July 20, 2021

The Honorable Maxine Waters
Chairwoman
U.S. House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Re: Hearing on Bond Rating Agencies: Examining the "Nationally Recognized" Statistical Rating Organizations; Subcommittee on Investor Protection, Entrepreneurship and Capital Markets; Wednesday, July 21, 2021, 2:00 p.m.

Dear Chairwoman Waters:

We commend you for organizing a hearing to examine some of the continuing regulatory challenges surrounding credit rating agencies. Better Markets has long advocated for a number of reforms that will help make this industry more transparent, accountable, and above all, less dominated by conflicts of interest. Those conflicts of interest harm investors, undermine the integrity of our capital markets, and ultimately threaten the stability of our financial system—as they did in the lead-up to the 2008 financial crisis. In this letter, we briefly offer some of our views on these important issues, and we respectfully request that this letter be included in the record of tomorrow's hearing.

Introduction

Effective regulation and oversight of the credit rating agencies has yet to become a reality, as the SEC has implemented only piecemeal reforms over the years. As a result, the current regulatory framework suffers from large and dangerous gaps. For example:

- **Conflicts of Interest.** Perhaps most important, almost all of the credit rating agencies—and certainly the three largest and most dominant Nationally Recognized Statistical Rating Organizations ("NRSROs")—suffer from deeply embedded conflicts of interest due to their primary compensation model. Under that model, bond issuers shop for high ratings, and the NRSROs have an incentive to accommodate those issuers in an effort to receive and maintain a steady and lucrative stream of revenue. Congress mandated that the SEC establish an assignment system for the initial ratings on structured products (or a more

effective alternative), to help end the practice of ratings shopping. However, with the exception of the SEC's 2012 study of the problem and a later roundtable, no real progress has been made.

- **Transparency and Enforcement.** The SEC's approach to examinations and enforcement is doubly flawed. In accordance with Section 932 of the Dodd-Frank Act, the SEC conducts annual examinations of the NRSROs. Also in accordance with the Dodd-Frank Act, the SEC makes those reports public. However, although those annual reports typically reveal significant violations of law, they include no identifying information that would inform the public as to which NRSROs are engaged in illegal acts and practices. Moreover, we see little evidence that the SEC is pursuing those violators in enforcement actions.

- **Accountability.** Accountability for the NRSROs has been undermined on another level. Section 939G of the Dodd-Frank Act expressly eliminated the exemption for NRSROs set forth in SEC Rule 436(g). That step was intended to ensure that the NRSROs could be held accountable under Section 11 of the Securities Act of 1933 for misleading ratings included in registration statements. However, the SEC issued no-action relief years ago that has in effect negated this Congressional reform.

- **ESG; Uniformity; and Preferential Treatment for the Dominant Firms.** In addition to these problems, credit ratings present a number of other important challenges. Environmental, social, and governance ("ESG") factors must be more fully and transparently incorporated into credit rating methodologies; there remains an unacceptable lack of uniformity and coherence in credit ratings; and the preferential treatment of the three major NRSROs—exemplified during the pandemic in the emergency credit facilities that conditioned participation on ratings from the three dominant firms—must be addressed.

In the balance of this letter, we focus primarily on the need to address the conflicts of interest that still pervade the credit ratings industry.

Powerful Conflicts of Interest Dominate the Industry

A dangerous conflict of interest lies embedded in the "issuer-pays" business model that most NRSROs prefer: The companies that issue bonds and need credit ratings to attract investors are the same ones that pick and pay the NRSROs to come up with the ratings. Because it's a repeat business, if the issuers that hire the NRSROs don't think the ratings are high enough, then they simply shop around for a replacement, turning to one of the other leading NRSROs—firms that will be more than happy to win the business and produce ratings aligned with what the issuer wants. This "ratings shopping" inevitably results in ratings inflation, and when this pattern becomes widespread, it means that reams of investments that are far riskier than they appear work their way into the financial system. That sets the stage for systemic risk and financial crisis. This is exactly what happened in 2008, and last Spring, we saw evidence of a recurrence.

