**Egan-Jones Ratings Company**
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*Providing timely, accurate credit ratings to Institutional Investors*

February 8, 2005

**Testimony of Sean J. Egan, Managing Director, Egan-Jones Ratings Co.
Before the Senate Committee on Banking, Housing, and Urban Affairs
The Role of Credit Rating Agencies in the Capital Markets**

Chairman Shelby, members of the Committee, good morning. I am Sean Egan, Managing Director of Egan-Jones Ratings Company, a credit ratings firm. By way of background, I am a cofounder of Egan-Jones Ratings Co., which was established to provide timely, accurate credit ratings to institutional investors. Our firm differs significantly from other ratings agencies in that we have distinguished ourselves by providing timely, accurate ratings and we are not paid by the issuers of debt, which we view as a conflict of interest. Instead, we are paid by approximately 400 firms consisting mainly of institutional investors and broker/dealers. We are based in the Philadelphia, Pennsylvania area, although we do have employees that operate from other offices.

The rating industry is in a crisis. At a time when the capital markets have become increasingly reliant on credit ratings, the ratings industry is suffering from a state that is hard to characterize as anything other than dysfunctional. The problems are:

**Severe consolidation** - Dept. of Justice personnel referred to the industry as a "partner monopoly" since S&P and Moody's control over 90% of the revenues and do not compete against each other as two ratings are normally needed for issues;
**Conflicts of interest** – issuers payment for ratings create conflicts of interest that are similar to those experienced by the equity research analysts;
**Freedom of speech defense** - there is no downside to bad rating calls by the two dominant firms.

Manifestations of the flawed structure are:

**Failure to warn investors** about problem credits such as Enron, the California utilities, WorldCom, Global Crossing, AT&T Canada, and Parmalat.

Enron was rated investment grade by the NRSRO's four days before bankruptcy,
The California utilities were rated "A-" two weeks before defaulting;
Worldcom was rated investment grade three months before filing for bankruptcy;
Global Crossing was rated investment grade in March 2002 and defaulted on loans in July 2002;
AT&T Canada was rated investment grade in early February 2002 and defaulted in September 2002; and
Parmalat was rated investment grade 45 days before filing for bankruptcy.
**Losses from the Enron and WorldCom failures alone were in excess of $100 billion, thousands of jobs, and the evaporation of pensions for thousands. It is likely that some of these failures could have been avoided had the problems been identified and addressed sooner.** (Enron was left with only Dynergy as an acquirer by the time the alarm was sounded.)

**Under-rating credits** - such as Nextel, American Tower, and Thyssenkrupp were assigned credit ratings which were too low, thereby significantly increasing their cost of capital and restricting growth.

**Insider trading** - CitiGroup and probably other institutions were given advanced information about the Enron downgrade. Additionally, S&P and Moody's request advance information about transactions and other major events which creates opportunities for insider trading. S&P analyst Rick Marano and his associates traded on confidential information relating to the acquisition of ReliaStar and American General.
**Investor fraud** - the NRSRO rating firms pulled their ratings on an Allied Signal entity so Allied could repurchase debt more cheaply;
**Issuer coercion** - forcing issuers to pay rating fees (see WashPost article for a description of Hanover Re actions and Northern Trust comments to SEC) http://www.washingtonpost.com/wp-dyn/articles/A8032-2004Nov23.html;
**Punishment ratings** - see the municipality lawsuits; and
**Expansion of monopoly** - expansion into consulting and corporate governance ratings despite rating failures.

Despite the recent credit rating debacles, S&P and Moody's revenues and earnings have continued to grow because of their lock on the market (Moody's operating earnings have increased 230% over the past four years) and the lack of normal checks and balances. To put the industry structure in perspective, it is as though there were only two major broker dealers for corporate securities and the approval of both were required before any transactions could be completed.

