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September 26, 2019

The Honorable Jay Clayton
Chairman
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Dear Chairman Clayton:

I write in regards to troubling reports regarding inflated bond ratings and the perverse incentives within the bond rating industry. As you know, poor decision-making and inflated bond ratings, caused by harmful market incentives and Wall Street greed, were a significant contributor to the 2008 financial crisis, which cost millions of Americans their homes, their jobs, and their savings. The financial crisis then sparked a recession that cost our nation's economy as much as $14 trillion.[1] I am deeply concerned that the bond rating industry continues these harmful practices, and I urge the Securities and Exchange Commission (SEC) to take immediate action to protect our economy from another economic crash.

In the years heading into the 2008 financial crisis, bond rating firms, such as Standard & Poor's (S&P) and Moody's, gave complex securities higher investment grade ratings than their risks warranted, saddling investors with riskier bets than they bargained for while allowing bond rating firms and the issuers to pocket high fees.[2] Ratings firms gave top ratings to complex financial products that were tied to risky and abusive consumer loans that lenders knew working families were unlikely to be able to repay. When the house of cards collapsed, investors and especially American families were nearly crushed. As Nobel laureate economist Joseph Stiglitz stated, rating agencies "were the party that performed that alchemy that converted the securities from F-rated to A-rated. The banks could not have done what they did without the complicity of the ratings agencies."[3]

In 2015, S&P agreed to an almost $1.4 billion settlement with the Department of Justice following civil charges from the federal government and the attorneys general of 19

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[1] New York Times, "Recession's True Cost Is Still Being Tallied," Eduardo Porter, January 21, 2014, https://www.nytimes.com/2014/01/22/business/economy/the-cost-of-the-financial-crisis-is-still-being-tallied.html.
[2] Wall Street Journal, "How Ratings Firms' Calls Fueled Subprime Mess," Aaron Lucchetti and Serena Ng, August 15, 2007, https://www.wsj.com/articles/SB118714461352698015.
[3] Bloomberg, "Bringing Down Wall Street as Ratings Let Loose Subprime Scourge," Elliot Blair Smith, September 24, 2008, https://www.bloomberg.com/news/articles/2008-09-24/bringing-down-wall-street-as-ratings-let-loose-subprime-scourge.

states and the District of Columbia.[4] Similarly, in 2017, Moody's agreed to an $864 million settlement following similar charges from the federal government and the attorneys general of 21 states and the District of Columbia.[5] But these settlements and the lack of meaningful structural reform to curb the worst impulses of the bond ratings industry have apparently not deterred these companies from risky behavior. Despite the harm the rating agencies' actions have had on millions of American families and communities, there are strong indications that rating agencies are continuing to prop up risky financial products.

According to a recent *Wall Street Journal* report, "Inflated bond ratings were one cause of the financial crisis. A decade later, there is evidence they persist. In the hottest parts of the booming bond market, S&P and its competitors are giving increasingly optimistic ratings as they fight for market share."[6] One major flaw in the incentive structure of the bond ratings firms' models is the "issuer-pays" model used by major firms like S&P and Moody's. Under the issuer-pays model, bond issuers – like large financial institutions – pay the agencies for their assessments of the products they hope to sell, ultimately giving the rating firms an incentive to give better ratings, regardless of the risk, since bond issuers might otherwise go to their competitors.[7] While the Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act rightly identified the rating agencies as culprits in the financial meltdown and made some meaningful reforms to curb these firms, the flawed incentives that lead to inflated ratings, like the issuer-pays model, still remain. There are even indications that due to increased competition in the industry, the perverse incentives have increased in recent years.[8]

Understanding the impact that bond rating agencies had on the financial crisis, Congress found that these agencies "face conflicts of interest that need to be carefully monitored and that therefore should be addressed explicitly in legislation in order to give clearer authority to the Securities and Exchange Commission."[9] The Dodd-Frank Act subsequently made a number of changes to the rating agencies, including requiring the SEC and Government Accountability Office to study the issuer-pays model and requiring the SEC to recommend a business model for the industry, reduce some of the uses of the ratings these firms produced, increasing the firms' legal liabilities, and give the SEC more authority to regulate these firms.[10] But the SEC and other federal agencies have neglected or delayed

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[4] New York Times, "S.&P.'s $1.37 Billion Reckoning Over Crisis-Era Misdeeds," Ben Protess, February 3, 2015, https://dealbook.nytimes.com/2015/02/03/s-p-announces-1-37-billion-settlement-with-prosecutors/.
[5] New York Times, "Moody's to Pay $864 Million to Settle Inquiry Into Inflated Ratings," Associated Press, https://www.nytimes.com/2017/01/13/business/moodys-inflated-ratings-inquiry.html.
[6] Wall Street Journal, "Inflated Bond Ratings Helped Spur the Financial Crisis. They're Back." Cezary Podkul and Gunjan Banerji, August 7, 2019, https://www.wsj.com/articles/inflated-bond-ratings-helped-spur-the-financial-crisis-theyre-back-11565194951.
[7] Council on Foreign Relations, "The Credit Rating Controversy," CFR Staff, February 19, 2015, https://www.cfr.org/backgrounder/credit-rating-controversy.
[8] Wall Street Journal, "Inflated Bond Ratings Helped Spur the Financial Crisis. They're Back." Cezary Podkul and Gunjan Banerji, August 7, 2019, https://www.wsj.com/articles/inflated-bond-ratings-helped-spur-the-financial-crisis-theyre-back-11565194951.
[9] Pub. L. 111-203, Dodd-Frank Wall Street Reform and Consumer Protection Act, https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.
[10] Brookings Institution, "Credit rating agency reform is incomplete," Alice Rivlin and John Soroushian, March 6, 2017, https://www.brookings.edu/research/credit-rating-agency-reform-is-incomplete/.

many requirements under the law and have failed to use the regulatory tools necessary to hold ratings agencies accountable.