It's an accepted fact that grossly inflated credit ratings assigned to thousands of mortgage-backed securities in the years leading up to the 2008 financial crisis helped bring our economy to its knees, costing over $20 trillion in lost GDP and untold suffering. As one leading report on the crisis explained, inaccurate AAA credit ratings and the inevitable and sudden downgrades thereafter "perhaps more than any other single event" triggered the crisis. *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, Majority and Minority Staff Report, United States Senate Permanent Subcommittee on Investigations, at 6 (Apr. 13, 2011).

The Dodd-Frank Act (Sections 939 *et seq.*) required reforms in the credit rating industry, not only to increase transparency and oversight, but also to root out the driving force behind bloated ratings: the powerful conflicts of interest inherent in the "issuer-pays" compensation model. Those incentives virtually guarantee that the NRSROs will inflate their ratings to attract business from issuers and underwriters, earn lucrative fees, and maintain the flow of future deals.

Over the last 10 years, the SEC has implemented a number of the Dodd-Frank Act mandates on credit ratings, but none of them individually or together has been strong enough to eliminate or even put much of a dent in the conflicts of interest that dominate the "issuer pays" model and lead to dangerously inflated ratings. In fact, the SEC has left out the single most important fix set forth in the law: creating an independent assignment system for ratings on "structured" debt securities (i.e. asset-backed securities) so the NRSROs won't have an incentive to yield to their clients, distort their ratings, and retain a steady flow of repeat business. *See* Dodd-Frank Act, Section 939F.

As the coronavirus pandemic swept over the country last Spring, potentially triggering another financial crisis, we saw ominous signs that the SEC's failure to follow through on the Dodd-Frank reforms was contributing once again to financial market instability and chaos. As detailed below, fresh concerns about inflated credit ratings emerged last Fall from Congress and in the press. Those voices turned out to be prescient, as credit rating downgrades—especially for highly leveraged companies and the securitizations built on their debt (the "CLOs")—exploded amidst the financial market turmoil triggered by the pandemic. *See, e.g.,* Lisa Lee, *Battered CLO Investors Are About to Get a Look at Their Losses,* BLOOMBERG (Apr. 20, 2020). Many believe that fundamentally, nothing has changed. Patrick Temple-West, *Ratings Agencies Brace for Backlash After Rash of Downgrades,* FINANCIAL TIMES (Apr. 2, 2020). Therefore, we must solve the perennial problem of corrupted and conflicted credit ratings once and for all, as Congress required.

Credit Ratings Have Proven to Be Valuable But Also Destructive Financial Tools

Credit ratings have existed for more than a century, becoming an extremely important fixture in our capital markets. They are heavily relied upon by investors and issuers, and they even became embedded in our securities laws and regulations as shorthand standards of creditworthiness used by regulators. When credit ratings are honest and accurate, they help promote investor confidence, capital formation, and market liquidity in corporate, municipal, and sovereign debt offerings.

However, credit ratings have also contributed to some of our most spectacular financial disasters, the financial crisis of 2008 foremost among them. Virtually every post-mortem of the 2008 crash puts grossly inflated or fraudulent credit ratings on complex mortgage-backed securities ("RMBS") squarely in the chain of causation. As a direct result of the Triple-A ratings cavalierly applied by the handful of leading NRSROs, everyone from pension and mutual funds to individual investors bought huge swaths of extraordinarily complex and ultimately worthless structured debt instruments stuffed with poorly underwritten, doomed-to-default mortgage loans. And they did so because the rating agencies said they carried virtually no risk at all.

But as the housing market collapsed, those RMBS failed in droves and the rating agencies were forced to issue sudden and dramatic ratings downgrades. In turn, the derivatives markets keyed to those investments sank, the credit markets froze, and banks and financial firms fell into a spiral of failures and near-failures prevented only by massive taxpayer bailouts. As economist and Nobel Laureate Joseph Stiglitz has famously said, "The banks could not have done what they did without the complicity of the ratings agencies." Elliot Blair Smith, *Bringing Down Wall Street as Ratings Let Loose Subprime Scourge,* BLOOMBERG (Sept. 24, 2008).

