Inundate NRSRO Credit Rating Companies with Comments to FIX Methodologies so that Measurements of Ability to Pay Derivative & Debt Obligations FULLY Incorporate Exposure to Climate Events

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May 14, 2020

Mr. Robert B. Litterman
Chairman
Climate-Related Market Risk Subcommittee
Commodity Futures Trading Commission
1155 21st Street, N.W. Washington, D.C. 20581

Re: Request for Public Comment: "Topics and issues being addressed by the Climate-Related Market Risk Subcommittee (MRAC Climate Subcommittee) under the Market Risk Advisory Committee (MRAC)"

Dear Mr. Litterman:

My name is Bill Harrington. I am a senior fellow at Croatan Institute — an independent, nonprofit, tax exempt 501(c)(3) research institute whose mission is to harness the power of investment for social good and ecological resilience.
(http://www.croataninstitute.org/william-j-harrington)

I am a Key Expert on Structured Finance Topics for the Experts Board of Wikirating.org — a worldwide, independent, transparent, and collaborative organization for credit ratings. The Swiss nonprofit Wikirating Association operates the Wikirating platform.
(https://www.wikirating.org/)

My professional experience includes being a:
- byline journalist who covered the regulation and NRSRO credit ratings of complex finance, including securitizations and derivative contracts, at *Debtwire ABS*;
- senior vice president and derivatives analyst for swap dealers and securitizations at the NRSRO credit rating company Moody's Investor Service;
- structurer of non-dollar derivative contracts at Merrill Lynch; and
- international economist at The WEFA Group.

(https://www.linkedin.com/in/williamjharrington/)

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NRSRO credit rating companies <u>divert</u> capital flows from debt issuers, derivatives end-users, derivatives providers, exchanges, and other rated entities that mitigate exposures to physical risk, such as inundation by fire and water.

Likewise, NRSRO credit rating companies <u>divert</u> capital from debt issuers, derivatives end-users, derivatives providers, exchanges, and other rated entities that are adapting to the transition from carbon.

Following is the SEC list of current NRSRO credit rating companies. (https://www.sec.gov/ocr/ocr-current-nrsros.html)

<u>NRSRO credit rating companies play an out-sized role in influencing capital flows globally</u> by assigning credit ratings to US debt issuers, to the derivative obligations of US end-users, US swap dealers, and US major swap participants, to ring-fenced aspects of US exchanges and US swap clearing facilities, and to the non-US counterparts of the aforementioned entities.

<u>NRSRO credit rating companies lie</u> in representing that they incorporate climate and other ESG factors that impact the ability to pay of any debt issuer, derivatives end-user, derivatives provider, exchange, clearing house, and any other rated entity worldwide into the respective credit ratings, credit assessments, and other credit products.

<u>NRSRO credit rating companies DO NOT incorporate climate and other ESG factors</u> that impact the ability to pay of a debt issuer, derivatives end-user, derivatives provider, exchange, clearing house, and any other rated entity worldwide into the respective credit ratings and credit assessments, and other credit products.

<u>As a result, NRSRO credit rating companies assign inaccurate credit ratings</u> to every debt issuer, derivatives end-user, derivatives provider, exchange, clearing house, and other rated entity worldwide.

<u>Further, NRSRO credit rating companies divert capital flows from debt issuers and other rated entities that mitigate exposures to physical risk</u>, such as inundation by fire and water.

<u>Similarly</u>, NRSRO credit rating companies *divert* capital from debt issuers and other rated entities that are preparing for the carbon transition.

In sum, inaccurate NRSRO credit ratings undermine the US and world economies and impede a sustained recovery from the Covid-19 pandemic.

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An NRSRO credit rating company has a perpetual license to print methodologies, ratings, and money without meaningful accountability.

All that an NRSRO credit rating company credit must do is facilitate public dialogue on methodologies as follows.

-- Post each methodology on publicly available website.
-- Invite comment, both confidential and public, on existing methodologies.
-- Solicit comment, both confidential and public, on proposals to update methodologies and to introduce new ones.
-- Post non-confidential comments on publicly available website.
-- Summarize comments, both confidential and public, on publicly available website.
-- Explain why comments were, or were not, incorporated into new methodology.

External comments are an under-utilized tool to pro-actively constrain NRSRO credit rating companies. An NRSRO credit rating company will finalize a methodology as proposed in the absence of comments but often incorporate at least some comments when many were submitted. Furthermore, an NRSRO credit rating company will often extend a comment period, or even post a new proposal, after receiving a critical mass of comments.

