

United States House of Representatives  
Committee on Financial Services  
2129 Rayburn House Office Building  
Washington, D.C. 20515

July 16, 2021

## Memorandum

**To:** Members, Committee on Financial Services  
**From:** FSC Majority Staff  
**Subject:** July 21, 2021, Investor Protection, Entrepreneurship, and Capital Markets Subcommittee Hearing entitled, “Bond Rating Agencies: Examining the ‘Nationally Recognized’ Statistical Rating Organizations.”

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The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, “Bond Rating Agencies: Examining the ‘Nationally Recognized’ Statistical Rating Organizations” on Wednesday, July 21 at 2:00 pm in room 2128 of the Rayburn House Office Building. There will be one panel with the following witnesses:

- Amy Copeland McGarrity, Chief Investment Officer, Colorado Public Employees Retirement Association
- Ian Linnell, President, Fitch Ratings
- Jim Nadler, Chief Executive Officer, Kroll Bond Rating Agency
- Robert J. Rhee, Professor, University of Florida Law School
- Michael Bright, Chief Executive Officer, Structured Finance Association

### Overview

Bond or credit rating agencies are Securities and Exchange Commission (SEC) registered and regulated entities that assign creditworthiness ratings to public and private institutions and the individual debt instruments those institutions issue. Credit ratings are commonly used by market participants, including retail and institutional investors, to determine whether to invest in bonds and other debt instruments. The Financial Crisis Inquiry Commission found that the rating agencies inflated ratings of mortgage-backed securities (MBS) and other asset-backed securities (ABS) were a primary cause of the 2008 financial crisis. As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), Congress passed several reforms of the rating industry in the wake of the crisis, including addressing the conflicts of interest inherent in a system in which the issuers of securities pay for their own ratings. However, some of these reforms have not been implemented or were curtailed by the SEC. Rating agencies also play a role in the markets as climate change and other emerging risks, such as pandemics, and affect the creditworthiness of private and public debt issuers. This hearing will review the state of the bond rating agency industry, the efficacy of the reforms that have been implemented, and whether additional regulatory or legislative reforms are warranted.

## Background

Today, there are nine rating agencies,<sup>1</sup> two of which are headquartered outside of the United States,<sup>2</sup> registered with the SEC as nationally recognized statistical rating organizations (NRSROs), a formal designation that has been granted to certain bond rating agencies by the SEC since 1975.<sup>3</sup> The designation was codified in statute by the passage of the Credit Rating Agency Reform Act of 2006 (the “Reform Act”). As of December 31, 2019, 95.1% of all NRSRO credit ratings outstanding were published by the three largest agencies, S&P Global Ratings (S&P), Moody’s Investors Service (Moody’s), and Fitch Ratings (Fitch).<sup>4</sup> Between 2016 and 2019, these three firms earned 93.3% of the revenues of all NRSROs.<sup>5</sup>

The ratings issued by NRSROs are based on the likelihood that the institution or instrument will default on its obligations or otherwise fail to make timely payments of interest and fall within six categories.<sup>6</sup> These categories include credit ratings for: (1) financial institutions; (2) brokers, or dealers; (3) insurance companies; (4) corporate issuers; (5) ABS issuers; and (6) issuers of government securities, municipal securities, or securities issued by a foreign government; or a combination of one or more categories of obligors previously listed.<sup>7</sup> Five NRSROs are registered to provide credit ratings in all six categories outlined by the Reform Act. A.M. Best Rating Services (AMB), Egan-Jones Ratings Company (Egan-Jones), and HR Ratings de México (HR) are each registered to provide ratings for three of the six categories.<sup>8</sup>

The credit ratings provided by NRSROs are typically summarized by an alphabetical or alphanumeric symbol that indicates the tier of creditworthiness which the NRSRO believes the institution or debt instrument falls into.<sup>9</sup> Although there is sometimes significant variation in the scoring frameworks used by different NRSROs, ratings generally range from “AAA” or “Aaa” at the highest level of creditworthiness to “D” at the lowest level, which typically indicates a default on a debt.<sup>10</sup> For the most part, each NRSRO maintains a set threshold at which an institution or instrument’s credit rating moves from being considered “investment grade” to “non-investment grade” or “high yield” debt (commonly referred to as “junk bonds”). For example, S&P deems any institution or instrument that it rates below “BBB-” as being non-investment grade. A wide range of institutional investors, including many pension funds, 401k plans, and life insurance companies, are bound by internal policies that limit, restrict, or prohibit them from investing in non-investment-grade financial assets.