The arguments used to by the NRSRO's to defend their actions and inactions are the following:

**"Issuer Misdeeds" (they didn't tell us)** – S&P, Moody's, and Fitch claim they did not assign the correct rating because WorldCom, Enron, et al. did not provide accurate information. We believe it is a pathetic state when major rating firms are unable to recognize when an issuer and its executives are desperate to keep their firms solvent; it was public knowledge that Bernie Ebbers owed WorldCom more than $400 million. Fraud is present in most failures, and the rating firms (at least those recognized by the SEC) should be able to detect the majority of egregious cases.

**"Little Incentive" (the Jack Grubman defense)** – another argument used by the current NRSRO's to defend their actions is that any single issuer represents only small portions of their overall revenue bases. However, revenues produced by equity analysts Jack Grubman and Henry Blodget were likewise only a small portion of CitiGroup's and Merrill's revenues. Furthermore, when large investment banks are pressing the rating firms to hold off on any rating action, it becomes difficult not to listen.

**"Our Reputation is Key" (the Arthur Andersen defense)** – Arthur Anderson argued that it would not do anything untoward because it would hurt the firm's reputation. Likewise, the current NRSRO's argue that they would not risk their reputation for any one issuer. However, since most issuers believe their ratings are too low and the lack of competition provides little downside for inaccurate ratings, there are few checks in the industry.

**"Committee Approach" (the Lemming defense)** – a final defense normally proffered for the flawed industry is that unlike the investment banks, the NRSRO's use a committee approach for assigning ratings, which is harder to manipulate. Unfortunately, one analyst typically covers a firm and during rating committees what superiors want is probably clear.

To reform the ratings industry, we recommend the following changes:

**1) Recognize some rating firms which have succeeded in providing timely, accurate ratings** - The problems with the current system are a) improving firms have been penalized by paying too much for capital, and b) investors have been hurt by not obtaining warning of deteriorating firms. The recognition of some firms that have succeeded in providing timely, accurate ratings would be of great benefit.

**2) Wean rating firms of issuer compensation** – the crux of the equity research analysts' scandal is that analysts were paid by issuers via investment banking fees, thereby corrupting the investment analysis. The same conflicts exist in the credit rating industry. Studies from the Kansas City Fed and Stanford University and the University of Michigan support the superiority of non-conflicted firms.

**3) Adopt the Code of Standard Practices for Participants in the Credit Rating Process issued by the ACT, AFP, and AFTE** – the proposed guidelines will assist in increasing the transparency and credibility in the ratings industry.

**4) Prohibit rating firms from obtaining inside information** – the rating firms should not be given preferential treatment over other financial analysts.

**5) 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.

**Broker/dealers were fined $1.4 billion for the issuance of conflicted equity research. In contrast, the SEC has been studying the rating industry since the early 1990's and has not yet made any substantive changes. The SEC has provided a false sense of security by giving its seal of approval to conflicted firms. If the SEC is unable to implement these changes rapidly, we recommend it withdraw from providing NRSRO designations and protecting the currently-recognized firms from competition. Perhaps a board made up of users of credit ratings (excluding broker/dealer affiliated firms) is best able to assess the competency of rating firms.**

Regarding Egan-Jones Ratings, we have provided warning for the Enron, Genuity, Global Crossing, and WorldCom failures (we did not rate Parmalat). Furthermore, we regularly identify improving credits; 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."
> Link: aaahq.org/AM2004/display.cfm?Filename =SubID_ 1213.pdf&MIMEType =application%2Fpdf

In August 1998 we applied for recognition by the SEC as a ratings firm (i.e., NRSRO status). We continue to provide information to the SEC and hope eventually to be recognized.

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. I would be happy to answer any questions.

Very truly yours,

Sean J. Egan

**Selected Quotes – Egan-Jones Ratings Co.**

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+."

