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The role of credit rating agencies in the capital markets is straightforward: to provide accurate financial analysis of the quality of various financial assets. Two firms have historically dominated this market and, to this day, Moody's and S&P account for approximately 80 percent of the total industry. Despite their market dominance, however, both S&P and Moody's failed to warn investors of impending defaults in such noteworthy corporate bankruptcies as Enron and WorldCom. With respect to the current wave of credit defalcations, it is clear that the major rating agencies, to include Fitch, not just failed to give early warning to investors but their ratings were a major factor in the most extensive and possibly expensive financial calamity in recent America history.

In order to understand how this could happen and what must be done to prevent a recurrence, it is necessary to begin with an overview of the industry structure.

STRUCTURE OF THE CREDIT RATING INDUSTRY

1. **Original Business Model** – From their founding in the early part of the last century, Moody's, S&P and Fitch earned their income by selling their ratings publications to bond *investors*. It was only in the 1970s, coinciding with the rise of asset-backed securitization, that these companies began to charge the *issuers* of debt for their services.

2. **Size** - In 2007, the credit rating industry had total revenues of approximately $5 billion. This amount is down considerably from projected amounts inasmuch as the second half of the year saw relatively few structured finance transactions.

3. **Partnered Monopoly –** According to Moody's itself, these three companies are responsible for 95% of global ratings with shares of 39, 40, and 16 percent respectively. Commentators have often referred to this industry as a "partner monopoly" rather than a "duopoly." Since, "it is common for securities issuances to have two ratings, they need not compete much against one another."[1]

4. **Profit Margins Consistent with a Business Monopoly –** As a stand alone company, Moody's numbers constitute the best indicia for the industry.[2] As noted

[1] Alex J. Pollock, "End the Government-Sponsored Cartel in Credit Ratings," American Enterprise Institute (January, 2005).

[2] S&P and Fitch are both subsidiaries of larger financial information providers (McGraw-Hill and FIMILAC, respectively).

below, the company enjoys an operating profit margin in excess of 50 percent which is not just consistent with monopoly profits, but is unheard of in any other industry. Professor Lawrence J. White of the Stern School of Business at New York University described this magnitude of return as "breathtaking."[3]

Moody's Profitability			
	2007	**2006**	**2003**
Revenues	$2.3 billion	$2 billion	$1.2 billion
Net Profit	$701.5 million	$753.9 million	$363.9 million
Operating Margin	50.1 %	61.8 %	53.2 %
ROE	N/A (neg. eq.)	316.2 %	N/A(neg. eq.)
After-tax ROI	194.5 %	94.4 %	73.4 %
Net Operating Cash Flow	$984 million	$752.5 million	$468.4 million

5. **Entry Barriers –** The establishment of SEC rules and requirements for Nationally Recognized Statistical Rating Organizations (NRSROs) had the perverse effect of cementing the market dominance of the major rating companies. The principal procedural obstacle for Egan-Jones and other companies seeking to become NRSROs was the SEC requirement that a new NRSRO be "nationally recognized" by the predominant users of such ratings in the U.S. *before* receiving the designation. This circular standard was specifically cited by the Antitrust Division of the U.S. Department of Justice in 1998 as likely to preclude new competitors in the credit rating market,[4] and this is precisely what happened.

6. **Congress Enacts the Credit Rating Agency Reform Act of 2006 –** Congress passed legislation in 2006 reforming the "process" by which the SEC certifies companies as Nationally Recognized Statistical Rating Organizations (NRSROs). The specific goal of that legislation was to improve competition by easing entry barriers and the early results have been positive inasmuch as additional companies are being certified as NRSROs. Pursuant to the adoption of implementing regulations by the SEC,[5] a number of additional companies have been certified as NRSROs. There are now ten NRSROs as opposed to five prior to the enactment of the 2006 legislation.

7. **Market Share Remains Highly Concentrated –** As compared to Moody's, S&P and Fitch, the new market entrants, of which three utilize the investor-supported business model (Egan-Jones, Lace and Realpoint), are relatively small companies in

[3] "The Credit Rating Industry: An Industrial Organization Analysis," Prepared for the CIPE Project on "Credit Ratings and the International Economy," p.17 (2001).