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<sup>1</sup> The nine credit rating agencies are: S&P Global Ratings, Moody’s Investors Service, Inc., Fitch Ratings, Inc., A.M. Best Rating Services, Inc., DBRS, Inc., Egan-Jones Rating Co., Kroll Bond Rating Agency, Inc., HR Ratings de México, S.A de C.V., and Japan Credit Rating Agency, Ltd.

<sup>2</sup> HR Ratings de México, S.A. de C.V. is headquartered in Mexico and Japan Credit Rating Agency, Ltd. is headquartered in Japan. Securities and Exchange Commission, [Annual Report on Nationally Recognized Statistical Rating Organizations](#), (Dec. 2020).

<sup>3</sup> Lawrence J. White, [Credit Rating Agencies: An Overview](#), Annual Review of Financial Economics, (Nov. 2013).

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> Chartered Financial Analyst Institute, [Credit Rating Agencies Regulation](#), (accessed Jul. 6, 2021).

<sup>7</sup> Credit Rating Agency Reform Act of 2006, [Public Law No: 109-291](#).

<sup>8</sup> Securities and Exchange Commission, [Annual Report on Nationally Recognized Statistical Rating Organizations](#), (Dec. 2020).

<sup>9</sup> Securities and Exchange Commission, [Updated Investor Bulletin: The ABCs of Credit Ratings](#), (Oct. 12, 2017).

<sup>10</sup> *Id.*

## The Role of Credit Ratings in the Financial Crisis

A primary cause of the 2008 financial crisis has been attributed to the inflated credit ratings of Moody's, S&P, and Fitch that significantly overstated the creditworthiness of MBS and other ABS.<sup>11</sup> According to the final report of the Financial Crisis Inquiry Commission, "the three credit rating agencies were key enablers of the financial meltdown" and "the mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval."<sup>12</sup> The report further found that "investors relied on them, often blindly."<sup>13</sup>

In December 2008, a total of 11 trillion dollars in structured finance products had been issued, representing 35% of the total value of the U.S. bond market.<sup>14</sup> Between 2007 and 2008, 36,346 tranches of these securities, rated by Moody's, received a downgrade in their credit rating. At that time, Moody's had provided ratings for over half the \$11 trillion structured products market, and close to one-third of the 36,346 products downgraded had previously received inflated AAA ratings from Moody's.<sup>15</sup>

## Dodd-Frank Reforms

In passing the Dodd-Frank Act, Congress created new oversight tools and regulatory requirements for NRSROs to address many of the issues which contributed to inflated credit ratings for structured finance instruments.<sup>16</sup> These reforms included:

- Directing federal government agencies to remove references to ratings in regulations;
- Creating the Office of Credit Ratings (OCR), authorizing SEC to fine or deregister NRSROs, and requiring SEC to examine the NRSROs at least once a year and make findings public;
- Requiring NRSROs to disclose their rating methodologies, use of third parties for due diligence efforts, and ratings track record;
- Requiring NRSROs to consider credible information that comes from sources other than the organizations being rated, instituting a one-year look-back review and notification to SEC when certain NRSRO employees leave to work for an issuer or underwriter of a rated security;
- Assigning liability to NRSROs by creating private rights of action and subjecting NRSROs to "expert liability" when their credit ratings are included in the prospectus of a security offering;
- Requiring ratings analysts to pass qualifying exams and have continuing education;
- Requiring at least half the members of NRSRO boards to be independent, with no financial stake in credit ratings; and,
- Directing the SEC to create a new mechanism to prevent issuers of ABS from picking the agency they think will give the highest rating after conducting a study and reporting to Congress.

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<sup>11</sup> Adam Ashcraft et al., [MBS Ratings and the Mortgage Credit Boom](#), Federal Reserve Bank of New York Staff Report no. 449, (May 2010).

<sup>12</sup> National Commission on the Causes of the Financial and Economic Crisis in the United States, [Final Report](#), (Jan. 2011).

<sup>13</sup> *Id.*

<sup>14</sup> Efraim Benmelech et al., [The Credit Rating Crisis](#), National Bureau of Economic Research, (Jun. 2009).

<sup>15</sup> *Id.*

<sup>16</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, [Public Law 111-203](#).

