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Providing timely, accurate credit ratings to Institutional Investors

Testimony of Sean J. Egan, Managing Director, Egan-Jones Ratings Company Before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises June 29 Hearing – The Credit Rating Agency Duopoly Relief Act of 2005

We strongly support the proposed legislation for reforming the ratings industry since it does not impair the freedom of speech defense afforded rating firms and it addresses the two major problems that have long plagued the industry:

1. the dearth of competition, and
2. the failure of the current rating firms to provide timely, accurate ratings for protecting investors.

Perhaps the most appealing aspect of the proposed legislation is that it removes the SEC from the role of recognizing rating firms (i.e., NRSRO firms), a role in which it has failed miserably. The SEC's primary mandate is protecting investors ("The primary mission of the SEC is to protect investors" to quote the SEC website, sec.gov – Who We Are). Within the past three years we have experienced two of the largest credit failures in US history, Enron and WorldCom, failures that resulted in the loss of hundreds of billions of dollars, tens of thousands of jobs, and the pensions of thousands. After these colossal failures, one would expect that the agency charged with recognizing rating firms would have shown some initiative for addressing the problems so that they do not occur again. Unfortunately, this has not been the case. Instead, the SEC is continuing its study of the industry; a study which began in the early 1990's and is continuing today. While the first NRSRO firm was recognized in 1970, it was only 90 days ago that the SEC finally devised a definition of NRSRO's (it seems obvious that a definition should have existed before the first NRSRO was designated). Furthermore, the SEC's proposal for NRSRO's requires that rating firms provide their ratings free to the public which effectively means that the rating firms have to seek compensation from the Enrons and Worldcoms of the world, which in many people's view is a system rife with conflicts. Yes, the SEC has recognized two new NRSRO's during the past 18 months. However, neither firm warned investors about the recent major failures, nor do they provide any significant competition to the two partner-monopoly firms, S&P and Moody's.

The SEC has indicated that it consults with the major rating firms before proposing any changes to their regulation of the industry. Perhaps they should have also consulted with investors who have been and continue to be hurt by the flawed industry structure. Conspicuously absent from the SEC's proposed definition of NRSRO rating firms are the following requirements:

Sever ties between rating firm personnel and issuers and dealers- the ex-chairman of Moody's should not have served as a director of WorldCom, nor should ratings firm personnel be tied to broker/dealers or broker/dealer industry associations such as the NASD.
Discourage insider trading – The proposal addresses the misuse of non-public information given to rating firms but does not address the misuse of information generated by the rating firms themselves such as Moody's informing CitiGroup of its intention to downgrade Enron below investment grade.

Take timely action – it has been over three years since the failure of Enron and yet the SEC still has not made any significant changes in the ratings industry.

Regarding, Egan-Jones Ratings, Kafkaesque (see Franz Kafka, The Trial) is probably the best description of our experience with the SEC. We have regularly issued timely, accurate ratings and provided warning for the Enron, Genuity, Global Crossing, and WorldCom failures (see the attachment). Furthermore, we consistently identify improving credits; most of our ratings have been higher than S&P's and Moody's over the past three years thereby assisting issuers in obtaining 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."

Stanford University and the University of Michigan drew a similar conclusion in a September 2004 study. We applied for NRSRO designation in July 1998, approximately eight years ago. Despite our success in issuing timely, accurate ratings, we are not designated and even after multiple requests, have not been told what is needed to be designated. In 2003, an SEC official told us that the SEC hesitated to tell us what the specific criteria were since we would probably meet them and the SEC would have to designate us. Throughout the process we have been told that progress would be made after Arthur Levitt was joined by other commissioners, after Harvey Pitt was installed, after the SEC completed the study mandated by the Sarbanes-Oxley Act, after the SEC held hearings on the ratings industry, and after Mr. William Donaldson became the new SEC Chairman. It has taken us time to lose faith in the SEC's ability to take action in the ratings industry, but after eight years of effort, we have come to believe that the SEC is incapable of acting in investors' interest in this area when it does not meet with the approval of the two partner-monopoly firms. Since missing the failure of Enron in 2001, Moody's operating revenues have more than doubled from \$398M to \$814M, as have S&P's with an increase from \$435M to \$893M, an indication of the severe lack of competition in the area.

The proposed legislation provides some hope for reform and real competition in the ratings area. It was artfully drafted to maintain the Freedom of Speech protections for ratings. Perhaps some review might be needed for purely quantitative ratings, but this can easily be accomplished. We continue to support the Code of Standard Practices for Participants in the Credit Rating Process published by the Association of Corporate Treasurers (United Kingdom), The Association of Financial Professionals (United States), and Association Francaise Des Tresoriers D'Entreprise (France).

