

**Testimony of Jim Nader
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Virtual Hearing – Examining the Role of Municipal Bond Markets in Advancing – and
Undermining – Economic, Racial and Social Justice
Subcommittee on Oversight and Investigations
House Committee on Financial Services
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Chairman Green, Ranking Member Barr and members of the subcommittee, thank you for the opportunity to testify today. I am testifying on behalf of Kroll Bond Rating Agency, LLC (KBRA).

KBRA is a global, full-service rating agency registered with the Securities and Exchange Commission (SEC) as a Nationally Recognized Statistical Rating Organization (NRSRO). Since our establishment in 2010, KBRA's mission has been to provide transparent ratings and thorough research. Our widely available research challenges entrenched and conventional thinking, and this approach has resonated powerfully with investors. Today KBRA has more than 400 employees in offices in the United States and Europe and has issued more than 42,500 ratings representing \$2.2 trillion in rated issuances. KBRA is currently one of the five largest rating agencies globally and the largest established after the Global Financial Crisis.

KBRA's Presence in the Municipal Bond Market

As of March 31, 2021, KBRA rates over \$364 billion of municipal debt - nearly 10% of the market's total outstanding debt.

Today, our ratings add important insight for investors across a wide variety of municipal issuers including:

- States such as Texas, New Jersey, Connecticut and the Commonwealth of Kentucky
- Cities including Dallas, Chicago and Los Angeles
- Transit systems such as New York's MTA, North Texas' DART, Washington's WMATA; Airports like DFW, Miami International and Chicago O'Hare
- Large municipal utilities like Los Angeles Dept of Water and Power.

Ten years ago, some said the last thing the world needed is another rating agency serving the muni market. But last summer, we proudly achieved another milestone when the Federal Reserve deemed KBRA to be one of only four "major" rating agencies whose ratings could be used by issuers accessing the central bank's emergency municipal liquidity facility window. Obtaining designation was a challenge, as the Federal Reserve was initially unwilling to include KBRA on the list of rating agencies and included the three major incumbent agencies. Investors and other market participants were unhappy with the Federal Reserve's initial position and Congress, including members of this subcommittee, intervened. As a result, the Federal Reserve changed its position and the House unanimously passed legislation requiring the Federal Reserve and the Treasury to accept securities rated by *any* credit rating agency registered with the SEC. Your support was integral to allowing all credit rating agencies to participate in government bond programs, in line with the specific goals of the Dodd-Frank Act, and we thank you for that.

Municipal Bond Market Overview and Recent Performance

The nearly \$4 trillion municipal bond market allows state and local governments to raise capital from investors in a cost-effective way for important public purposes such as schools, roads, bridges, airports, hospitals, water and sewer facilities, power plants, and public buildings, among many others. As many of these projects are costly but long-lived, borrowing enables governments to prudently spread costs across multiple generations.

In 2020, the municipal market was significantly impacted by the outbreak of COVID-19. The effect of the pandemic was uneven, and varied city to city and state to state. There were and continue to be disparities in the municipal market, and those disparities were exacerbated by COVID-19. Initially, credit spreads (costs of issuing debt) widened (increased) considerably particularly for lower rated credits. This happened as many investors sought to de-risk their portfolios by selling securities to raise cash. Moreover, investors feared that some municipal bond sectors (transportation, sales tax-dependent credits, and communities highly dependent on local retail, leisure, conventions, and business travel) might be disproportionately impacted by lost revenues experienced during the pandemic lockdown.

Reacting quickly, the federal government implemented extraordinary fiscal relief and monetary intervention, restoring order to the market and paving the way for the largest issuance volume in its history, as state and local governments took advantage of what ultimately became historically low borrowing rates. Meanwhile, targeted aid to transportation systems, including transit systems, and surprisingly buoyant retail sales, aided by a substantial stimulus boost to personal income and an effective workaround in the form of online shopping, stabilized some of the vulnerable sectors of the market. With respect to certain transit systems, we observed that federal aid, coupled with responsible municipal management and a large tax base, led to stable ratings. Transit systems are particularly important because they are vital to those who rely most heavily on them, and a collapse of a transit system would have a disparate impact on those communities.

The COVID-19 relief bills injected resources into states and other municipalities and their enterprises at an unprecedented scale. Independent from federal relief bills, many states and their municipalities brought to bear state and local resources to devise targeted responses to ease the effects of COVID-19 and performed well throughout the pandemic. For these reasons, many states and their municipalities will come out of this crisis stronger. However, this may not be true for those municipalities that had pre-existing structural deficits in their budgets, and possibly those whose particular economies may be fundamentally altered for some time - including those dependent on long commutes to downtown office districts, and leisure and business travel destinations.

KBRA's Views on Economic, Racial, and Social Justice and the Municipal Bond Market

Bond investors, both institutional and individual, are increasingly interested in the social impact of their investments. Accordingly, in the municipal bond market, investors will need to understand how state and local government issuers plan to address economic, racial, and social justice within their communities. We support efforts to improve the quality of meaningful disclosure on these topics from all levels of municipal government.