I have reviewed the comments and summaries for 92 methodology overhauls that the four major NRSRO credit rating companies — DBRS, Fitch, Moody's, and S&P — completed in 2019. The methodologies addressed the gamut of bond sectors, including securitizations of tax liens, public pension managers, power companies, bond insurers, and sovereigns.

-- Moody's lists 58 methodology proposals for 2019, with the number of comment responses ranging from zero to 15 (of the 15, 14 are confidential and one is available on Moody's site).
-- S&P lists 17 methodology proposals for 2019, with the number of comment responses ranging from one to 46 (of the 46, 36 are confidential and 10 are posted on the S&P site).
-- Fitch lists nine methodology proposals for 2019, with the number of comment responses ranging from 1 to 19 (of the 19, 13 are confidential and six are posted on the Fitch site.)
-- DBRS list six methodology proposals for 2019, with the number of comment responses ranging from 0 to 1.

No 2019 commenter addressed climate or other ESG factors on issuer ability to pay! The majority of 2019 commenters on NRSRO methodologies were issuers and industry groups arguing against provisions that would lower sector ratings.

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Any person may pressure NRSRO credit rating companies to reverse course and honor their representations by incorporating climate and other ESG factors that impact the ability to pay of a debt issuer, derivatives end-user, derivatives provider, exchange, clearing house, and any other rated entity worldwide into the respective credit ratings, credit assessments, and other credit products.

See my Croatan View "Croatan Forum: Plain Speaking Produces Sustainable Action" of October 8, 2019 **(final two sections "**A new activist front: municipal debt investors and issuers vs credit rating agencies!" and "Moody's Investors Service is an especially big target through 2022.") **(**http://www.croataninstitute.org/latest/news/croatan-forum-plain-speaking-produces-sustainable-action)

See also my Responsible Investor opinion "Investors who want to fast-track sustainable fixed-income investments should inundate credit rating agencies with methodology critiques" of January 28, 2020.
(https://www.responsible-investor.com/articles/investors-who-want-to-fast-track-sustainable-fixed-income-investments-should-inundate-credit-rating-agencies-with-methodology-critiques)

A person has complete flexibility regarding format, tone, and public dissemination of a methodology comment. However, a commenter must be tenacious, and both submit multiple comments herself and convince allies to do the same. No NRSRO credit rating company is likely to capitulate suddenly given that continuing to dissemble boosts earnings.

The content of a methodology critique must tightly hone in on provisions that a commenter wishes to change. The language must be unambiguous, so that an NRSRO credit rating company either correctly incorporates the critique into a given methodology, or accurately summarizes the critique in publicly justifying its omission. Over time, the collective pile-up of well-articulated, commonsense critique will erode credit rating company intransigence by forcing each NRSRO to air and exhaust unconvincing rationales for ignoring physical risks and exposures to the transition from carbon.

Importantly, rigorous credit rating methodologies will obligate NRSRO credit rating committees to downgrade as well as upgrade. In a cohort of otherwise similar issuers, those with significant exposures to physical and carbon transition risks will have lower ratings than the remainder that either don't face the exposures or are mitigating them. Equally important, each announcement of a credit rating will state whether the credit impact of physical and carbon transition exposures raises the rating, lowers it, or is a wash. Even if the initial answer is most often "wash," the assessment process will refine existing measurement tools and create new ones.

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For a real-world instance of a person pressuring an NRSRO credit rating company to reverse course and honor its climate representations in 2020, see this letter's Appendix. It contains my submission to Moody's Investors Service (Carbon Transition Feedback) Re Request for Feedback: "Proposed framework to assess carbon risks for the global refining and marketing sector," dated March 27, 2020.

Respectfully,

/s/William J. Harrington

William J. Harrington
Senior Fellow, Croatan Institute
Wikirating.org Experts Board — Structured Finance Topics

Appendix

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March 27, 2020

VIA ELECTRONIC MAIL

Moody's Investors Service
CarbonTransitionFeedback@moodys.com

Re: Request for Feedback: "*Proposed framework to assess carbon risks for the global refining and marketing sector*," February 27, 2020.

Dear All:

The entirety of my response herein is intended to be publicly available on Moodys.com.