Until the fundamental problems in the rating industry are addressed, investors, employees, pensioners, and ultimately issuers will be needlessly harmed. The SEC should gracefully withdraw from this area in the interest of protecting investors. We strongly support the proposed legislation.

Egan-Jones Ratings Company

Selected Quotes – Egan-Jones Ratings Co.

Research Division, Federal Reserve Bank of Kansas City February 2003
"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."

Stanford University and the University of Michigan September 2004
"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."

New York Times
Gretchen Morgenson (Pulitzer Prize Winner July 7, 2002
"Egan-Jones makes a practice of alerting investors to corporate credit problems well before they are acknowledged by management… As early as November 2000, for example, Egan-Jones cut its ratings on WorldCom to the lowest investment-grade level, citing its deteriorating profit margins and credit quality."

Fortune's "Against the Grain"
Herb Greenberg January 21, 2002
"The best balance-sheet snoops are often way ahead of the pack in finding signs of trouble. Sometimes, however, the big credit-rating firms, Standard & Poor's and Moody's, which get paid by the companies they rate, are slow off the mark--slower, as a rule, than independent bond-rating services like Egan-Jones.

Investment Dealers Digest (cover)
Dave Lindorff August 13, 2001
"It didn't take long for Sean Egan, managing director of Egan-Jones Ratings Co., a small ratings agency outside Philadelphia, to figure out last fall's California power crisis would eventually put the state's utilities in a bind. "We saw a train wreck ahead for these companies," recalls Egan, who says his analysts quickly fired off two reports to clients warning them of the troubles facing the state's two utilities-Pacific Gas & Electric Corp. and Edison International, the parent company of Southern California Edison. On Sept. 27, the firm lowered EIX's rating from A- to BBB-, and PG&E's rating from A to BBB+."

Bloomberg News
Mark Gilbert October 14, 2004
"S&P wouldn't be the first to pin a non-investment grade rating on Ford. Egan-Jones Ratings Co., a private company run by Sean Egan in Pennsylvania, cut the automaker's grade in January 2002."

Grant's Interest Rate Observer
Jim Grant Annual Conference, October 2002
"The big two-and-a-half rating agencies have not exactly covered themselves in glory during the current credit debacles. Sean Egan, co-founder of Egan-Jones Ratings Co. (which saw many disasters coming before they landed in the newspapers), will discuss debacles and opportunities yet over the horizon."

Enron's Senior Unsecured Ratings

The bold indicates non-investment grade

Date	Egan-Jones*	S&P	Moody's
4/19/2001	BBB+	BBB+	Baa1
→**6/27/2001**	**BBB**	BBB+	Baa1
8/15/2001	BBB/ BBB-	BBB+	Baa1
10/16/2001	BBB/ BBB-	BBB+	Baa1 (neg.)
10/23/2001	BBB-	BBB+	Baa1 (neg.)
10/24/2001	BBB-/ BB+	BBB+	Baa1 (neg.)
10/26/2001	**BB+**	BBB+	Baa1 (neg.)
10/29/2001	**BB+/ BB**	BBB+	Baa2 (neg.)
10/31/2001	**BB+/ BB**	BBB+	Baa2 (neg.)
11/1/2001	**BB**	BBB (neg.)	Baa2 (neg.)
11/6/2001	**BB**	BBB (neg.)	Baa2 (neg.)
11/7/2001	**BB-/ B-**	BBB (neg.)	Baa2 (neg.)
11/9/2001	**BB**	BBB- (neg.)	Baa3 (neg.)
11/21/2001	**BB/ BB-**	BBB- (neg.)	Baa3 (neg.)
11/26/2001	**BB-/ B+**	BBB- (neg.)	Baa3 (neg.)
11/28/2001	**B+/ B-**	**BBB- (neg.)**	**Baa3 (neg.)**
11/28/2001	**C/ D**	**B-**	**B2 (neg.)**
11/29/2001	**D**	**B-**	**B2 (neg.)**
11/30/2001	**D**	**CC (neg.)**	**B2 (neg.)**
12/3/2001	**D**	**D**	**Ca**