[4] Letter from Antitrust Division of the U.S. Department of Justice in the matter of File No. S7-33-97 Proposed Amendments to Rule 15c3-1 under the Securities Exchange Act of 1934 (Mar. 6, 1998).

[5] 17 CFR Parts 240 and 249b; 72 FR 116 (June 18, 2007).

terms of their share of the U.S. rating agency market.[6] Total U.S. revenue of rating agencies other than Moody's, S&P and Fitch is estimated to be less than $25 million.

THE MAJOR CREDIT RATING AGENCIES HAVE CONSISTENTLY FAILED TO PERFORM THEIR BASIC MISSION OF PROVIDING TIMELY AND ACCURATE RATINGS OF DEBT OBLIGATIONS

1. **1900-1970 –** A comprehensive study of the bond rating industry by L. Macdonald Wakeman concluded that "although the rating agencies had acquired excellent reputations since the early 1900s for accurately evaluating and reporting the risks of new bond issues," by the 1970s, bond ratings came to do little more than mirroring the market's assessment of a bond's risk.[7]

2. **Enron, *et al.* –** While the Enron case, where S&P and Moody's maintained their investment grade ratings on the company's debt as late as four days before its bankruptcy filing, became a cause célèbre, the work product of the major ratings agencies was equally dismal in numerous other instances, including Orange County California, Mercury Finance, Pacific Gas & Electric, Enron, WorldCom, Delphi, General Motors and Ford. As stated by Professor Jonathan R. Macey of the Yale Law School in congressional testimony leading up to the enactment of the 2006 reform legislation, there is "a plethora of academic studies showing that credit ratings changes lag the market."[8] He further observed that "to the extent that it [their work product] is accurate, by the time it reaches investors it is so stale as to be useless to the investors…"

3. **The Major Credit Rating Agencies not just Missed the Subprime Meltdown They Actively Abetted It –** A recent report of the President's Working Group On Financial Markets concluded that "credit rating agencies contributed significantly to the recent market turmoil by underestimating the credit risk of subprime RMBS and other structured products, notably ABS CDOs."[9] In a formal Complaint filed with the SEC, the National Community Reinvestment Coalition stated the proposition somewhat more bluntly: "The rating agencies knowingly issued false and inflated ratings for securities backed by problematic high-cost loans that have created a financial nightmare for millions of families across the country whose homes have been lost to foreclosure or are now in jeopardy of foreclosure…" Because rating agencies are paid by the companies whose bonds they rate, Taylor

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[6] Two of the five new NRSROs are Japanese companies with negligible U.S. business.

[7] "The Real Function of Bond Rating Agencies," *Modern Theory of Corporate Finance*, 391 (1984), (quoted by Frank Partnoy, "The Siskel and Ebert of Financial markets?: Two Thumbs Down for the Credit Rating Agencies," 77 Wash. U.L.Q. 619, 648 (1999)).

[8] Field hearing on H.R. 2990, the "Credit Rating Agency Duopoly Relief Act of 2005." Before the House Committee on Financial Services, 109^{th} Cong., 1^{st} Sess. (Nov. 29, 2005).

[9] "Policy Statement on Financial Market Developments," p.8, (March, 2008).

said the agencies suffer from "an inherent conflict that created one of the worst financial crisis this country has ever faced."[10]

4. **The Major Rating Agencies have Accumulated so much Dominance that it actually Impedes the Performance of their Market Function –** The current example of the bond insurers such as MBIA, ACA, and FGIC demonstrates the perverse situation where the market power of S&P and Moody's works in the opposite direction of their role as providers of timely and accurate bond ratings, i.e. their practices actually serve to hide financial risk from the investing public. As MBIA and the other bond insurers went from enhancing relatively safe state and local obligations to guarantying complex asset-based credit instruments, their liabilities (now losses) increased dramatically relative to capital levels. S&P and Moody's are still carrying the insurance units of MBIA as AAA even though state insurance officials have been arranging "bail-out" scenarios for the entire industry. The regulators and the market are of the view that the companies would likely fail if their AAA ratings were revoked. Bear Sterns was another example of the regulators and the credit rating agencies working to prop up a company through false assurances until it was too late.