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

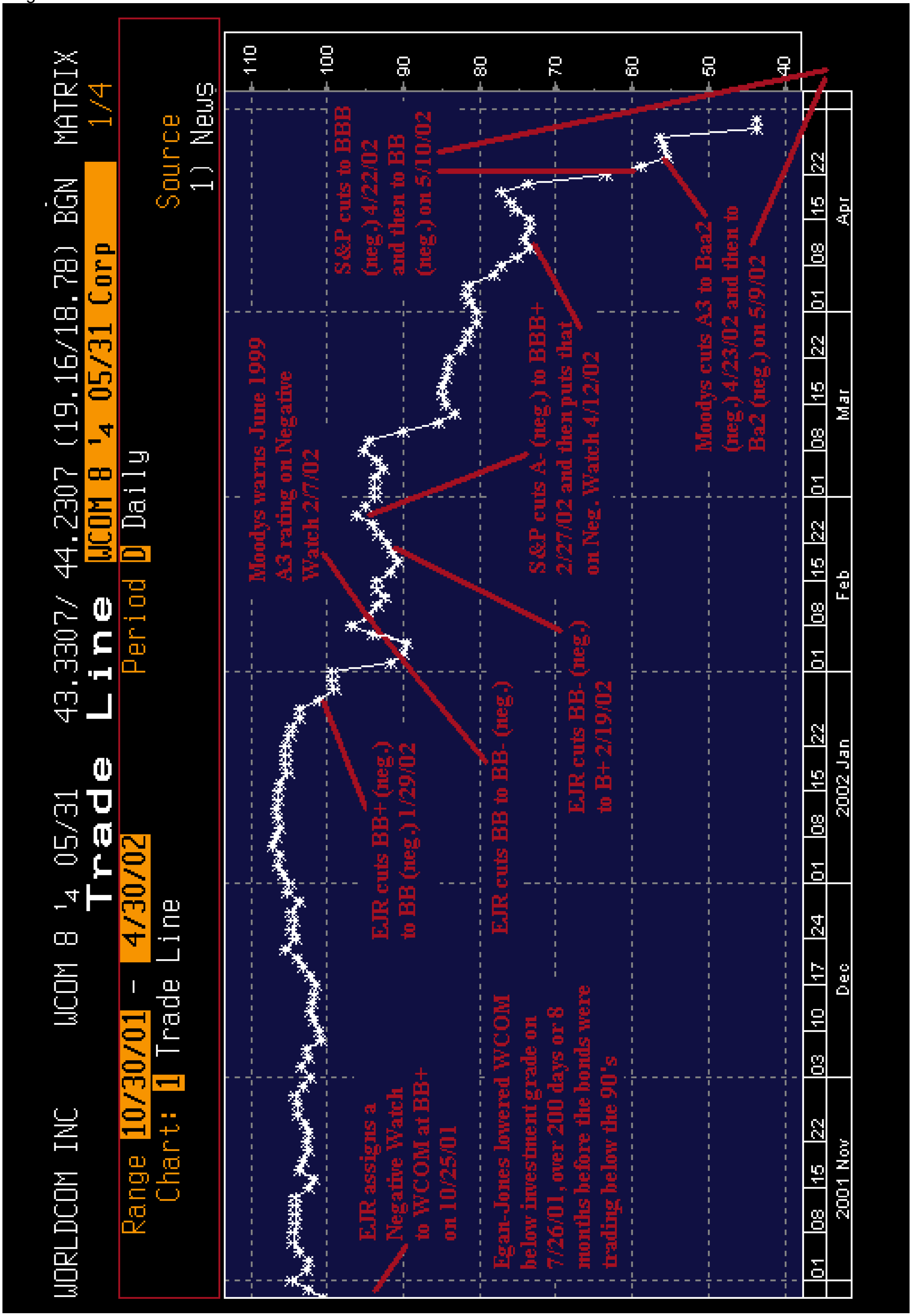
| Date | Egan-Jones* | S&P | Moody's |
|---|---|---|---|
| 4/19/2001 | BBB+ | BBB+ | Baa1 |
| à **6/27/2001** | **BBB** | BBB+ | Baa1 |
| 8/15/2001 | BBB/ BBB- | BBB+ | Baa1 |
| 10/16/2001 | BBB/ BBB- | BBB+ | Baa1 (neg.) |
| 10/23/2001 | BBB- | BBB+ | Baa1 (neg.) |
| 10/24/2001 | BBB-/ BB+ | BBB+ | 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** |

