Egan-Jones Ratings Company
Tel. 1-888-837-4878 Research@Egan-Jones.com

Providing timely, accurate credit ratings to Institutional Investors

Testimony of Sean J. Egan, Managing Director, Egan-Jones Ratings Co.
Before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Sept. 14 Hearing – The Ratings Game – Improving Transparency and Competition Among the Credit Rating Agencies

Chairman Baker, members of the Subcommittee, 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 currently is suffering from a severe lack of competition (S&P and Moody's dominate the industry) which has caused the following problems: i) issuers 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 two 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 have continued to grow because of their lock on the market. 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. Some other manifestations of the limited competition in the ratings industry include abuses in the use of unsolicited ratings and heavy-handed marketing of related corporate services such as issuer governance ratings.

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 to eventually be recognized.

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.

3) Adopt 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) Encourage SEC action – this area has been under review since the early 1990's and is dire need of reform. The cost of delaying the recognition of additional firms is greater than the benefit of additional study.

I would be happy to answer any questions.