WHY HAS EGAN-JONES BEEN ABLE TO PROVIDE MORE TIMELY AND ACCURATE RATINGS THAN MOODY'S, S&P AND FITCH?

1. **Investor vs. Issuer Pay Business Model –** A critical distinction between Egan-Jones and its larger competitors in the credit rating industry is that its revenues are derived from the institutional investors who subscribe to its services, i.e., the business model which Moody's, S&P and Fitch followed during the era when they still enjoyed reputational capital. Many observers have criticized the system whereby credit rating agencies are paid by the corporations whose debt they are evaluating as a fundamental conflict of interest. In the words of one industry expert, "it would be like cattle ranchers paying the Department of Agriculture to rate the quality and safety of their beef."[11] Professor John C. Coffee, Jr. of Columbia University Law School has even described the "subscriber pays" model as one "that issuers and underwriters may fear (because a more independent rating agency may be more critical of issuers)."[12]

SOME MISCONCEPTIONS ABOUT THE PROBLEM

1. **Problems are limited to the Structured Finance area** - the recent credit failures/breakdowns of New Century, Countrywide, the bond insurers, the home builders, and Bear Stearns were outside of structured finance; the key issue is that

[10] Press Release of April 8, 2008: "Civil Penalties & Equitable Relief Sought For Consumers & Communities Injured By Rating Agencies Role In Foreclosure Epidemic; SEC Urged To Suspend Licenses Of Culpable Rating Agencies."

[11] Testimony of J. Kyle Bass, Managing Partner, Hayman Advisors, L.P., before the U.S. House of Representatives Committee on Financial Services, 110th Cong., 1st Sess. (Sept. 27, 2007).

[12] "Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies," Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong., 2nd Sess. (April 22, 2008).

inflated ratings facilitated the unsustainable growth and resulting collapse of credit quality. Enron, WorldCom and Delphi are also examples of failures of corporate debt obligations.

2. **Issuer-supported rating firms distribute their ratings for free to the market** - fund managers such as Fidelity pay over $500,000 per year to obtain electronic feeds and additional commentary on their ratings.

3. **Higher "Chinese Walls" will do the trick** - where there is a will, there is a way. The April 11th WSJ article regarding Moody's firing rating officers for failing to maintain market share is an indication of the core conflicts. The current situation of incentivizing high ratings and no penalties for inflated ratings (because of the freedom of speech defense) is likely to result in serial failures.

4. **More rating firms will "open" the market** - the growth of Fitch as a viable competitor to S&P and Moody's has not resulted in more timely, accurate ratings.

5. **"They lied to us"** - some of the issuer-supported rating firms contend that their failure to issue timely, accurate ratings were the result of false information provided by issuers. The issuers have an incentive to skew their information and if the rating firms have no recourse for ascertaining the truth, they will not.

6. **Separate consulting from rating** - from a practical standpoint, it is impossible to separate the two; the consulting business is not really a significant and separate business for the major rating agencies. Furthermore, it is extremely difficult to ascertain when a rating firm is simply responding to investment banker questions or structuring securities.

7. **Viability of investor-supported model** - the issuer-supported rating firms used a subscription based model from the early 1900's to the early 1970's which was a substantially longer period than the issuer-supported period.

8. **Investor-supported rating firms have conflicts** – investor-supported rating firms normally do not know whether investors are long or short and are normally motivated by issuing timely, accurate ratings.

9. **"Investors are at fault"** - there is a natural limit on the amount of due diligence most investors can easily perform; a chief investment officer of a non-domestic insurance firm is unable to get the depth of information some of the rating agencies are able to obtain. There is a natural need for reliance on credible agents. A person going to a doctor should be able to assume that the doctor will do his or her best to properly treat that person. Likewise, investors should be able to assume that a rating firm will use reasonable effort to issue timely, accurate credit ratings.

INADEQUACY OF REFORM PROPOSALS ADVANCED TO DATE

In the face of an estimated $1 trillion or more in losses as estimated by the International Monetary Fund, there have been three major U.S. initiatives put forward to address the situation.