*Issuer-Pay Business Model.* The Dodd-Frank Act required the SEC and Government Accountability Office (GAO) to each individually study the “issuer-pays” business model used by all of the largest NRSROs, in which issuers of securities select and contract directly with an NRSRO and pay to receive a credit rating.<sup>17</sup> Since at least 2003, the SEC has found that the issuer-pay business model “naturally creates the potential for conflict of interest” because NRSROs are incentivized to provide credit ratings that will help maintain their business relationships with their issuer clients.<sup>18</sup> Many have attributed the inflated credit ratings which helped foment the 2008 financial crisis to this conflict of interest.<sup>19</sup> In their analyses, both the SEC and GAO were required to assess this conflict of interest and propose potential policy reforms which would foster alternatives to the issuer-pay business model.<sup>20</sup> Section 939F of the Dodd-Frank Act also directed the SEC to address this issue by establishing a new body to independently, and potentially randomly, assign NRSROs to provide credit ratings to newly issued structured finance instruments if the Commission found in its analysis that such a reform was necessary to resolve the conflict of interest.<sup>21</sup>

Both agencies highlighted in 2012 several benefits and disadvantages of potential alternatives to the issuer-pay business model. On June 1, 2020, the SEC’s Fixed Income Market Structure Advisory Committee (FIMSAC) put forward a package of recommended reforms for consideration by the Commission intended to mitigate potential conflicts of interest in credit ratings.<sup>22</sup> However, since 2013, the SEC has taken no actions to reform the issuer-pay framework.

*Liability for NRSROs.* The Dodd-Frank Act also sought to improve the quality of credit ratings by increasing the potential legal liability faced by NRSROs that provide inaccurate ratings for structured finance products.<sup>23</sup> In addition to creating a new private right of action, Section 939G immediately nullified SEC Rule 436(g). Rule 436(g) excluded NRSRO credit ratings included in registration statements and prospectuses filed with the SEC for newly issued ABS from being considered an “expert” opinion. Under the Securities Act of 1933, experts who consent to being quoted in these filings can themselves be subject to legal liability for material misstatements or omissions under Section 11 of the Act and barred from conducting business with the SEC.

The inclusion of this provision in the Dodd-Frank Act prompted several major NRSROs to announce that they would no longer consent to their credit ratings being included or referenced in the prospectuses or registration statements to avoid any Section 11 liability. This resulted in a temporary halt in the issuance of new ABS because under the SEC’s Regulation AB, ABS issuers were required to include details of the credit rating of the security in their prospectus and registration statement filings. On July 22, 2010, Ford Motor Credit Co. LLC sent a letter to the SEC requesting that it be exempted from these

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<sup>17</sup> *Id.*

<sup>18</sup> Securities and Exchange Commission, [Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets](#), (Jan. 2003).

<sup>19</sup> CNBC, [SEC Urged to End the "Issuer Pay" Bond Ratings Model Once Tied to the Financial Crisis](#), (Nov. 5, 2019).

<sup>20</sup> Securities and Exchange Commission, [Report to Congress on Assigned Credit Ratings](#), (Dec. 2012).

<sup>21</sup> The framework for this reform was initially embodied in the Franken-Wicker Amendment which was included as Section 939D of an earlier version of the Dodd-Frank Act when it was passed by the Senate on May 20, 2010.

<sup>22</sup> FIMSAC, [FIMSAC Recommendation Regarding Ways to Mitigate Conflicts of Interest in Credit Ratings](#), (Jun. 1, 2020).

<sup>23</sup> Morgan Lewis & Bockius LLP, [Dodd-Frank Act's Impact on Rating Agencies as the ABS Market Continues to Evolve](#), (Dec. 15, 2010).

requirements to include details of credit ratings in its disclosures when issuing new ABS. On November 23, 2010, the SEC responded with a no-action letter granting Ford’s no-action request and stated that it would not enforce those requirements of Regulation AB until further notice.<sup>24</sup>

*Government Use of Ratings.* Section 939A of the Dodd-Frank Act also sought to reduce direct reliance on credit ratings by directing federal regulators to update regulations and guidance by removing specific references to credit ratings produced by NRSROs and instead develop alternative standards.<sup>25</sup> Since the enactment of the provision, most federal agencies have taken steps to eliminate reliance on credit ratings from their respective agency regulations and policies. However, in response to turmoil in corporate debt markets sparked by the COVID-19 pandemic in early 2020, the Federal Reserve created several lending facilities to support credit markets,<sup>26</sup> and several of these facilities only accepted instruments that received a credit rating from a “major NRSRO,” namely S&P, Moody’s, and Fitch.<sup>27</sup> As a result, many issuers, including smaller corporations, were not initially eligible to benefit from the credit support provided by these facilities. Under pressure from Congress, the Federal Reserve expanded collateral requirements for the programs to include securities rated by any of the nine NRSROs.

