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## Wanted: Credit Ratings. Objective Ones, Please.

By GRETCHEN MORGENSON

**F**OR years, the nation's credit rating agencies have thrived, booking mouth-watering profits from operations that are riddled with conflicts and shielded from competition.

Soon, however, that may finally change. And investors should be better off for it.

Within the next two months, the Securities and Exchange Commission will press a new regulatory framework for the industry to ensure that debt ratings published by the big three - Standard & Poor's, Moody's Investors Service and Fitch Ratings - are a result of thorough analysis, not a desire for fatter profits.

"I think it's fair to say that the oversight of the industry is insufficient," said Annette L. Nazareth, director of market regulation at the Securities and Exchange Commission. "We want the firms to commit to meet certain standards with respect to policies and procedures on conflicts of interest and solicitation of ratings. Right now we don't have that at all."

Now that would be an upgrade, long overdue. Indeed, given how regulators have attacked conflicts of interest among Wall Street firms, insurance companies and other financial services concerns, it's astounding that the ratings agencies have been allowed to go on this way for so long.

Rating agencies play an enormous role in a huge market. After all, far more debt is issued than stock; last year, corporations issued \$1.2 trillion in straight debt versus \$146 billion raised in common stock, according to Thomson First Call. An additional \$1.4 trillion was issued last year in mortgage debt and asset-backed securities.

All that paper needed a rating before it could be sold to the public. As such, the financial markets rely heavily on the companies that rate them.

Since 1931, for example, the Federal Reserve Board, the Comptroller of the Currency and federal and state laws have regulated the debt held by banks and other financial institutions, using credit ratings assigned to the debt. Pension funds, banks and money market funds are barred from buying debt issues

that carry ratings below a certain level.

But not just any rating agency's rating, mind you. In 1975, the S.E.C. ruled that the laws relating to debt carried by banks and financial institutions refer only to ratings provided by agencies that it recognizes. Right now, these are the big three and a much smaller fourth, Dominion Bond Rating Service of Canada.

What you have, in other words, is an oligopoly.

Even more troubling, this oligopoly earns its keep from fees charged to the companies whose debt it rates. This conflicted business model means that the paying customers for these agencies are the corporations they analyze, not the investors who look to the ratings for help in assessing a company's creditworthiness.

Other industry practices also lend themselves to producing less-than-rigorous analysis. For example, rating agencies typically receive the largest fees when they analyze an initial bond issue. After that a nominal fee is levied, providing something of a disincentive to do in-depth, time-consuming work.

And because the nation's courts have ruled that the work of these agencies is opinion and therefore protected by the First Amendment, the big three are protected from lawsuits from investors contending defective analysis. Such lawsuits could act as policing mechanisms.

To make matters worse, these companies have recently begun to expand the services they offer to corporations, leading regulators to fear that ratings could be swayed by revenues earned on other products.

These problems are on the agenda for Tuesday, when Senator Richard C. Shelby, the Alabama Republican who is chairman of the Banking, Housing and Urban Affairs Committee, will hold hearings on the state of the rating agencies. Executives from the big three are scheduled to testify.

This is not the first time that Standard & Poor's, [Moody's](#) and Fitch have been in the hot seat. When [Enron](#) and [WorldCom](#) failed, investors were stunned by how long it had taken the agencies to recognize the companies' declining fortunes. For example, all three agencies had rated Enron an investment-grade company until four days before it filed for bankruptcy. They had rated WorldCom similarly until a few months before it collapsed.

The rating agencies stress that they analyze debt issuers' financial positions to try to predict for investors an entity's ability to pay off its debt. They are not in place to audit auditors, they say, and cannot root out fraud. Their mandate is to provide transparency to the financial market.

IN an interview on Friday, Raymond W. McDaniel, Jr., president of the Moody's Corporation, acknowledged the industry's conflicts but said his company manages them effectively. "We do not link analyst compensation, including bonus compensation, to the ratings they have on the companies they

follow or to the amount of fees they receive from those companies," he said. "Beyond that, we have a collection of business conduct policies and codes of practice and behavior which the entire Moody's population is required to adhere to." Top executives at Standard & Poor's, a division of the [McGraw-Hill Companies](#), and Fitch, a unit of Fimalac, were not available for comment, but both companies said they were aware of the potential for conflicts and careful to prevent them.

Increased competition would certainly help investors who are troubled by the conflicts. Unfortunately, companies hoping to break into the ratings game must first earn the all-important designation from the S.E.C. Such nods do not come often.

One upstart concern that has applied unsuccessfully to the S.E.C. is Egan-Jones Ratings, of Philadelphia. It rates approximately 800 companies and had warned of problems at WorldCom, Enron and Global Crossing well before other agencies. Egan-Jones does not accept payment from companies it rates; investors who use its services pay the freight.

A recent academic study compared ratings by Moody's with those of Egan-Jones. William H. Beaver, professor of accounting at Stanford's graduate school of business, Catherine Shakespeare, assistant professor at the University of Michigan Business School and Mark T. Soliman, also at Stanford, analyzed ratings on some 800 companies made by both services from 1997 to 2002.

The academics found that Egan-Jones's ratings changes were more timely than those of Moody's, coming up to six months sooner. The study also found much higher stock returns after rating changes by Egan-Jones than by those of Moody's.

"Using several tests we find that the noncertified firm, EJR is more responsive and closely associated with investors," the study noted.

There is no evidence, of course, that Moody's tardiness is a result of a conflicted business model. And Mr. McDaniel maintains that ratings stability and accuracy are what customers want. "The market has become extremely intolerant of false positives or false negatives, and encouraged the ratings to only be moved when there is not a likelihood that they would be reversed," he said.

But Sean J. Egan, managing director of Egan-Jones, said: "Timely, accurate credit ratings are critical for robust capital markets. Investors, issuers, workers and pensioners will continue to be hurt by the flawed credit rating industry until someone addresses the basic industry problems."

Maybe, just maybe, that process has begun.