that, according to the Philadelphia Inquirer, "It's no easier for Black Philadelphians to become homeowners now than it was 30 years ago," despite the billions of dollars in "community development" funding these three organizations have received. See: <https://www.inquirer.com/real-estate/housing/home-ownership-gap-black-philadelphia-fed-20211213.html>

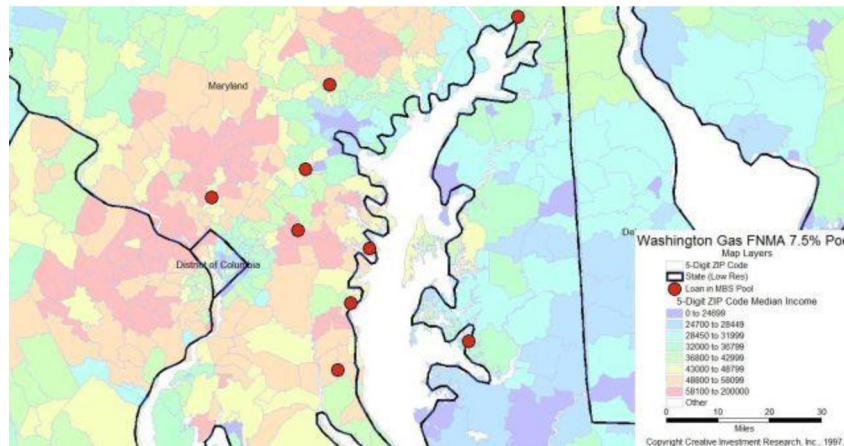
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Appendix A

William Michael Cunningham manages an investment advisory and research firm, Creative Investment Research, founded in 1989 to expand the capacity of capital markets to provide capital, credit and financial services in minority and underserved areas and markets.

We have done so by creating new financial instruments and by applying existing financial market technology to underserved areas. The Community Development Financial Institution Fund of the US Department of the Treasury certified the firm as a Community Development Entity on August 29, 2003. The Small Business Administration certified the firm as an 8(a)-program participant on October 19, 2005. (We did not receive any benefit or revenue due to our participation in the 8(a) program.)

In 1991, Mr. Cunningham created the first systematic bank analysis system using social and financial data, the Fully Adjusted Return® methodology. In 1992, he developed the first CRA securitization, a Fannie Mae MBS security backed by home mortgage loans originated by minority banks and thrifts.



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<http://www.creativeinvest.com>

In 2001, he helped create the first predatory lending remediation/repair MBS security.⁶

Also see:

BLACK LIVES MATTER: CORPORATE AMERICA HAS PLEDGED \$1.678 BILLION SO FAR. June 10, 2020.
<https://www.blackenterprise.com/black-lives-matter-corporate-america-has-pledged-1-678-billion-so-far/>

BLACK WOMENOMICS Maternal Mortality Reparation Facility
<https://blackwomenomics.com/>

CHILD TAX CREDIT <https://www.childtaxcredit.net/>

FIFTEEN DOLLAR MINIMUM WAGE <https://fifteendollarminimumwage.com/>

THE FAIRNESS ECONOMY <https://thefairnesseconomy.com/>

The Crisis in Black Housing
<https://drive.google.com/file/d/11jEtWfQY5RpdBpw0s6stHhawY0iero6/view>

6

Pool	Client	Originator	Social Characteristics
FN374870	Faith-based Pension Fund	National Mortgage Broker	Mortgages originated by minority and women-owned financial institutions serving areas of high social need.
FN296479			
FN300249			
GN440280	Utility Company Pension Fund	Minority-owned financial institutions	
FN374869			
FN376162			
FN254066	Faith-based Pension Fund	Local bank	Predatory lending remediation

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Appendix B

December 8, 2005

Ms. Elaine M. Hartmann
Division of Market Regulation
U.S. Securities and Exchange Commission
450 5th Street, NW
Washington, DC 20549

Dear Ms. Hartmann,

Creative Investment Research (CIR) has requested that the Division of Market Regulation not recommend enforcement action to the U.S. Securities and Exchange Commission if CIR is recognized as a Nationally Recognized Statistical Rating Organization (NRSRO) for purposes of applying Rule 15c3-1 under the Securities and Exchange Act of 1934, as amended and codified at 17 C.F.R. 240.15c3-1 with respect to rating short term debt vehicles issued by women and minority owned financial institutions.

As part of the NRSRO recognition process, we have provided you and your staff with information regarding our qualifications, including confidential, nonpublic information on our trade secret protected Fully Adjusted Return ® methodology.

Thank you.