That wasn't even the first high-profile failure linked to credit ratings. The spectacular collapse of Enron in 2001, preceded by strong ratings until the eve of its bankruptcy, generated fresh concerns about the role of credit ratings and the need for oversight. The same sobering lesson was driven home again during the 2010 Eurozone crisis, which was inflamed when NRSROs issued sudden downgrades of Greek sovereign debt after consistently rating it A+ for years. And the fact that only one of the three major rating agencies downgraded long-term U.S. debt in 2011 speaks volumes about the fundamentally arbitrary, unreliable, and at times even politically driven nature of credit ratings.

Efforts to Regulate the Credit Rating Agencies Have Been Slow, Incremental, and Incomplete

Establishing an effective regulatory regime for credit rating agencies has proven to be a long, slow, and challenging process, one that has not kept pace with the power of credit ratings to profoundly affect our markets. Consider how much was done and yet how little was really accomplished:

- The Commission incorporated credit ratings in its rules for the first time in 1975, as one factor to be used in calculating net capital requirements for broker-dealers. As the capital markets grew in volume and complexity, reliance on credit ratings in the markets and in the regulations increased, yet these important "gatekeepers" remained essentially ***unregulated for decades***.

- In 1994, the SEC issued a concept release to explore the merits of establishing formal procedures for designating credit rating agencies as NRSROs and monitoring their activities, but a resulting 1997 rule proposal was ***abandoned***.

- Following the Enron disaster, Congress amended the Sarbanes-Oxley Act of 2002 to require the SEC to study ways to improve transparency in the ratings field and

ways to address conflicts of interest in the operation of credit rating agencies. The result was ***a report*** to Congress on the role of credit rating agencies in the securities markets.

- Congress finally undertook systematic oversight of credit rating agencies in the Credit Rating Agency Reform Act of 2006. The statute created the first general framework for regulating credit rating agencies, but it was essentially a light-touch approach, focused on the registration of credit rating agencies with the SEC as NRSROs, a duty ***simply to manage*** conflicts of interest arising from compensation arrangements, and appointment of a compliance officer.

- After the financial crash of 2008, the Dodd-Frank Act required a more robust set of reforms.

    - It built on the ***regulatory requirements*** that were implemented in the 2006 law, adding new provisions on corporate governance, disclosure of methodologies and performance, training standards, and conflicts of interest, including measures to prevent marketing or sales considerations from influencing ratings. And it created the SEC's Office of Credit Ratings to conduct annual examinations of the NRSROs and oversee the credit ratings marketplace.

    - It sought to ***reduce reliance*** upon credit ratings by requiring the SEC and other federal agencies to remove any references to credit ratings in regulations and to substitute appropriate standards of creditworthiness in their place.

    - And in Section 939F, it required the SEC to study the feasibility of establishing a system in which a public or private utility would assign NRSROs to determine the initial credit ratings for structured finance products. That provision also imposed an ***unequivocal mandate***: It required the SEC either to establish such an assignment system (which would prevent the issuer or underwriter of the structured finance product from selecting the NRSRO) or to pursue an alternative system if the SEC found one that would better serve the public interest and the protection of investors.

    - But while the SEC issued a variety of rules pursuant to the Dodd-Frank Act, it ***never fulfilled*** its obligation to establish the assignment system—the one measure that would have finally helped eliminate the lure of revenue that issuers use to procure inflated ratings from the NRSROs.

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Fresh Calls for Reform Arose Before the Coronavirus Crisis, But Last Year's Market Turmoil Appeared to Validate Yet Again the Need for More Decisive Regulatory Action

Not long after the Dodd-Frank Act was passed, many advocates, including Better Markets, urged the SEC to follow through on its mandate to institute the assignment system. Over the years, calls for reform have intensified, as media reports, members of Congress, and market experts have expressed increasing concern about the persistent problem of inflated ratings, the dominant issuer-pays model of compensation, and the potential for another round of disastrous financial failures linked to inflated credit ratings.

