

Big Bond Rally Isn't in Bonds, But in the Raters

Credit Firms S&P and Moody's Are Awash in New Business; 'A Free Ride' of Growing Fees

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Rating Game

Facts on two credit raters:

■ S&P Ratings Services

History: Predecessor firm Standard Statistics began assigning bond ratings in 1916. Unit of McGraw-Hill

Analysts: Has 1,250 globally

■ Moody's Investors Svc.

History: Founded in 1900 by John Moody; parent is Moody's Corp.

Analysts: 1,000

As Wall Street investment banks devise ever more complicated ways to slice, dice and package the humble bond, analysts and academics can only guess what the impact will be on investors, markets and the banks themselves.

But no matter what happens, one group has benefited immensely: the companies whose job it is to rate all those new investments.

Analysts expect the two biggest credit-rating services, Standard & Poor's and Moody's Investors Service, to log the latest in a string of impressive annual earnings gains when their parent companies, McGraw-Hill Cos. and Moody's Corp., report 2005 results in coming weeks. One key driver of their success: record activity in the market for complex securities backed by mortgage loans, credit-card debt, corporate bonds and other assets -- an area known as "structured finance."

"They enjoy a free ride on the innovation of Wall Street," says William Bird, a stock analyst at Citigroup Inc. in New York, calling the recent growth of structured finance an "absolute boon" to the ratings firms. Citigroup does business with both

Moody's and McGraw-Hill.

Investors have taken notice, piling into Moody's stock, which has been the purest play in the ratings business since Dun & Bradstreet spun it off in 2000. As of 4 p.m. composite trading yesterday on the New York Stock Exchange, Moody's stock fetched \$62.43, up 49% from a year ago. That is 31 times the company's expected 2006 earnings, well above the broader market's price-to-earnings ratio of 15.

Ratings firms long have profited by issuing opinions on the packaged pools of credit-card and mortgage debt known as asset-backed securities -- a staple of structured finance. But more recently, Wall Street has added a twist, repackaging existing securities into collateralized-debt obligations, or CDOs.

Banks and, increasingly, hedge funds, create CDOs by buying up securities -- anything from mortgage-backed bonds to sovereign bonds to other CDOs -- and divvying up the income into slices with varying levels of exposure to the risk of losses. CDO sponsors then sell the slices to investors according to their tolerance for risk.

The advent of the CDO has expanded the ratings business, because CDO investors -- largely European and Asian banks and insurance companies -- tend to have specific requirements for the ratings of whatever securities they buy.

The ratings firms often get paid twice, first to rate the securities that get packaged into the CDOs, then to rate all the slices.

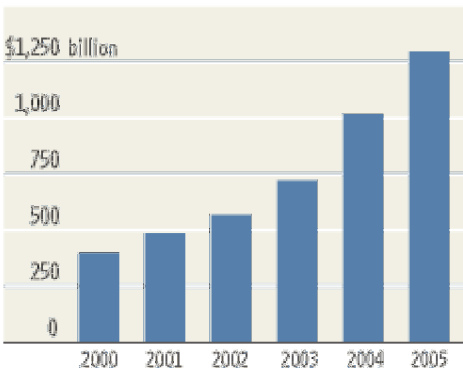
What's more, rating CDOs is a relatively complex business, so the ratings firms can charge extra: as much as 0.11% of a CDO's value, compared with about 0.04% for plain-vanilla bonds.

Debt Instruments

A look at the rise in "structured finance" and global debt's effect on Moody's Corp.'s stock price on the NYSE.

Growth in debt markets ...

Issuance of asset-backed securities in the global market*

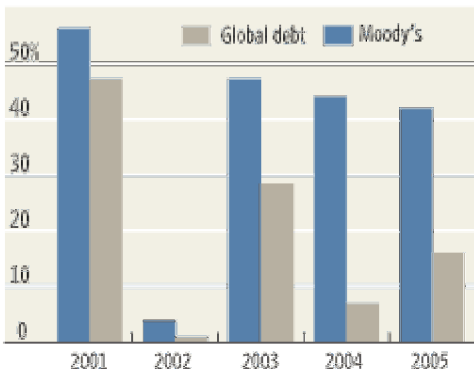


*Includes issuance of collateralized-debt obligations; excludes issues that are callable or can be sold back (or "put") in less than one year or are not underwritten.

Source: Thomson Financial

... means growth for those who rate them

Annual percentage change in Moody's Corp.'s stock price and global-debt issuance



CDO sponsors are all but obliged to get a rating from either Moody's or S&P, partly because they are the most widely recognized ratings firms and partly because the Securities and Exchange Commission has boosted their competitive advantage by officially recognizing their ratings.

This designation allows certain banks and insurers to use the ratings for regulatory purposes. The SEC also has recognized the third-largest ratings firm, Fitch Ratings, a subsidiary of

French business-services group Fimalac SA, as well as Dominion Bond Rating Service and A.M. Best Co. Moody's and S&P each control about 40% of the global ratings market.

Moody's alone rated about \$140 billion in CDO deals in 2005, up from less than \$100 billion in 2004 and next to nothing a decade ago.

John Neff, an analyst at Chicago-based investment bank William Blair & Co., expects Moody's total revenue from structured finance in 2005 to have reached about \$681 million, up 24% from 2004 and accounting for about half the company's ratings revenue. William Blair doesn't do business with Moody's.

McGraw-Hill Chief Executive Harold McGraw III recently cited structured finance and the CDO market as major areas of growth for S&P, though the parent company's financial statements provide less detail.

Both companies expect another year of double-digit growth in 2006, but they will face some headwinds. For one, mortgage lenders are likely to issue a lot fewer new mortgage-backed securities -- a revenue source that proved surprisingly strong in 2005 as unexpectedly low interest rates kept the mortgage market going.

Mr. McGraw has forecast a 10% decline in mortgage issuance, though in a recent poll by the Bond Market Association, a trade group, Wall Street bankers predicted a drop of more than 20%.

Analysts see room for growth in the European market, where the introduction of the euro has driven a boom in securitization. Still, given the tepid outlook in the U.S., William Blair's Mr. Neff doesn't see much upside in Moody's stock at the present high price. "I'm not recommending it for new money," he says.

The ratings firms also have attracted the attention of politicians and regulators. The House Committee on Financial Services, for example, has held hearings on a piece of legislation called "The Credit Rating Agency Duopoly Relief Act of 2005," which is aimed at increasing competition in the ratings business and giving the SEC more regulatory power.

The ratings firms have responded with proposals for self-regulation, though Moody's CEO Raymond McDaniel said in a conference call last week that the outcome in the U.S. remains "less certain" than in Europe, where politicians appear likely to eschew added legislation.

In a separate action, the New York state attorney general's office last year asked Moody's for information on how it rates mortgage-backed securities. Moody's has declined to comment further, and it

isn't clear whether the request was part of a larger investigation.

Whatever happens, though, most analysts think that, in the long term, S&P and Moody's are well placed to profit from the growth of debt markets and financial innovation.

"These two companies have very unique franchises," Citigroup's Mr. Bird says. "The barriers to entry are generally higher than most people appreciate, with or without regulations."

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