Sincerely,

William Michael Cunningham
CEO and Social Investment Advisor

Sample page below

Creative Investment Research
<http://www.minorityfinance.com>
www.minoritybank.com
<http://www.creativeinvest.com>

Creative Investment Research, Inc. Minority Bank & Thrift Report

Page No.: 71

Dryades Saving Bank

233 Carondelet St

New Orleans

LA 70130

Phone: (504) 581-5891

Fax: (504) 598-7233

Route #: 265070516

Certificate #: 1470512650

INST TYPE: Savings Bank

Branches: 4

Employees: 54

Ethnic Group: Black

Community Reinvestment Act Rating:

Latest Rating: Outstanding

Rating 1-1: Outstanding

Rating 1-2: Satisfactory

Rating 1-3: Satisfactory

Management

President: Virgil Robinson

CFO: Frank J Oliveri

Loan Officer: Tomorr LeBeauf

Operations Officer: Hedy Hebert

Fully Adjusted Return (TM): 173

Index of social and financial performance.
Range 300 to 0. (Higher is better.)

Regulatory and Business Status

Trading Status: Not Publicly Traded

Insurance Type: Savings Association Insurance Fund(SAIF)

Holding Company: Dryades Bancorp, Inc.

Social Data COUNTY:

Orleans

Unemployment, %, 7/1/2005: 5.60

Population, 7/1/04: 462,269

Population change, % 2000 to 2004: -4.6 %

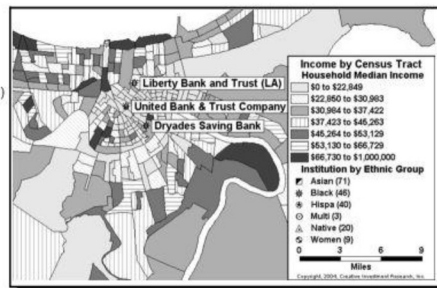
Offices of FDIC-Insured Inst, 8/22/05: 108

Minority population, % of total in County: 73.4 %

Per Capital personal income, 2003: \$30,152

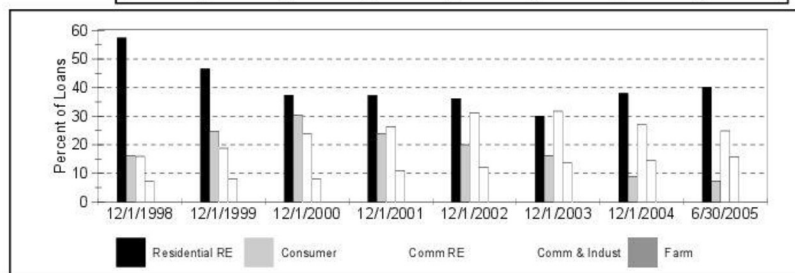
Minority firms in County, % of total, 1997: 28.6 %

Women-owned firms in County, % of total, 1997: 26.6 %



Year

Year	12/1/1998	12/1/1999	12/1/2000	12/1/2001	12/1/2002	12/1/2003	12/1/2004	6/30/2005
Assets	\$88,946	\$95,937	\$105,717	\$122,844	\$123,349	\$92,773	\$103,456	\$111,051
GrLns	\$68,952	\$74,217	\$82,735	\$76,801	\$61,982	\$56,390	\$62,766	\$66,165
Deposits	\$79,132	\$83,939	\$87,046	\$116,073	\$114,874	\$75,938	\$86,965	\$94,535
Equity	\$6,112	\$5,886	\$5,779	\$5,832	\$7,119	\$8,484	\$7,046	\$6,978
Salaries	\$2,697	\$3,039	\$3,151	\$3,132	\$2,921	\$2,793	\$2,839	\$1,428
Net Inc.	\$365	\$292	\$3	(\$44)	\$302	\$1,733	(\$427)	(\$4)
Net Ch	0.14	0.16	0.61	0.43	0.30	2.16	0.66	1.35
Offs%	0.56	0.82	1.42	1.03	1.50	2.83	2.23	1.34
NonPerfLns	0.44	0.32	0.00	-0.04	0.23	1.71	-0.42	-0.01
%	6.21	4.85	0.05	-0.75	4.66	20.00	-5.35	-0.11
ROA								
ROE								



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NRSRO Corporate Issuer Ratings Scales	
Moody's	S&P Global Ratings
Aaa	AAA
Aa1	AA+
Aa2	AA
Aa3	AA-
A1	A+
A2	A
A3	A-
Baa1	BBB+
Baa2	BBB
Baa3	BBB-
Ba1	BB+
Ba2	BB
Ba3	BB-
B1	B+
B2	B
B3	B-
Caa1	CCC+
Caa2	CCC
Caa3	CCC-
Ca	CC
C	C