In Congress, Sen. Elizabeth Warren was among the first to sound the alarm about inflated bond ratings as a growing, contemporary problem. In a Sept. 26, 2019, letter to SEC Chair Jay Clayton, she explained "there are strong indications that rating agencies are continuing to prop up risky financial products" as the leading NRSROs fight for market share. Sen. Warren also pointed to the enduring conflicts of interest in the market arising from the issuer-pays model, the rapid growth in particular of collateralized loan obligations (risky securitizations comprised of loans to already highly indebted companies), and the SEC's failure to address these issues and to implement the Dodd-Frank ratings assignment system or a better alternative. The Senator issued a series of questions asking the Chair to explain his agency's inaction. Four other Senators issued a letter to Chair Clayton on February 3, 2020, also questioning the SEC's failure to implement the Dodd-Frank assignment system.

An August 7, 2019, Wall Street Journal article reported that many investors remain skeptical of ratings, especially those assigned to structured or securitized debt offerings, viewing them as inflated in ways reminiscent of the 2008 crisis. The article also shared the findings of an analysis indicating that all firms—established and newcomers alike—still boost ratings in a constant struggle to preserve or enlarge their market share among issuers. Cezary Podkul & Gunjan Banerji, *Inflated Bond Ratings Helped Spur the Financial Crisis. They're Back,* WALL ST. J. (Aug. 7, 2019). The article thus suggested that increased competition among issuer-pays NRSROs by itself will not solve the problem until the underlying conflicts of interest are addressed. An October 29, 2019, Wall Street Journal article also highlighted the enduring problem of conflicts of interest, explaining that the promise of "unsolicited ratings" favored by the SEC as a check on paid ratings remains unfulfilled: NRSROs aren't interested in devoting resources to the effort because they don't get paid to do it. *See* Cezary Podkul, *SEC Fix for Conflicts of Interest at Credit-Ratings Firms Has Failed,* WALL ST. J. (Oct. 29, 2019).

Market watchers are also concerned. In an opinion piece in The Hill on Jan. 20, 2020, Kurt Schacht with the CFA Institute expressed grave concern that the old familiar pattern of NRSROs slapping inflated ratings on complex structured debt offerings was playing out again in the booming economy and low interest rate environment that prevailed until the pandemic hit. *See* Kurt Schacht, *Ratings Agency Redux,* THE HILL (Jan. 21, 2020). He suggested that regulators would be well-advised to "check the NRSROs math." Others saw evidence that ratings continue to be inflated and that the issuer-pays model—and the conflicts of interest that go with it—remain resilient. As one report noted, regulators "merely tinkered" with oversight of the ratings industry

following the 2008 crisis. *Credit Rating Agencies Are Back Under the Spotlight,* Finance and Economics, THE ECONOMIST (May 7, 2020). A 2020 SEC enforcement action illustrates the problem: Marketing incentives continue to contaminate the ratings process, but occasional enforcement actions will have little effect, especially if the SEC targets only the smaller NRSROs. Caitlin Reilly, *Morningstar Pays $3.5M to Settle SEC Conflict of Interest Charges*, CQ ROLL CALL (May 15, 2020); Jaclyn Jaeger, *Morningstar to Pay $3.5M for Conflicts of Interest Violations*, COMPLIANCE WEEK (May 19, 2020). Even some in the industry, such as Egan-Jones, have pressed for fundamental change to address conflicts of interest in the prevailing issuer-pays model. *See* Letter from Sean Egan, Chief Executive Officer, Eagan-Jones Ratings Co., to the Securities and Exchange Commission Fixed Income Market Structure Advisory Committee (Jan. 31, 2020) (urging greater reliance on investor-paid ratings).

Last year, as the pandemic triggered huge market turmoil, ratings downgrades came in huge waves, at breakneck speed, and across multiple sectors, from corporate and municipal bonds to sovereign debt. *See* Olivia Raimonde, *S&P, Moody's Cut Credit Grades at Fastest Pace in a Decade,* BLOOMBERG (Mar. 26, 2020). But the carnage appeared to be greatest among the ratings for already highly leveraged companies, whose debt had been bundled into the securitizations known as "collateralized loan obligations" or CLOs. Those companies were being downgraded dramatically and in droves, in turn causing downgrades to the CLOs themselves. Lisa Lee, *Battered CLO Investors Are About to Get a Look at Their Losses,* BLOOMBERG (Apr. 20, 2020); Joe Rennison, *Rating Agencies Put 1,000 CLO Slices on Review for Downgrade*, FINANCIAL TIMES (May 13, 2020).

