Rating Agencies Under Review for Downgrade

By TOM SULLIVAN

Major SEC action is needed to reform the Big Three rating agencies.

THE SECURITIES AND EXCHANGE COMMISSION is scheduled to vote this week on a plan to change the regulation of the Big Three rating agencies -- Moody's Investors Service, Standard & Poor's and Fitch Ratings. A *Barron's* comparison of their ratings on companies hit hard by the weak economy and mortgage securities mess and the ratings done by their much smaller rivals suggests substantial change is needed.

Alex Wong/Getty Images

Fitch chief Stephen Joynt, Moody's CEO Raymond McDaniel, and S&P President Deven Sharma prior to testifying before Congress in October.

Open to question is the basic business model employed by the largest agencies: Issuers of securities -- not investors in them -- pay the agencies for ratings. Because the credit ratings are key determinants of the interest rates issuers will pay on their debt, the issuers are willing to pay up for strong ratings. At the same time, the rating agencies must compete with one another for business -- meaning a credit agency that's too rigorous risks losing business.

For the same reason, ratings are crucial to investors, who rely on them to make buying decisions. In some cases, pension or mutual funds can buy only so-called investment-grade paper -- and not less creditworthy high-yield, or junk, bonds. Several new "alternative" agencies that have cropped up in recent years are paid by investors. Of the Big Three, only S&P, a unit of McGraw-Hill (ticker: MHP) was willing to talk to *Barron's*.

It was just five years ago that the SEC reviewed the Big Three agencies' performance when they failed to detect problems at companies like Enron and Worldcom. That failure cost investors billions of dollars and employees a big chaunk of their retirement nest eggs.

The SEC response then was to expand the number of raters eligible to be designated a "nationally recognized statistical rating organization." Gaining NRSRO status gives the agency the SEC's stamp of approval. Canada's Dominion Rating Service gained the designation, but its push into the U.S. hasn't gained much traction.

Barron's took a look at how well the Big Three NRSROs anticipated problems at certain troubled companies versus the performance of the alternative raters. In these cases, the alternatives mostly proved better at spotting deteriorating credit stories. In fairness, analysts at the Big Three generally have a decent record over time.

Let's compare (see table below). Egan-Jones is one of the new NRSROs, and is paid by investors. It suggested to its long/short equity and credit investor-clientele that they short General Motors (GM) back on April 6, 2006, and warned that bankruptcy was possible. That, obviously, was a good call. Rapid Ratings, another alternative, is an NRSRO that provides financial-health assessments for investment and risk managers using "econometric" analysis. CEO James Gellert says it had GM and Ford Motor (F) below investment grade at the start of the decade, well before the major raters.

Gimme Credit isn't a rating agency per se. It's a research firm that offers opinions on the creditworthiness of companies for investor-clients. "We focus on fundamentals, financial statements, and don't accept just what management says," says analyst Kathleen Shanley.

In March, before Bear Stearns collapsed, Egan-Jones rated the brokerage firm triple-B-minus, a very weak investment-grade rating. Rapid Ratings had it a notch below at the equivalent of double-B-plus. Gimme Credit had a "Sell" recommendation on Bear's bonds.

AS LATE AS MARCH 13, Moody's and S&P, by comparison, rated Bear as single-A, while Fitch was a notch higher at A-plus -- both are investment grade ratings. Three days later JPMorgan said it was buying Bear. Sean Egan, Egan-Jones managing director, explains that his firm noticed that the fundamentals for the mortgage business had started to falter and "killed a major source of profitability" in January, when it stripped Bear of its single-A-status.

S&P, Moody's (a unit of Moody's Corp. , MCO), and Fitch, a unit of **Fimalac** (FIM.France) all rated Lehman Bros. at single-A or better in September, before it crashed, while Egan-Jones had it at triple-B-minus, Rapid Ratings at the equivalent of a high triple-B and Gimme Credit at "Underperform."

The biggest split between the majors and the alternatives is in the ratings for bond insurer MBIA (MBI), also caught up in the subprime mess. Egan-Jones has the company rated triple-C, a weak, non-investment-grade rating, since mid-May. Moody's has it at Baa2; S&P two notches higher at A-minus. That's a difference of 11 notches. Fitch yanked its rating in April as the scope of MBIA's problems became more apparent.

MBIA had "slim capital" for the amount of structured finance it was on the hook for, says Egan. For the same reason, Gimme Credit put a "Sell" on it in October 2007.

S&P's A-minus rating is based on "fundamental analysis that MBIA has sufficient cash for all calls on liquidity and adequate capital versus loss expectations..." says analyst Mark Puccia.

In light of the discrepancies we found and the short period since the last big batch of credit problems arrived mostly undetected in 2002 and 2003, the SEC needs to take substantial action. After all, its own efforts to reform the process via increased competition have failed spectacularly.

While forcing the Big Three to be paid only by investors might be draconian, the SEC should consider downgrading the importance of its NRSRO designation. That would let the market decide whose word it wants to take about a security, based on performance rather than government approval.

Another possibility would be to force the agencies to disclose all the information they receive in crafting a rating. At present, executives can call and ask a rater how a certain acquisition, say, might affect their rating.

The Bottom Line

After the SEC reviewed them a few years ago for failing to foresee Enron's and Worldcom's problems, the big rating agencies misread this year's credit markets. Change is needed.

In a statement to *Barron's*, S&P said "credit ratings play an important role in the financial markets -- providing an opinion on creditworthiness that serves as one tool in the investment decision-making process. Standard & Poor's believes that sound, globally consistent regulation can help restore confidence in the rating process."

Still, last week there was more head-scratching. After the U.S. government gave Citigroup (C) a $306 billion guarantee on its toxic assets and injected $20 billion in fresh capital, Moody's, which rates Citi Aa3, said it was maintaining its review of its ratings for a possible downgrade. Presumably Citi's survival now seems more assured. Yet Moody's maintained the Aa3 rating through more than a year's worth of problems.

Why? Investors deserve to know.