I am especially concerned about collateralized loan obligations (CLOs), given the rapid growth of CLOs and the lack of appropriate responses from federal agencies, including the SEC. These securitizations have helped enable increased leveraged loans that are generally poorly underwritten and include few protections for lenders and investors, which creates significant risk to the financial system and the American economy. Like mortgage-backed securities before the financial crisis, issuers do not have risk retention requirements, meaning that they have no incentive to ensure that the ratings are accurate or that the bonds are safe. The Dodd-Frank Act, however, established an Office of Credit Ratings under the SEC that is responsible for promoting the accuracy of ratings issued by rating agencies and ensuring that these ratings are not unduly influenced by conflicts of interest.[11] It is deeply concerning that the SEC has not taken meaningful action to ensure that these securities are accurate and not unduly influenced by conflicts of interest.

Investors have also been expressing their concerns regarding inflated ratings to the SEC since at least 2014, but the SEC has yet to take action that would limit the industry's most dangerous practices and protect U.S. consumers.[12]The SEC has not proposed legal liabilities for rating agencies and, despite being required to do so under the Dodd-Frank Act, has not yet endorsed a business model for rating agencies.[13] The current issuer-pays model is clearly detrimental to our nation's economy, and I urge the SEC to prevent the growing bond inflation from reaching catastrophic levels similar to those that caused the 2008 financial crisis.

It is difficult to understand why the SEC has not yet taken meaningful action to curb the activities of bond rating agencies, given their large contributions to the financial crisis that cost the U.S. economy trillions of dollars and millions of Americans their homes, jobs, and savings. In order to better understand the SEC's inaction, I request that you answer the following questions no later than October 18, 2019:

1. The most recent Annual Report on Nationally Recognized Statistical Rating Organizations (NRSROs), prepared by SEC staff in December 2018, states that the issuers-pay model of rating agencies is "subject to a potential conflict in that the [rating agency] may be influenced to determine more favorable (i.e., higher) ratings than warranted in order to retain the obligors or issuers as clients."[14]

    a. Given the SEC's own acknowledgement that the issuers-pay model, as well as other existing business models in the industry, are susceptible to conflicts of

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[11] Pub. L. 111-203, Dodd-Frank Wall Street Reform and Consumer Protection Act, https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

[12] Securities and Exchange Commission, "Meeting with the Association of Institutional Investors – Rating Shopping in CMBS," Memo from NRSO Motoring Unit to File, December 15, 2014, https://s.wsj.net/public/resources/documents/RATINGS_MEMOS.pdf.

[13] *Id.*

[14] Securities and Exchange Commission, "Annual Report on Nationally Recognized Statistical Rating Organizations," December 2018, https://www.sec.gov/files/2018-annual-report-on-nrsros.pdf.

interest that can artificially inflate bond ratings, why has the SEC failed to recommend a business model as required under the Dodd-Frank Act? Please provide details.

b. Is the SEC currently undergoing a process to recommend a business model for the industry that ensures that bond rating agencies remain objective and independent from the undue influence of bond issuers? If so, please describe any relevant processes and any findings. If not, please explain.

2. According to the SEC, "[Rating agencies] are required by law to disclose these potential conflicts of interest. [Rating agencies] are also required to establish, maintain, and enforce written policies and procedures to address and manage these potential conflicts of interest."[15]

   a. Upon learning of potential conflicts of interest in rating agency practices, what actions has the SEC taken to deter these practices and enforce procedures to combat conflicts of interest? Please provide specific details.

   b. Since the SEC has acknowledged the inherent conflicts of interest that exist in the issuer-pays model of the ratings industry, what actions has the SEC taken to remove the perverse incentives in the issuer-pays model to artificially inflate bond ratings? Please provide specific details.

3. News reports have shown that the SEC has insufficient resources and technology challenges that have prevented the SEC from gathering the information necessary to identify problems in the bond ratings industry.[16] A former SEC staff member stated, "Despite a clear mandate in the Commission's own rulemaking, there are still tons of questions about the lack of analysis the SEC is doing to [bond rating] agencies."[17] A recent SEC report also highlighted at least 20 compliance failures by rating agencies, including disclosure of inaccurate, misleading, and incomplete information about how they determined their ratings.[18]

   a. As rating agencies continue to engage in harmful practices that artificially inflate bond ratings, similar to their actions that played a significant role in causing the 2008 financial crisis, and the SEC has identified various compliance failures by these firms, what actions, if any, has the SEC taken to correct these compliance failures and hold these firms accountable? If the SEC has taken action, why has this failed to keep ratings agencies from inflating bond ratings?

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[15] Securities and Exchange Commission, "Updated Investor Bulletin: The ABCs of Credit Ratings," October 12, 2017, https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_creditratings.
[16] Reuters, "Data problems complicate U.S. regulator's watch over ratings firms," Katanga Johnson, December 19, 2018, https://www.reuters.com/article/us-usa-sec-ratings/data-problems-complicate-u-s-regulators-watch-over-ratings-firms-idUSKCN1OI27H.
[17] *Id.*
[18] *Id.*

b. What resources are the SEC missing to fully implement the reforms made by the Dodd-Frank Act to deter the harmful practices of the bond ratings agencies? What technological challenges exist that prevent the SEC from properly identifying problems in the industry? Has the SEC documented these resources and technological challenges to Congress? Please provide specific details.

Sincerely,

Elizabeth Warren
United States Senator