When ratings are inflated, the damage is magnified on several levels. As a result of ratings downgrades, CLO managers faced the prospect of having to offload those bonds as their ratings sink below acceptable levels, thus liquidating losses and further depressing the value of that debt. Investors in the CLOs faced the prospect of lost interest and ultimately principal. Congress compounded the problem, since the $2.3 trillion rescue package (The CARES Act) signed into law on March 27, 2020, was heavily laced with references to credit ratings as criteria for allocating billions of dollars in loan relief—even though the Dodd-Frank Act (Section 939, 939A) required the removal of all references to credit ratings in financial laws and regulations. *See* Twitter Feed of Professor Frank Portnoy, UC Berkeley Law, https://twitter.com/FrankPartnoy. Worse, the term sheets for some of the emergency credit facilities insisted on ratings from one of the three dominant NRSROs as a condition of participation. This requirement excluded many small to mid-size companies from those relief programs, since the big three often don't cover those companies. It also unfairly disadvantaged the smaller NRSROs, and it even threatened to inject more risk into the financial system given the infamously poor track record of the dominant NRSROs. *See* Letter from Rep. Maxine Waters, Chairwoman, House Financial Services Committee, to the Hon. Jerome H. Powell, Chair, Board of Governors of the Federal Reserve (Apr. 16, 2020).

The large NRSROs helped create and sustain this modern mania in the CLO market. As one report explained, "[l]ax underwriting standards, rosy profit predictions and rock-bottom interest rates all fueled the irrational exuberance in a market that's come crashing down as a worldwide health crisis brings the global economy to a standstill." Brandon Kochkodin, *Riskier CLOs Get Big Boost From S&P in "New Ratings Shopping,* BLOOMBERG (Apr. 17, 2020). But it is precisely the job of the NRSROs to see through bad underwriting, rosy predictions, and

temporary economic conditions to arrive at objective and accurate credit ratings. This they failed to do, as in 2008. Worse, it appears that at least one major NRSRO (S&P Global) may have deliberately employed a methodology designed to inflate CLO ratings and attract the bulk of the ratings business in that sector. *Id.* More broadly, evidence presented in the Journal of Structured Finance indicates that the NRSROs are both regularly deviating from their standard methodology for rating CLOs and failing to disclose the frequency of or reasons for those deviations. Gene Phillips and Mark Adelson, *CLO Credit Ratings Gone Awry,* THE JOURNAL OF STRUCTURED FINANCE (Aug. 2020). In spite of the significant doubts about the validity of CLO ratings raised by this evidence, new CLO offerings and refinancings continue at a record pace even as the market faces complicated new risks stemming from the upcoming LIBOR transition. Adam Tempkin, *'Nonchalant' CLO Market Faces Hedging Risks in Libor Transition,* BLOOMBERG (July 8, 2021).

With respect to the SEC, last year, the former head of the SEC's Office of Credit Ratings, Jessica Kane, acknowledged that the effort to promote non-hired ratings as a safeguard against paid, issuer-influenced ratings was under fire as ineffective. And she further reported that "conflicts of interest management" was among the leading problem areas in the examination reports spanning 2011 to 2019. Yet she offered little promise of action on the Dodd-Frank assignment model, listing instead a series of enhanced disclosure requirements as the primary remedies under consideration at the agency. The SEC's 2020 exam report shows that conflicts of interest continue to be a problem. It must be solved, and the SEC must implement the assignment system contemplated in the Dodd-Frank Act (giving due consideration to the mechanism set forth in section 939D of H.R. 4173) or an alternative that more effectively serves the public interest.

We hope these observations are helpful and will make a valuable contribution to the record of the Subcommittee's important hearing this Wednesday.

Sincerely,

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