STRUCTURED FINANCE ASSOCIATION

Nationally Recognized Statistical Rating Organizations (NRSROs)

Play Vital Role in Capital Markets

NRSROs
Play Vital Role in Bond Market

Background

- A nationally recognized statistical rating organization (NRSRO) is a credit rating agency registered and approved by the U.S. Securities and Exchange Commission (SEC).
  - There are currently nine (9) approved NRSROs – with seven (7) approved to rate all five sectors.
- **Credit ratings agencies contribute to the efficiency and stability of the bond markets** including securitization by enhancing the ability of issuers to raise capital for their businesses and providing investors with an independent credit assessment of the creditworthiness of a company or financial product.
- **Issuer-Pay Model.** A company raising capital through the issuance of a security ("issuer") most often selects and hires the NRSROs that will provide a credit rating assessment of the issuer.
  - NRSROs providing the rating are generally compensated by the company obtaining the rating; referred to as the "issuer-pay model".
  - An inherent conflict arises when the issuer pays a NRSRO to have its own creditworthiness assessed.
  - Since the financial crisis over a decade ago, lawmakers, regulators and market participants have taken substantial steps to further mitigate these *potential* conflicts of interest related to NRSRO credit ratings.

Dodd-Frank Act added robust disclosure and oversight regulations

- **Today, NRSROs are directly regulated in a way that they were not regulated before the financial crisis.** Substantially adding to the Credit Rating Agency Reform Act of 2007, the Dodd-Frank Act has provided increased accountability, governance, conflict management and transparency including:
  - Providing the SEC with more power to regulate the NRSROs.
  - Increasing sanctions that the SEC can impose.
  - Requiring the OCR to conduct examinations of each NRSRO at least annually.
  - Requiring greater transparency from NRSROs, including a requirement that credit ratings be determined by NRSRO board-approved methodologies and made publicly available.

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- **Moreover, the law has led the SEC to adopt rules setting forth a broad range of requirements related to internal controls and mandated disclosures**, including those related to managing conflicts of interest, standards for credit analysts, methodology transparency and rating performance statistics (such as separation of rating and sales &marketing activities and delinking rating analyst compensation to revenue, conflict checks).

Reviewing current rating process and its oversight

- **SFA believes it is imperitive to ensure proper regulatory requirements and market practices to address the potential conflicts of interest** associated with the current issuer-pay model to instill and maintain confidence in the investor community that the NRSROs will issue ratings independent and free from influence resulting from conflicts of interest.
- **Given this vital role that credit ratings play, we agree that it is important for the SEC to periodically review its regulation of the credit rating process.**
  - In doing so, the SEC should keep in mind the comprehensive changes to the oversight of NRSROs, as highlighted above.

Alternative selection and compensation models

- SFA members deliberated extensively over the viability of alternative means to compensate rating agencies to address potential conflicts of interest. **SFA foresees undesirable consequences with some of the previously proposed compensation and assignment models.**
  - **SFA strongly advises against an rating assignment model.** Conceptually, an rating assignment model involves the assignment of an NRSRO by a governmental or quasi-government body to determine the initial credit ratings of the underlying security.
    - **This model would not eliminate potential conflicts**; but rather simply replace one potential conflict for another.
    - **It also raises a number of feasibility and oversight concerns** including 1) significant government control of vital market activitiy, 2) anti-competitiveness nature of a government-directed assignment system, 3) foreseeable risk for degradation in service quality, 4) a company's cost of capital determined by quasi-government board, and 5) substitution of a small board's judgement for that of the diverse group of investors in the market.
  - **SFA does not recommend an investor-subscription model**. In an investor-subscription model, investors of the transaction would pay an NRSRO to rate a bond. This model does not solve for the inherent problem of conflicts of interest – but rather shifts the potential onto investors. It also may limit rating analysis to the largest investors able to allocate the revenue.

FIMSAC Recommendations

- The Fixed Income Market Structure Advisory Committee (FIMSAC) Credit Ratings Subcommittee, an advisory group to the SEC, was formed to consider the role of NRSRO credit ratings in various financial markets and explore the potential conflicts of interted in the issuer-pay model.
  - In 2019 – 2020 the FIMSAC re-examined – and rejected recommending – the government assignment model.
  - Instead the FIMSAC made three other recommendations to the SEC:
    - Enhanced Issuer Disclosure: *SFA supports the recommendation* to provide enhanced issuer disclosure detailing their process of selecting a NRSRO.
    - Additional Rating Agency Disclosure: *SFA supports considering initiatives to further enhance transparency with regard to the criteria employed by NRSROs*. However, SFA is concerned that suggestions from the FIMSAC seem to reflect a misunderstanding of the ratings process for securitization transactions.
    - Bondholder Ratification: *SFA found the bondholder ratification recommendation unworkable for structured finance products.* The concept of a ratification process involves periodic affirmations by bondholders to ratify the NRSROs chosen to rate a security through a bondholder voting procedure. While such a concept may be feasible for corporate audit firms due to its backward looking nature, this process is unworkable within the forward looking credit rating construct and could result in consequences that are foreseeable and adverse.

Conclusion

- SFA believes that with the right balance of information disclosure, supervisory oversight and market discipline, concerns related to potential conflicts of interest can continue to be managed in a manner that (1) instills and maintains investor community’s confidence that the NRSROs will issue ratings independent and free from influence and (2) protects and enhances the critical role that NRSROs play in the health and stability of our financial system and within the securitization market.
  - The checks and balances already in place should continue to be evaluated to ensure that they are sufficient and effective, and that their benefits continue to outweigh related costs.

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About the Structured Finance Association

The Structured Finance Association (SFA) is the leading securitization trade association representing over 370 member companies from all sectors of the securitization market. Our core mission is to support a robust and liquid securitization market and help its members and public policymakers grow credit availability and the real economy in a responsible manner. SFA provides an inclusive forum for securitization professionals to collaborate and, as industry leaders, drive necessary changes, advocate for the securitization community, share best practices and innovative ideas, and offers professional development for industry members through conferences and other programs. For more information, visit www.structuredfinance.org.

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