Many municipal governments require inclusion of minority- and women-owned business enterprises in many aspects of government, including development projects and vendor sourcing guidelines. Municipalities by their very nature have attributes of positive social impact that deserve amplification. Many of these attributes are not included in Environmental, Social, and Governance scores that are proliferating in the market, particularly in the areas of health, safety, housing, and education. More and more, investors are driving what needs to change in these areas, and credit rating agencies should analyze the implications of those changes on the overall credit health of a given municipality.

KBRA believes that as investors increase their focus on social justice, it will be in a municipality's best interest to improve diversity and inclusion in municipal roles and recalibrate municipal responses to economic, racial and social justice issues. Over time, KBRA believes that social factors will have a greater direct effect on bond pricing and liquidity, as evolving investor preferences direct funds increasingly towards investments in municipalities that have exhibited a commitment to economic, racial, and social justice. This in turn will directly affect a municipality's financial position and liquidity, two of the key drivers of municipal credit ratings. We believe that those municipalities that make strong progress on economic, racial and social justice issues will be rewarded with active investor participation in their bond issuances, and those that do not will be penalized for their inaction.

KBRA believes that improved disclosure can level the playing field for municipalities and is beneficial for the public overall, and we support smart regulation designed to further this goal. Because investor preferences move quickly, we believe that regulation in this area should be just as nimble, so it does not become outdated quickly. Three years ago, most investors talked about board composition as the biggest social issue. Today, we know investors have broadened their focus to include diversity and inclusion across workforces, and we expect increased emphasis on economic, racial and social issues.

While we cannot predict with certainty what will come next, we believe that thoughtful regulation done right – with a focus on improved disclosure, the flexibility to apply across all ESG factors and not solely focused on a particular ESG issue – is the right approach. This kind of regulation can provide investors and other market participants with the ongoing protection of high quality, transparent disclosure that allows investors to focus on additional ESG factors as they increase in importance.

KBRA's View on Incorporating Climate Risks into Credit Ratings

Investors have told KBRA that they want to see thorough, consistent disclosure about climate issues. We believe that most disclosure may not have an immediate effect on a municipality's credit but could over time as investors choose their investments based on the strength of a municipality's climate strategy and position.

Our approach to ESG factors is informed by bottoms-up fundamental credit analysis, and our approach to climate issues has been further informed by discussions with hundreds of investors on this topic in the past few years. We believe our approach, combined with tailored disclosures on material risks, will provide information that investors and other stakeholders demand and deserve. This will also help reduce the burden on municipal governments who are increasingly being pressured by some to supply superfluous data that do not correlate to credit risk.

KBRA incorporates climate risk (and all material risks) in all ratings where it is relevant, including in municipal ratings. Our new ESG Methodology is posted for public comment, and our approach is also described in a recent research report entitled "Credit Ratings Deserve ESG Risk Analysis not ESG Scores."

In our discussions with municipal management teams on ESG topics, KBRA's analysts seek to understand a management team's awareness of the factors that are material – including the analytical approach they use to reach their conclusions. Management's analytical approach to these issues provides insight into their strength as managers of dynamic organizations. KBRA also hopes to understand a management team's planning, its plans to address particular issues, ability to execute on those plans and whether the municipal management team's plan is achievable and affordable for that particular municipality. In all cases, KBRA recognizes that stronger management teams are more likely to be able to identify, analyze, and plan for multiple climate related risk scenarios.

KBRA took this same approach when it began rating community banks in 2013. Other rating agencies demonstrated a size bias and only rated banks with a certain minimum revenue. These other credit rating agencies failed to account for other factors such as strength of management. KBRA conducted a study of bank defaults after the Global Financial Crisis and found that community banks performed better than their much larger counterparts. Based on this study, KBRA devised a bank methodology that recognized the strength of management and allowed for smaller banks to be rated. As a result, KBRA has rated over 200 community banks. On the heels of our thorough published research and entry into this market, the incumbent rating agencies followed suit and began rating community banks as well. KBRA's ratings have opened markets to community banks that had previously and unfairly struggled to access important sources of capital. The strength of our ratings is demonstrated by the fact that these markets are as liquid as those for the larger banks.

Similarly, when we assess a municipality's climate risk, KBRA's analysts focus on the quality of management. Our analysts also assess the direct impact of climate risk, including understanding the physical or financial assets directly exposed to climate change (e.g., subway and car tunnels) and related

physical or regulatory risks, and exposure to transition risks which need to incorporate the possibility of new state or federal laws or regulations and an understanding of stakeholder preference risks.

I will end on this note: municipalities by their very nature have attributes of positive social impact that deserve amplification. Education, health, safety, housing are vital municipal services, some of which have struggled to serve all constituents equally. Municipal stakeholders will drive decisions on what needs to change in those areas. Analyzing how municipal managers respond to those stakeholder preferences, and the implications of those preferences on credit is the role of a credit rating agency.

Conclusion

I thank the subcommittee for the opportunity to testify today. I look forward to your questions and am happy to provide additional information that may be useful as you contemplate these important issues.