1. **Industry Best Practices –** The major credit ratings agencies have reshuffled management and announced a number of industry "best practices" to address concerns in the marketplace. Included among these measures are:

   • Enhanced review of the due diligence process conducted by originators and underwriters;

   • Enhancement of analytical methodologies;

   • Providing more clarity about the credit characteristics of structured finance ratings;

   • Promoting objective measurement of ratings performance;

   • Enhancing investors' understanding of the attributes and limitations of credit ratings;

   • Rotation of analysts; and,

   • Establishment of Ombudsman to manage conflicts.

2. **New York Attorney General Settlement –**

   • Credit rating agencies will establish a fee-for-service structure where they will be compensated regardless of whether the investment bank ultimately selects them to rate a RMBS.

   • Credit rating agencies will disclose information about all securitizations submitted for their initial review. This will enable investors to determine whether issuers sought, but subsequently decided not to use, ratings from a credit rating agency.

   • Credit rating agencies will establish criteria for reviewing individual mortgage lenders, as well as the lender's origination processes.

   • Credit rating agencies will develop criteria for the due diligence information that is collected by investment banks on the mortgages comprising an RMBS.

   • Credit rating agencies will perform an annual review of their RMBS businesses to identify practices that could compromise their independent ratings. The credit rating agencies will remediate any practices that they find could compromise independence.

• Representations and Warranties. Credit rating agencies will require a series of representations and warranties from investment banks and other financially responsible parties about the loans underlying the RMBS.

3. **SEC Proposal to Amend NRSRO Regulations –** The first part of the SEC's proposal would:

• Prohibit a credit rating agency from issuing a rating on a structured product unless information on assets underlying the product are available.

• Prohibit credit rating agencies from structuring the same products that they rate.

• Require credit rating agencies to make all of their ratings and subsequent rating actions publicly available. This data would be required to be provided in a way that will facilitate comparisons of each credit rating agency's performance. Subscriber-based rating agencies will be accorded a six-month delay in providing this information.

• Prohibiting anyone who participates in determining a credit rating from negotiating the fee that the issuer pays for it.

• Prohibit gifts from those who receive ratings to those who rate them, in any amount over $25.

• Require credit rating agencies to publish performance statistics for one, three, and ten years within each rating category, in a way that facilitates comparison with their competitors in the industry.

• Require disclosure by the rating agencies of the way they rely on the due diligence of others to verify the assets underlying a structured product.

• Require disclosure of how frequently credit ratings are reviewed; whether different models are used for ratings surveillance than for initial ratings; and whether changes made to models are applied retroactively to existing ratings.

• Require credit rating agencies to make an annual report of the number of ratings actions they took in each ratings class, and require the maintenance of an XBRL database of all rating actions on the rating agency's website.

• Require the public disclosure of the information a credit rating agency uses to determine a rating on a structured product, including information on the underlying assets.

• Require documentation of the rationale for any significant out-of-model adjustments.

The second part of the Commission's proposal would require credit rating agencies to differentiate the ratings they issue on structured products from those they issue on bonds, either through the use of different symbols, such as attaching an identifier to the rating, or by issuing a report disclosing the differences between ratings of structured products and other securities. A third initiative by the SEC seeks to lessen reliance on credit ratings by removing regulatory mandates.

4. ***ANALYSIS –*** *These proposals are well-intentioned and some certainly move in the right direction but they share a common defect: they proceed from the erroneous premise that the major rating agencies are in the business of providing timely and accurate ratings for the benefit of investors when, in fact, these companies have, for the last 35 years, been in the business of facilitating the issuance of securities for the benefit of corporate issuers and underwriters, i.e., the entities which pay them.*

RATING AGENCY REFORM PROPOSALS

1. Disclosure by Rating Agency - The publication of any debt rating, whether in written reports or on websites, should be accompanied by a prominent disclosure statement indicating how the entity which provided the rating has been compensated. For example, if a rating agency is paid by the issuer of the securities, a securities dealer, a securities broker or any other party being compensated from the proceeds of the sale of the debt obligations being rated, this fact would be disclosed. If the rating agency's report is paid for by investors or any other party, it would likewise be required to disclose the generic source of its compensation.

