

Egan-Jones Ratings Co.'s Response to IOSCO's Proposed Code of Conduct Fundamentals for Credit Rating Agencies

IOSCO's proposed Code of Conduct Fundamentals for Credit Rating Agencies does not address the base problems in the rating industry and creates a false sense of security.

The rating industry currently is suffering from a severe lack of competition (S&P and Moody's dominate the industry) which has caused the following problems: i) many issuers to pay too much for capital because they are under-rated and ii) investors are not provided with sufficient warning about failing firms such as Enron, WorldCom, and Parmalat. There are few industries where the two major firms do not directly compete, and yet control over 90% of the revenues. Since two ratings are needed to issue debt, the major rating firms do not compete and therefore are not subjected to the normal checks and balances. Even after the recent credit rating debacles, S&P and Moody's revenues continued to grow because of their lock on the market.

More competition from firms particularly from those which are not compensated by issuers for their ratings would be of great value to the market. (Additional competition from issuer-compensated rating firms might result in some rating inflation, that is, the issuance of inflated ratings to undeserving issuers.) In the U.S., it has been established that despite rather significant "Chinese Walls", compensation from issuers tainted equity research analysts' reports. Similarly, compensation from issuers for credit ratings creates a conflict and should be eliminated over time. Institutional investors pay substantial sums to ratings firms and should be the main source of compensation. In the event of a failure to properly assess credit quality (positively or negatively) the rating firm should be reviewed, although in a vibrant, competitive market, the market would provide discipline.

Domination of the market by the two partner monopoly firms has results in various improprieties such as issuers being mis-rated, issuers being charged for unwanted services (see the Northern Trust letter to the SEC and also comments on consulting services and corporate governance ratings), misuse of insider information (CitiGroup was given advanced information about a pending downgrade of Enron by Moody's), and substantial investor losses as a result of the failure to warn about pending failures. Moody's Chairman, Clifford Alexander served on WorldCom's board in 2002 and yet Moody's still failed to provide warning of the failure of WorldCom. Over the long-run, the market participants would probably be better off if the partner monopoly firms of Moody's and S&P were broken up and issuer compensation prohibited.

Various proposed reforms of the credit rating industry have suggested increased regulating and supervising the level of skills of rating firms' staff and

methodologies used for ratings. We believe such actions will be counter-productive. Some of our best ratings calls were controversial but were proven accurate over time. We believe time is best spent on improving the structure of the industry by maintaining a vibrant stable of rating firms which are not paid by issuers. The Association of Corporate Treasurers have provided some reasonable guidelines that can be used once the major industry problems of consolidation and issuer compensation are addressed.

Regarding Egan-Jones Ratings, we have succeeded in providing timely, accurate credit ratings. We provided warning regarding the Enron and WorldCom failures (we did not rate Parmalat) and yet most of our ratings have been above S&P's and Moody's over the past two years (thereby providing issuers with more competitive capital). Our success has been recognized by the Federal Reserve Bank of Kansas City which compared all our ratings since inception in December 1995 to those of S&P and concluded:

“Overall, it is robustly the case that S&P regrades from BBB-moved in the direction of EJR's earlier ratings. It appears more likely that this result reflects systematic differences between the two firms' rating policies than a small number of lucky guesses by EJR.”

Source: Research Division, Federal Reserve Bank of Kansas City, Feb. 2003

Link: <http://www.kc.frb.org/publicat/reswkpap/RWP03-01.htm>

Stanford University and the University of Michigan drew similar conclusions “we believe our results make a strong case that the non-certified agency [Egan-Jones] is the leader and the certified agency [Moody's] is the laggard.” (aaahq.org/AM2004/display.cfm?Filename=SubID_1213.pdf&MIMEType=application%2Fpdf). To avoid conflict, Egan-Jones does not accept payment from issuers.

Any questions or comments can be addressed to:

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