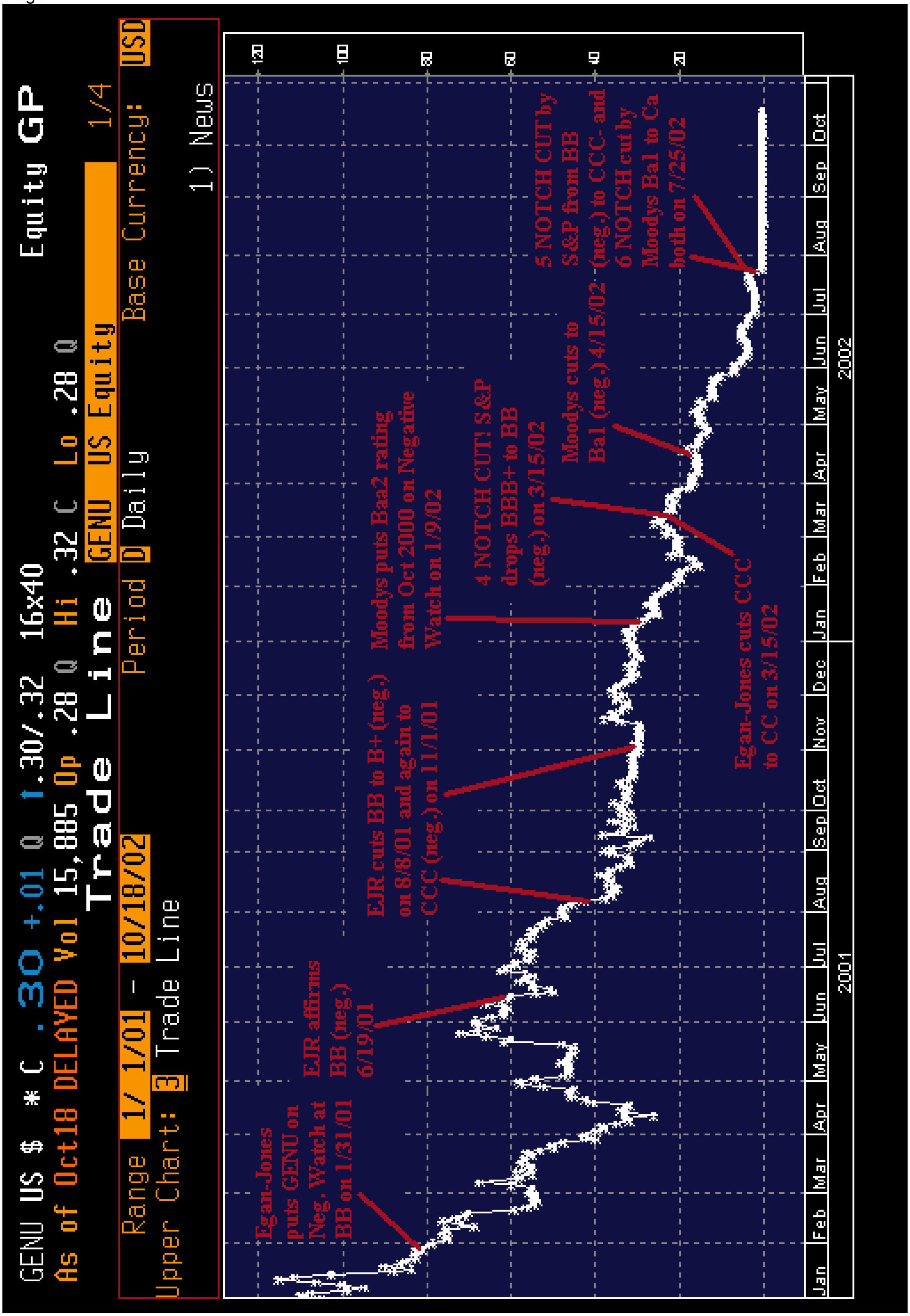
* Current and projected ratings

## 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 |


WORLDCOM INC
WCOM 8 1/4 05/31
43.3307/ 44.2307 (19.16/18.78) BGN
MATRIX
Trade Line
1/4
WCOM 8 1/4 05/31 Corp
Range 10/30/01 - 4/30/02
Period D Daily
Chart: 1 Trade Line
Source
1) News
110
100
90
80
70
60
50
40
2001 Nov
Dec
2002 Jan
Feb
Mar
Apr
EJR assigns a Negative Watch to WCOM at BB+ on 10/25/01
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+ (neg.) to BB (neg.) 1/29/02
EJR cuts BB to BB- (neg.)
EJR cuts BB- (neg.) to B+ 2/19/02
Moodys warns June 1999 A3 rating on Negative Watch 2/7/02
S&P cuts A- (neg.) to BBB+ 2/27/02 and then puts that on Neg. Watch 4/12/02
S&P cuts to BBB (neg.) 4/22/02 and then to BB (neg.) on 5/10/02
Moodys cuts A3 to Baa2 (neg.) 4/23/02 and then to Ba2 (neg.) on 5/9/02


GENU US $ * C .30 +.01 Q ↑.30/.32 16x40 Equity GP
As of Oct18 DELAYED Vol 15,885 Op .28 Q Hi .32 C Lo .28 Q
Trade Line GENU US Equity 1/4
Range 1/ 1/01 - 10/18/02 Period D Daily Base Currency: USD
Upper Chart: 3 Trade Line 1) News
120
100
80
60
40
20
Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun Jul Aug Sep Oct
2001
2002
Egan-Jones puts GENU on Neg. Watch at BB on 1/31/01
EJR affirms BB (neg.) 6/19/01
EJR cuts BB to B+ (neg.) on 8/8/01 and again to CCC (neg.) on 11/1/01
Moodys puts Baa2 rating from Oct 2000 on Negative Watch on 1/9/02
4 NOTCH CUT! S&P drops BBB+ to BB (neg.) on 3/15/02
Egan-Jones cuts CCC to CC on 3/15/02
Moodys cuts to Ba1 (neg.) 4/15/02
5 NOTCH CUT by S&P from BB (neg.) to CCC- and 6 NOTCH cut by Moodys Ba1 to Ca both on 7/25/02