2. Disclosure by Institutional Money Managers - Fiduciaries such as mutual funds, pension funds and investment advisors currently disclose the general risk profile of a particular fund in their annual or more frequent investor reports. If the fiduciaries invest in rated debt instruments, they should also be required to disclose and describe the extent to which they rely on external ratings and whether or not those ratings were generated by rating firms compensated directly or indirectly from the sales proceeds of the debt issuance.

3. Elimination of SEC Exemption - Rating agencies are exempt from the SEC's Fair Disclosure rules (Regulation FD), which can allow them special access to material nonpublic information from issuers of corporate debt. This is a form of information monopoly which puts the investing public at a disadvantage and contributes to the perception that rating agencies "know better." This special treatment should be ended in order to ensure the uniform release of credit information to all market participants.

If Regulation FD is not abolished, then, at a minimum, issuers soliciting ratings for a corporate or asset-based security should be required to provide their offering data and related information to all SEC designated NRSROs each of which can then decide whether or not to rate the issue. This can be easily accomplished through a secure, NRSRO-access only web site, as is utilized today by all the major investment banking firms for M&A transactions. Once offered, this information cannot be withdrawn from an individual rating agency, as was recently done recently by MBIA when the company became concerned that Fitch was likely to downgrade its status.

4. Business Model Independence - Both Moody's and S&P followed the "investor paid" business model from their founding in the early 1900s until the 1970s when the shift to the "issuer pay" business model came into prominence. As part of its recent exposé of the industry, *Barron's* suggested that rating agencies "be encouraged to make their money from investor subscriptions rather than fees from issuers, to ensure more impartial ratings." One way to do this would be to phase in a requirement that any rating agency, in order to maintain its NRSRO designation, derive a given percentage of its annual revenues from investors rather than relying almost exclusively on issuers.

5. Financial Regulatory Requirements - Bank capital requirements, particularly after the recent adoption of the so-called Basel II revisions, rely on NRSRO ratings for purposes of prescribing appropriate capital levels. Assets with high quality ratings are subject to lower capital requirements than lesser rated and non-investment grade bonds. Financial regulatory bodies in the U.S. and abroad are increasingly concerned about the impact which inflated ratings may have on the banking system. Since most bond issues carry ratings from two agencies, an antidote would be to require that one of these ratings be from a company which was not compensated by the issuer of the bonds.

As noted, banks using external ratings to compute their capital compliance should also be required to disclose in their SEC and other regulatory filings the extent to which they rely on NRSRO ratings to value their bond portfolios and the rationale for this reliance, including whether or not those external ratings were generated by rating firms compensated directly or indirectly from the sales proceeds of the debt issuance.

6. Disclosure of "Forum Shopping" for Ratings - Assigning ratings on structured finance bonds differs from the process for corporate and municipal bonds. In the unsecured corporate and municipal markets, debt issuers are subject to being rated by all of the rating agencies because financial information is publicly available to all parties. The structured finance market has been a "rating by request" market where the debt issuers invite some or all of the major rating agencies to preview the collateral pools so the rating agencies can provide preliminary rating indications that can be used to size the bond classes and structure the bond transactions.

Historically, all of the rating agencies have agreed to bow out of the rating process if they are not actually selected by the debt issuer to rate a securities transaction. This has encouraged the debt issuers to shop for the best ratings so they can optimize their securitization proceeds. Given the lucrative nature of the rating business for structured finance ($750,000 to $1 million per issue), rating agencies have had incentives to compete for rating assignments. This incentive could be neutralized by requiring issuances over a certain dollar threshold to disclose whether the issuer discussed a rating with any rating agency that did not issue a rating for the issue.

THE NEED FOR LEGISLATION

In August, the Congress completed action on important remedial legislation addressing the following industries perceived to have contributed to the mortgage meltdown: appraisers, mortgage brokers, other lenders, investment banks and the secondary mortgage agencies. It is time for the U.S. Congress to correct the glaring omission of credit rating agencies from this list by insisting that the industry return to the business model which characterized its first 75 years of successful performance, namely service to and payment by the investing public.