MAXINE WATERS, CA
CHAIRWOMAN

United States House of Representatives
Committee on Financial Services
Washington, DC 20515

PATRICK McHENRY, NC
RANKING MEMBER

May 5, 2022

The Honorable Maxine Waters
Chair
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Madam Chair:

We are writing to request that you immediately convene a hearing with the full Securities and Exchange Commission. As you know, on October 5, 2021, Securities and Exchange Commission Chair Gary Gensler testified before the Committee on Financial Services (Committee) for the second time.¹ The next day, Committee Republicans requested that you schedule a hearing with the full Commission no later than April 2022.² It is now May, and we have yet to hear from you. However, since then, the SEC has taken several actions outside the scope of its authority and jurisdiction, and it has done so without giving stakeholders a fair chance to provide input. It is imperative that our full Committee convene to discuss the SEC's unprecedented rulemaking agenda and hear the full range of views on the Commission.

Hearing from the Chair alone is insufficient to fully understand the Commission's ongoing deliberations. Moreover, at the time of the hearing, Chair Gensler repeatedly refused to testify about forthcoming rulemakings. In fact, as of October 2021, only one open meeting with one rulemaking had occurred—leaving Members unable to question him or obtain additional information. His responses to questions including those for the record have been less than forthcoming and insufficient. This is unacceptable.

Unfortunately, over the last seven months, our concerns have been realized. After the October 2021 hearing, the SEC has embarked on a scorched earth rulemaking agenda that includes 54 separate items for fall 2021 alone³—perhaps “the most ambitious agenda in the SEC's 87-year history.”⁴ Meanwhile, Chair Gensler has set “short and overlapping comment

¹ Hearing before H. Comm. on Financial Services, *Oversight of the U.S. Securities and Exchange Commission: Wall Street's Cop Is Finally Back on the Beat*, 117th Cong. (Oct. 5, 2021).

² Press Release, House Financial Services Republicans, October 6, 2021, https://republicans-financialservices.house.gov/UploadedFiles/2021-10-06_Letter_to_Chair_Waters_-_Full_Commission_Hearing.pdf.

³ See OIRA website at https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPub=true&agencyCode=&showStage=active&agencyCd=3235&csrf_token=BE4F9317D217B943E573A6C611ED0FA9476204D948D5D1A24B3900A8C272ADA7A2D3D4085128188C63C8D40B1848324D224D.

⁴ Bloomberg, *SEC Chief to Wall Street: The Everything Crackdown is Coming* (Oct. 8, 2021), available at <https://www.bloomberg.com/news/articles/2021-10-08/sec-chief-to-wall-street-the-everything-crackdown-is-coming>. See also Market Watch, Chris Matthews, *Gensler's aggressive agenda continues as SEC proposes shortening settlement times in wake of GameStop saga* (Feb. 9, 2022) (stating “Securities and Exchange Commission Chairman Gary Gensler has been one of the most active regulators appointed by President Joe Biden, proposing a slew of new regulations at a pace that could make his chairmanship the most significant era of financial

periods” as the new normal for the SEC.⁵ This undermines the public’s role in the rulemaking process and invites litigation, among other things.

The SEC’s unilateral actions under Chair Gensler are even more troubling in light of the 10-year anniversary of the Jumpstart Our Business Startups Act, which President Obama signed into law in April 2012. This bipartisan legislation helped small businesses access capital by reducing the regulatory barriers and created new avenues to facilitate capital formation. While the SEC’s mission is to: protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation, the Commission has and continues to chill the environment for small business capital formation. This is evident by the fact the Commission’s rulemaking agenda does not include one capital formation proposal. Many Members of our Committee—on both sides of the aisle—are focused on expanding opportunities for entrepreneurs and businesses. It is important that they, and all Members, can discuss relevant policies with the full Commission.

There is precedent for this Committee inviting the full Commission. As you will recall, you invited the full Commission to testify before the Committee in the 116th Congress.⁶ Our Members deserve to hear from the full Commission. Moreover, the public has a right to know the full range of views among the SEC Commissioners, especially in the absence of a meaningful notice-and-comment process under Chair Gensler. Thank you for your attention to our request and we look forward to working with you.

Sincerely,



Patrick McHenry
Ranking Member



Bill Huizenga
Ranking Member
Subcommittee on Investor Protection,
Entrepreneurship, and Capital Markets

reform since the passage of the Dodd-Frank Financial Reform Act more than a decade ago.”), available at <https://www.marketwatch.com/story/genslers-aggressive-agenda-continues-as-sec-proposes-shortening-settlement-times-in-wake-of-gamestop-saga-11644439740>.

