STATEMENT

Rating the Raters: Enron and the Credit Rating Agencies

Committee on Governmental Affairs

Chairman Joe Lieberman
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Good morning. I'd like to welcome everyone today to the fourth in a series of Governmental Affairs Committee hearings on the collapse of Enron and the implications for Enron employees, investors, and the American economy as a whole. We are engaged in an ongoing investigation into whether the private and public watchdogs did all they could have done to prevent or, at least, anticipate and warn the rest of us of Enron's collapse. Today, we will take a look at the private-sector credit-rating agencies that wield immense, quasi-governmental power to determine which companies within the corporate world are creditworthy and which are not. In pursuit of our purpose here, which is to learn the lessons of Enron and craft solutions to avoid future calamities of this sort, we will ask why the credit raters continued to rate Enron as a good credit risk, right up until four days before it declared bankruptcy.

Simply put, a credit rating is an assessment of a company's credit worthiness or its likelihood of repaying its debt. The entire corporate credit-rating industry consists of just three agencies - Moody's Investors Service, Standard & Poor's, and Fitch Ratings - three agencies that exercise significant power over corporate America, the markets, and, therefore, over our entire economy. They are private companies, but the enormous scope of their influence comes largely as a result of their government-conferred power.

John Moody, the founder of what is now Moody's Investors Service, is recognized for devising credit ratings in 1908 for public debt issues, mostly railroad bond issues. Moody's credit ratings, first published in 1909, met a need for accurate, impartial, and independent information.

Now, almost a century later, an "investment grade" credit rating has become an absolute necessity for any company that wants to tap the resources of the capital markets. The credit raters hold the key to capital and liquidity, the lifeblood of corporate America and of our capitalist economy. The rating affects a company's ability to borrow money; it affects whether a pension fund or a money market fund can invest in a company's bonds; and it affects stock price. The difference between a good rating and a poor rating can be the difference between success and failure, prosperity and bad fortune.

The government - through hundreds of laws and regulations - requires corporate bonds to be rated if they're to be considered appropriate investments for many institutional investors - and, by the way, 95% of corporate bonds are held by institutional investors. Most of these laws and regulations involve banks and securities. But their reach also extends into education, where schools must be rated in order to participate in certain financial assistance programs, and into transportation, where a highway project might need a rating to qualify for federal funding, and into telecommunications, where companies must be rated in order to receive federal loan guarantees.

Along with this power, comes special access and special protections. The credit raters, for example, are allowed to look at a company's inside information when making assessments and they are exempted from liability when they participate in securities offerings - two benefits that give them more information than other analysts working within the system.

Someone once said that raters hold "almost biblical authority." On a NewsHour with Jim Lehrer program in 1996, *New York Times* columnist Tom Friedman went so far as to say - and I quote - "there are two superpowers in the world... the United States and Moody's Bond Rating Service... and believe me, it's not clear sometimes who is more powerful."

With so much power, access, and protection, it is not surprising that profitability follows close behind. Not all the agencies' books are open for inspection because they're subsidiaries of larger corporations. But Moody's was spun off into a separate company a few years ago, and is worth $6.2 billion. Moody's $40 stock price is almost 50 percent higher today than what it was trading at last year.

It seems reasonable to me that power of this magnitude should go hand in hand with some accountability. And yet, once the SEC anoints the credit-rating, they are left alone. So, I think it's appropriate, as we try to learn the lessons of Enron, to ask if the agencies should have some sense of accountability, some oversight, from the SEC perhaps, to ensure they properly perform their function as watchdogs.

In the Enron case, I would have to conclude, that the credit raters appear to have been no more knowledgeable about the company's problems than anyone else who was following the its fortunes in the newspapers. Let's look at the events leading up to the raters' decisions to withdraw their assessment of Enron as a good credit risk. After a summer during which Enron stock steadily declined, it was reported on October 22 last year that the SEC asked the company to disclose its ties to outside investment partnerships set up by the company's chief financial officer. Enron's stock dropped 20 percent that day to a closing price of $20.65 per share. On October 24, the CFO, Andrew Fastow, resigned, and the stock dipped to $16.41.

Five days later, on October 29, Standard and Poor's credit rating analyst appeared on CNN. By this time, the agencies had put Enron on a "credit watch," but the company was still considered a good risk. The Standard and Poor's analyst predicted that - and I quote here -- "Enron's ability to retain something like the rating that they're at today is excellent in the long term." End of quote. When asked about the off-balance sheet partnerships, the analyst assured investors that there would be no long term implications. "That's something that's really in the past," he said.

Now, let me take you back a moment to our last hearing on Enron, when a Wall Street analyst testified that his "buy" recommendation was supported by the confidence expressed by the credit rating agencies - which, he specifically pointed out, had access to inside information about Enron's liabilities that he didn't have. So, S&P's confidence had an effect on others. On November 2, the S&P analyst once again expressed his strong belief that Enron's off-balance sheet problems were nothing to worry about. The analyst said S&P had - quote - "a great deal of confidence there are no more surprises to come... I think it's going to take a little bit more time before everybody can get fully comfortable that there's not something else lurking out there." End of quote.

We now know the market was not convinced. The stock price continued its descent, dropping to $8.41 on November 8, when Enron disclosed it had overstated earnings by over half a billion dollars since 1997. Still, the rating agencies kept Enron at "investment grade." By November 28, the day Moody's and Standard & Poor's downgraded Enron to junk bond status, the company's stock was trading at just over a dollar. Four days later, of course, it went into bankruptcy. In other words, the credit raters - despite their unique position to obtain information unavailable to other analysts - were no more astute and no quicker to act than others.

The agencies defend their ratings as "opinions," protected by the First Amendment. They refer to their assessments as "the world's shortest editorials," but, in fact, their endorsements are required by law.

The mounting problems inside Enron's executive suites were missed by many people. None of the watchdogs barked, including the credit rating agencies, who had greater access to Enron's books. The fundamental question today is why did that happen and what can we do together to make sure the authority the credit rating agencies have is used as actively as possible to protect and defend our capital markets, let alone the average investors and the institutional investors. Thank you.

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