### **Private Sector Use of Ratings and Market Concentration**

The policies and practices of large institutional investors may be reinforcing the dominance of the big three rating agencies and preventing smaller rating firms from competing. In a December 2020 report, the OCR indicated that one factor that may be contributing to the continued dominance of S&P, Moody’s, and Fitch are contracts and investment guidelines “of some fixed income mutual fund managers, pension plan sponsors, and endowment fund managers, which require the use of ratings of specified rating agencies.”<sup>28</sup> According to a 2013 survey of open-end fixed-income funds, 42% employed investment guidelines call for the use of credit ratings from S&P, Moody’s, or a “major NRSRO.”<sup>29</sup>

### **Climate Change and Bond Ratings**

Financial risks posed by climate change are negatively affecting the ratings of many businesses and municipalities as they seek to raise debt financing.<sup>30</sup> This is occurring as some businesses with greater exposure to climate change risks are increasingly turning to debt markets, as equity financing has become more expensive.<sup>31</sup> In the \$4 trillion municipal bond market, S&P, Moody’s, and Fitch have all “issued reports warning state and local governments that their exposure to climate risk could affect their credit ratings.”<sup>32</sup>

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<sup>24</sup> [Letter from Securities and Exchange to Ford Motor Credit Company LLC](#), (Nov. 23, 2010).

<sup>25</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, [Public Law 111-203](#).

<sup>26</sup> Speech By Daleep Singh, [The Federal Reserve’s Corporate Credit Facilities: Why, How, and For Whom](#), Federal Reserve Bank of New York, (Oct. 20, 2020).

<sup>27</sup> Gibson Dunn & Crutcher LLP, [Emergency Lending: Federal Reserve Expands Primary Market Corporate Credit Facility, Secondary Market Corporate Credit Facility and Term Asset-Backed Lending Facility](#), (Apr. 9, 2020).

<sup>28</sup> Securities and Exchange Commission, [Annual Report on Nationally Recognized Statistical Rating Organizations](#), (Dec. 2020).

<sup>29</sup> *Id.*

<sup>30</sup> Governor Lael Brainard, [Financial Stability Implications of Climate Change](#), (Mar. 23, 2021).

<sup>31</sup> Brookings Institute, [Markets are flying blind on climate change](#) (Sept. 16, 2020).

<sup>32</sup> New York Times, [Moody’s Buys Climate Data Firm, Signaling New Scrutiny of Climate Risks](#), (Jul. 24, 2019).

## Legislation

- **H.R. \_\_\_, Commercial Credit Rating Reform Act of 2021 (Sherman):** This bill would require the establishment of a credit rating agency assignment board within the jurisdiction of the SEC, which would be responsible for assigning NRSROs to provide ratings for corporate issuers and issuers of new asset-backed securities.
- **H.R. \_\_\_, Uniform Treatment of NRSROs Act (Dean):** This bill would provide for the uniform treatment of nationally recognized statistical rating organizations registered with the SEC under any future emergency credit facilities established by the Federal Reserve.
- **H.R. \_\_\_, Transparency and Accountability of NRSROs Act:** This bill would require the SEC to specifically name the credit rating agencies that have significant shortcomings and compliance failures in SEC’s annual examination reports. Currently, the Commission omits the names of the credit rating agencies, and instead describes them as “large NRSRO” or “small NRSRO.”
- **H.R. \_\_\_, Restoring NRSRO Accountability Act:** This bill, effective January 1, 2022, would nullify a no-action letter issued by the Division of Corporate Finance of the SEC, which stated that the Division would not recommend an enforcement action if ABS issuers did not include the NRSRO credit rating in a registration statement after obtaining and filing the NRSRO’s consent to include such rating. This consent would hold the NRSRO liable as an expert under Section 11 of the Securities Act for material misstatements or omissions relating to its rating.
- **H.R. \_\_\_, Accurate Climate Risk Information Act:** This bill would require the SEC to adopt rules within 180 days requiring NRSROs to adopt, integrate, and disclose written supervisory policies that govern how the NRSRO considers climate-related risks in their credit ratings.