⁵ Al Barbarino, *SEC Under Fire Over Shorter Rule Proposal Comment Periods*, LAW360, Mar. 9, 2022, <https://www.law360.com/articles/1471291/sec-under-fire-over-shorter-rule-proposal-comment-periods>.

⁶ Hearing before H. Comm. on Financial Services, *Oversight of the Securities and Exchange Commission: Wall Street’s Cop on the Beat*, 116th Cong. (Sept. 24, 2019).

WRITTEN RESPONSES TO QUESTIONS FOR THE RECORD

YANN LE PALLEC
HEAD OF GLOBAL RATINGS SERVICES
S&P GLOBAL RATINGS

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

MAY 11, 2022

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 testified at the May 11, 2022 hearing entitled “A Notch Above? Examining the Bond Rating Industry” before the United States House Subcommittee on Investor Protection, Entrepreneurship and Capital Markets (the “Hearing”). I write now in response to the questions for the record submitted to S&P by Representatives Hill and Huizenga following the May 11, 2022 hearing (the “Questions for the Record”).

The Hearing followed S&P’s December 6, 2021 publication seeking 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 insurers. Among other things, our proposal laid out a multi-step process for determining the appropriate credit quality assumptions to use as inputs to our capital adequacy model, including in certain instances the use of inputs “mapped” to the ratings of other rating agencies or the use of conservative assumptions where S&P has formed no credit view of a particular asset and other alternative measures of credit risk are unavailable or unreliable.

As part of our RFC process, we received a number of comments criticizing this aspect of the proposal. Given the number and nature of some of the concerns raised in the comments we received, on May 9, 2022, we announced to the market that we had withdrawn this aspect of the proposed approach and would be considering alternatives.² Our consideration of alternatives continues.

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

² <https://www.spglobal.com/ratings/en/research/articles/220509-s-p-global-ratings-withdraws-rating-input-approach->

One of the Questions for the Record speaks to the concept of “notching.” Specifically, Representative Huizenga asks whether S&P will commit that “notching will not be part of [S&P’s] final proposal.” The term “notching” can refer to different things. For example, Congress has referred to “notching” as the practice of “lowering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless a portion of the assets within such pool or part of such transaction, as applicable, also is rated by the nationally recognized statistical rating organization.”³ This practice is prohibited by federal law. The SEC has also used the term “notching” to mean “taking into consideration but not necessarily adopting the credit ratings of another credit rating agency” in connection with its consideration of assets not rated by the rating agency.⁴ In certain circumstances, where an NRSRO takes another rating agency’s rating into consideration, SEC rules require the NRSRO to make and retain records of that fact.

The term notching is not defined in Representative Huizenga’s question. To the extent the question is meant to refer to some type of refusal to rate an insurance company unless all or a portion of the assets owned by the insurance company are also rated by S&P, S&P can confirm that notching will not be part of S&P’s new proposal. However, at this time, as our review of alternatives remains ongoing, S&P cannot comment definitively on whether and how S&P might propose to evaluate the risk presented by an asset held by an insurance company in instances where S&P does not have its own rating or alternative credit measure on the asset. When our review of alternatives is complete and we have our new proposal, we intend to issue a new request for

[from-proposed-insurer-risk-based-capital-adequacy-criteria-12371141.](#)

³ 15 U.S.C. § 78o-7(i)(1)(B).

⁴ Oversight of Credit Rating Agencies Registered at Nationally Recognized Statistical Rating Organizations, Final Rule, 72 Fed. Reg. 33,563, 33,601-04 (June 18, 2007).

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 remaining Questions for the Record raise issues concerning other aspects of assessing an insurance company's risk-based capital adequacy that do not involve the potential "notching" of the ratings of other rating agencies. These include questions as to how S&P's forthcoming proposal will address certain perceived issues in the insurance market, the nature of the U.S. insurance market and the differences in U.S. insurance products, the treatment of GAAP/IFRS filers versus statutory filers, the treatment of whole life products versus the treatment of products with higher risk profiles, the exclusion of variable annuities from the life insurance products that receive diversification benefits, how and when S&P might incorporate any proposed changes to its capital model, and the potential incorporation of aspects of the Insurance Capital Standard developed by the International Association of Insurance Supervisors.

These questions about our forthcoming proposal are appreciated but we cannot answer these questions at this time. While the RFC period for our first proposal is now closed, we have determined to treat your identification of these issues and questions relating to them as comments received in connection with the original RFC. Accordingly, they will be sent for consideration to the appropriate project team in connection with the development of our proposed revised methodology and assumptions for analyzing the risk-based capital adequacy of insurance companies. When we publish our final criteria, we will also publish the comments received during the comment period, as well as information about the types of substantive comments received and how we considered those types of comments in arriving at the finalized criteria.