* Current and projected ratings

WorldCom's Senior Unsecured Ratings

The bold indicates non-investment grade

Date	Egan-Jones*	S&P	Moody's	Action
11/1/2000	A- (neg. watch)	A-	A3	EJR issued neg. watch (A-)
11/ 3/00	A- (neg. watch)	A- (neg. watch)	A3	S&P issued a neg. watch (A-)
11/17/2000	BBB+ (neg. watch)	A- (neg. watch)	A3	EJR cut A- to BBB+ (neg. watch)
2/8/2001	BBB	A- (neg. watch)	A3	EJR cut BBB+ to BBB
2/27/01	BBB	BBB+	A3	S&P cut A- to BBB+
6/25/2001	BBB-	BBB+	A3	EJR cut BBB to BBB-
7/26/2001	**BB+ (neg. watch)**	BBB+	A3	EJR cut BBB- to BB+ (neg watch)
1/29/2002	**BB (neg. watch)**	BBB+	A3	EJR cut BB+ to BB (neg watch)
2/ 7/02	**BB- (neg. watch)**	BBB+	A3	EJR cut BB to BB- (neg watch)
2/ 7/02	**BB- (neg. watch)**	BBB+	A3 (neg. watch)	Moody's issued a neg. watch (A3)
2/19/2002	**B+**	BBB+	A3 (neg. watch)	EJR cut BB- to B+
4/12/02	**B+**	BBB+ (neg. watch)	A3 (neg. watch)	S&P issued a neg. watch (BBB+)
4/22/02	**B+**	BBB	A3 (neg. watch)	S&P cut BBB+ to BBB
4/23/02	**B**	BBB	A3 (neg. watch)	EJR cut B+ to B
4/23/02	**B**	BBB	Baa2	Moody's cut A3 to Baa2
4/25/2002	**B-**	BBB	Baa2	EJR cut B to B-
5/ 9/02	**B-**	BBB	**Ba2**	Moody's cut Baa2 to Ba2
5/10/02	**B-**	**BB**	**Ba2**	S&P cut BBB to BB
6/14/2002	**B- (neg. watch)**	**BB**	**Ba2**	EJR issues neg. watch
6/17/02	**B- (neg. watch)**	**B+**	**Ba2**	S&P cut BB to B+
6/20/02	**CCC (neg. watch)**	**B+**	**Ba2**	EJR cut B- to CCC (neg. watch)
6/20/02	**CCC (neg. watch)**	**B+**	**B1**	Moody's cut Ba2 to B1
6/26/02	**D**	**B+**	**B1**	EJR cut CCC to D
6/26/02	**D**	**CCC-**	**B1**	S&P cut B+ to CCC-
6/26/02	**D**	**CCC-**	**Ca**	Moody's cut B1 to Ca
7/ 1/02	**D**	**CC**	**Ca**	S&P cut CCC- to CC
7/17/02	**D**	**D**	**Ca**	S&P cut CC to D


ENRON CORP
ENE7 3/8 05/15/19
D E F A U L T E D
Trade Line
ENE7 3/8 05/15/19 Corp
1/5
Range 12/ 7/00 - 11/20/01
Period D Daily
Upper Chart: 1 Trade Line
1) News
Egan-Jones lowers to BBB (neg.)
Egan-Jones cuts A- rating to BBB+; analyst comment, "Cracks appear to be developing in a heretofore great corporate story" (4/19/01)
Moodys warns March '00 rating of Baa1 on Negative Watch on 10/16/01. They cut WCOM to Baa2 (neg.) on 10/29/01 and matched S&P with Baa3 (neg.) on 11/9/01
S&P lowers 1995 BBB+ rating to BBB (neg.) on 11/1/01, then cuts to BBB- (neg.) 11/9/01
100
95
90
85
80
75
2001 Jan
Feb
Mar
Apr
May
Jun
Jul
Oct


WORLDCOM INC
WCOM 8 ¼ 05/31
43.3307/ 44.2307 (19.16/18.78) BGN
MATRIX
Trade Line
WCOM 8 ¼ 05/31 Corp
1/4
Range 10/30/01 - 4/30/02
Period D Daily
Chart: 1 Trade Line
Source
1) News
Moodys warns June 1999 A3 rating on Negative Watch 2/7/02
S&P cuts to BBB (neg.) 4/22/02 and then to BB (neg.) on 5/10/02
EJR assigns a Negative Watch to WCOM at BB+ on 10/25/01
EJR cuts BB+ (neg.) to BB (neg.) 1/29/02
Egan-Jones lowered WCOM below investment grade on 7/26/01, over 200 days or 8 months before the bonds were trading below the 90's
EJR cuts BB to BB- (neg.)
S&P cuts A- (neg.) to BBB+ 2/27/02 and then puts that on Neg. Watch 4/12/02
EJR cuts BB- (neg.) to B+ 2/19/02
Moodys cuts A3 to Baa2 (neg.) 4/23/02 and then to Ba2 (neg.) on 5/9/02
110
100
90
80
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08
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15
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2001 Nov
Dec
2002 Jan
Feb
Mar
Apr