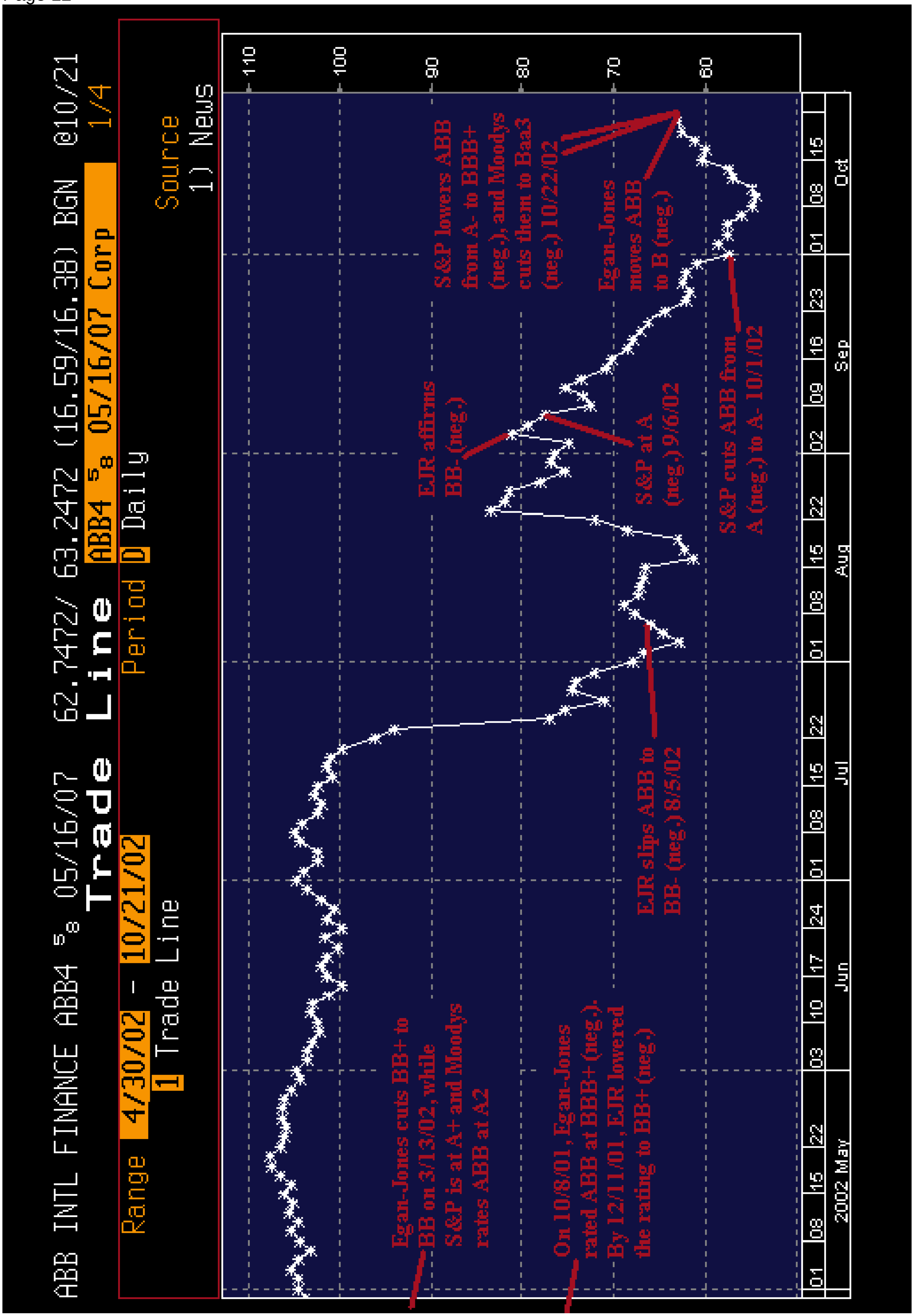


ABB INTL FINANCE ABB4 5/8 05/16/07 62.7472/ 63.2472 (16.59/16.38) BGN @10/21
Trade Line
ABB4 5/8 05/16/07 Corp 1/4
Range 4/30/02 - 10/21/02 Period D Daily
1 Trade Line
Source
1) News
110
100
90
80
70
60
01 08 15 22 03 10 17 24 01 08 15 22 01 08 15 22 02 09 16 23 01 08 15
2002 May Jun Jul Aug Sep Oct
Egan-Jones cuts BB+ to BB on 3/13/02, while S&P is at A+ and Moodys rates ABB at A2
On 10/8/01, Egan-Jones rated ABB at BBB+ (neg.). By 12/11/01, EJR lowered the rating to BB+ (neg.)
EJR slips ABB to BB- (neg.) 8/5/02
EJR affirms BB- (neg.)
S&P at A (neg.) 9/6/02
S&P cuts ABB from A (neg.) to A- 10/1/02
S&P lowers ABB from A- to BBB+ (neg.), and Moodys cuts them to Baa3 (neg.) 10/22/02
Egan-Jones moves ABB to B (neg.)