My name is Bill Harrington. I resigned as a Moody Senior Vice President in July 2010, joined the Experts Board of Wikirating.org in 2015, and affiliated as a senior fellow with the non-profit Croatan Institute in 2017.
(https://www.linkedin.com/in/williamjharrington/)
(https://www.wikirating.org/)
(http://www.croataninstitute.org/william-j-harrington)

My Responsible Investor opinion "Investors who want to fast-track sustainable fixed-income investments should inundate credit rating agencies with methodology critiques" of January 28 urges fixed-income practitioners to respond to NRSRO methodology proposals.
(https://www.responsible-investor.com/articles/investors-who-want-to-fast-track-sustainable-fixed-income-investments-should-inundate-credit-rating-agencies-with-methodology-critiques)

The delivering email copies Director, SEC Office of Credit Ratings, Ms. Jessica Kane (https://www.sec.gov/page/ocr-section-landing). Ms. Kane publicly conceded that the SEC failed its ten-year oversight of NRSROs in remarks to a large industry conference this year. (*Wall Street Journal*, "SEC Rethinks Approach to Conflicts Among Bond Rating Firms," Cezary Podkul, February 24, 2020, https://www.wsj.com/articles/sec-rethinks-approach-to-conflicts-among-bond-rating-firms-11582589644?mod=searchresults&page=1&pos=4.)

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Moody's is obligated to enforce the Compliance Commitments that it, affiliate Moody's Analytics, and parent Moody's Corporation agreed in the settlement with the US Department of Justice and the attorneys general of 21 state and Washington, DC on January 13, 2017. (https://www.justice.gov/opa/pr/justice-department-and-state-partners-secure-nearly-864-million-settlement-moody-s-arising.) Accordingly, I will deliver copies of this letter to the US Department of Justice contacts to whom the Moody's entities report.

US Senator Josh Hawley of Missouri, former Missouri attorney general, is a signatory to the Moody's settlement (https://www.justice.gov/opa/press-release/file/926551/download). The delivering email copies Senator Hawley's Chief of Staff.

Moody's Corporation CEO Ray McDaniel often attests to the value of my critiques of NRSRO ratings and methodologies for all sectors that use derivative contracts and securitizations (https://www.businessinsider.com/moodys-analyst-conflicts-corruption-and-greed-2011-8).

As an overarching improvement to the proposal:

Moody's must set a cap of "CT-7" for the Carbon Transition Assessment for the global refining and marketing sector.

As the proposal states on page 2, "no company in the sector will be positioned to benefit from the low-carbon transition." Page 3 of the proposal defines "CT-6," "CT-7," and "CT-8" as "Issuers exhibit 'moderate' positioning for the carbon transition."

Accordingly, the proposed cap of "CT-3" is irresponsibly generous. Page 3 of the proposal defines "CT-3," "CT-4," and "CT-5" as "Issuers exhibit 'strong' positioning for the carbon transition."

The following rationale on page 3 of the proposed cap of "CT-3" is unconvincing. How believable are any "mitigation plans and longer term resilience" in the global refining and marketing sector?

"*CTAs are designed to incorporate current positioning of the business as well as future risks and mitigation plans and longer-term resilience. Therefore, companies with substantial current exposure may nevertheless achieve a better CTA on account of robust longer-term plans and implementation strategies to position their company for the carbon transition.*"

Furthermore, the proposal to use "proxy" measures mandates the cap level of "CT-7." Any proxy measure introduces variability and lack of precision into a calculation. (See page 4 ". . . *for energy requirements, this subcomponent looks at the bottom of the barrel (BoB) index*" and page 5. ". . . *average of the analyst-adjusted, consolidated EBIT to total throughput barrels ratio for the last three years. We are not able to use the refining-only EBIT, which would exclude retail marketing, petrochemicals and other non-refining activities, because it is not publicly reported on a consistent basis.*")

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Finally,

Moody's must publish a rigorous algorithm for mapping the Carbon Transition Assessment scores of "CT-7" to "CT-10" to the associated credit rating.

Moody's must end the practice of deploying all manner of nebulous "assessments" to inflate credit ratings (https://www.debtwire.com/info/moody%E2%80%99s-bets-germany-will-support-deutsche-bank-derivatives-above-all-else-%E2%80%94-analysis.)

Respectfully,

/s/William J. Harrington

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Senior Fellow, Croatan Institute
Wikirating.org Experts Board — Structured Finance Topics

CC: Jessica Kane, Director of Office of Credit Ratings, US Securities and Exchange Commission

United State Attorney for the District of New Jersey, United States Attorney's Office for the District of New Jersey,
970 Broad Street, 7th Floor Newark, NJ 07102

Director, Consumer Protection Branch, U.S. Department of Justice
450 5th Street NW Washington, DC 20530

Kyle Plotkin, Chief of Staff for US Senator Joshua D. Hawley

Raymond McDaniel, Chief Executive Officer, Moody's Corporation