REGULATORS

THE CREDIT-RATERS: HOW THEY WORK AND HOW THEY MIGHT WORK BETTER

As Washington bears down, talk of new rules, new tools, and more competition

Credit-rating agencies are the newest target of congressional ire over the Enron debacle. What's gotten Washington's attention is their failure to uncover the extent of Enron's weakening financial condition and the pace at which they downgraded the energy trader in the months prior to its implosion. Despite growing questions about Enron's ties to the private partnerships that proved its undoing, the agencies kept it at an investment-grade rating until just four days before it filed for bankruptcy on Dec. 2, 2001. At a Mar. 20 hearing, Senate Governmental Affairs Committee Chairman Joseph I. Lieberman (D-Conn.) suggested tougher regulation of the ratings industry may be needed. "Power of this magnitude should go hand in hand with some accountability," he said.

For years, the ratings agencies have wielded enormous quasi-governmental power. Federal securities law recognizes just three raters: Moody's Investors Service, a unit of Moody Corp.; Standard & Poor's, which is owned by The McGraw-Hill Companies, the corporate parent of *BusinessWeek*; and Fitch Inc.

Here's a primer on why the agencies exist, how they work, and what new regulations or self-imposed changes might be in the offing:

What's the role of rating agencies?

They assess and grade the creditworthiness of companies and public entities that issue debt and the debt itself. All three (Standard & Poor's, Moody's, and Fitch) have teams of analysts who grill executives about operations, finances, and management plans, then sift the data to arrive at a rating. All use letter-based grading systems. S&P's ratings, for example, range from AAA for the most financially stable companies to D for a company in default.

Ratings serve other purposes, too. They help determine the interest rate a company pays on its debt and the price at which debt trades. Equity analysts and investors regard ratings as a key measure of a company's financial health. Some loans must be restructured or repaid if an issuer's credit rating falls below investment grade.

Does the Enron debacle reveal chinks in the industry's structure—or just a need to get tougher?

How did rating agencies start?

John Moody invented ratings in 1909, when he published the *Manual of Railroad Securities*, which rated 200 railroads and their securities. The Standard Co. began grading bonds in 1916. Poor's and Fitch followed in the 1920s. Poor's and Standard merged in 1941. All initially made their money by charging investors for their ratings. They began charging issuers instead in the 1970s, partly because the spread of photocopying made it easy for nonpaying investors to get hold of ratings.

How did raters acquire government-sanctioned roles?

In 1936, the Comptroller of the Currency decreed that banks could hold only investment-grade securities. Ever since, regulators have been delegating risk assessment to the rating agencies. A rising tide of regulatory requirements has forced banks, insurers, mutual funds, and other financial institutions to pay attention to bond ratings. The upshot: Companies, municipalities, and governments that want to tap the U.S. capital markets need credit ratings.

Why are there only three?

To prevent unscrupulous outfits from selling triple-A ratings to the highest bidders, the Securities & Exchange Commission in 1975 designated the ratings of Moody's, S&P, and Fitch as the only ones that may be used to satisfy creditworthiness regulations. The SEC later anointed four more as "Nationally Recognized Statistical Ratings Organizations." Mergers have left just the original three.

Are the agencies privy to information that analysts and investors lack?

Usually. An exemption from SEC rules lets companies reveal sensitive financial information only to bond-raters. It may be client lists or profits on particular business lines. Companies aren't required to divulge the info to raters, but many do so in

an effort to put their financial health in the best light.

As Enron's condition worsened, what did the rating agencies do?

Beginning in late October, after Enron announced a $2.2 billion equity write-down, the agencies gradually lowered their ratings and short-term outlooks. But they kept Enron at just-above junk status until Nov. 28, when it became clear that an acquisition by Dynegy Corp. was unraveling.

The agencies say Enron duped them with incomplete and misleading information about private partnership deals. In particular, Enron failed to reveal its Chewco, Raptor, and LJM partnerships, S&P Managing Director Ronald M. Barone told lawmakers. He also said that S&P's investment-grade rating on Enron in November was coupled with public warnings that it would be lowered to junk status absent the merger with Dynegy.

Critics insist, however, that the raters should have pressed Enron harder for answers and should have downgraded the company sooner.

What might prod rating agencies to do a better job?

Senator Lieberman is considering asking the SEC to act as watchdog for the agencies. Tighter regulation could include regular audits of the raters' timeliness and accuracy. The commission is, in fact, mulling whether to keep a closer watch over the raters. Other critics think a jolt of competition would force the agencies to scrutinize companies more aggressively. They want the SEC to extend the raters' special status to new competitors. At least one, Egan-Jones Rating Co., which sells ratings to investors, downgraded Enron to junk a month before the big agencies.

ALL DEBTORS ARE NOT ALIKE

Defaults on investment grade bonds —those rated BBB—or better— don't happen very often

ORIGINAL RATING	DEFAULT RATE*
AAA	0.52%
AA	1.31
A	2.32
BBB	6.64
BB	19.52
B	35.76
CCC	54.38

*Percentage of defaults by issuers rated by Standard & Poor's over the past 15 years, based on rating they were initially assigned

Data: Standard & Poor's Corp.

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>
> —SENATOR JOSEPH LIEBERMAN

Why not just abolish the agencies' special status and let the market gauge creditworthiness?

Some critics want to eliminate the agencies' special standing altogether. They would put responsibility for ensuring creditworthiness back on bank and other regulators and let investors buy ratings as they saw fit. Some would replace credit ratings with credit spreads—the difference between the yield to maturity on the security being evaluated and the yield to maturity on a similar, risk-free security, such as a U.S. government obligation.

But such a radical move would force a rewrite of hundreds of regulations that require pension funds and others to hold securities that meet specific risk standards. Someone, or the SEC, would have to develop the formula for determining the credit rating equivalent of a credit spread. And credit spreads don't apply to new or complex issues.

Are there steps the agencies can take to improve their ratings?

They are considering more frequent reviews of ratings. But so far, investors have balked at such changes. They fear it would make stock and bond markets more volatile. After Moody's suggested speedier judgments about companies' ability to repay debts, they were flooded with complaints by institutional investors. Greater volatility in ratings could force companies to pay a higher price to tap the debt markets.

The agencies have also begun using new financial tools, such as quantitative risk modeling, which relies on stock and bond prices to predict the likelihood of default. And they promise to alert investors to loan "triggers," such as a stock-price or ratings decline, that could force a company to renegotiate or repay loans to bankers.

By Amy Borrus, with Mike McNamee, in Washington and Heather Timmons in New York

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