began to issue corporate bond ratings as part of its research service for private clients in the U.S. and Europe. A second Canadian agency, Dominion Bond Rating Service, opened its doors in Toronto in 1977. And London-based IBCA issued its first bank ratings in 1978.

Most, if not all, of these new agencies were looking to compete head-to-head with Moody's and S&P. To do so successfully they would need to be sure that their ratings could be used to meet ratings-based regulations in the U.S. markets. At the same time, regulators, notably the Securities and Exchange Commission, were concerned that new entrants to the rating industry should meet minimum quality standards. The first attempt at clarification came in 1975 as part of two new SEC regulations that applied to holdings of investment banks and mutual funds.

Under SEC Rule 15c3-3, regulated broker/dealers were subject to capital requirements (known as the Net Capital Rule) based, in part, on current ratings of securities held in their own accounts. SEC Rule 2a7 sought to assure the safety and liquidity of money market funds applying minimum rating standards to the funds' assets. Rather than naming specific rating agencies, the SEC introduced the term "Nationally Recognized Statistical Rating Organization" (NRSRO). The NRSRO concept was subsequently incorporated into regulations and guidelines of many state authorities, industry organizations, and mutual funds.

The old standards in the ratings business—Moody's, S&P, and Fitch—were deemed "nationally recognized" from the beginning. But criteria for inclusion of other rating agencies were not spelled out in detail. Instead, as new agencies applied for NRSRO status, several received "no action" letters indicating that the SEC would take no enforcement action if their ratings were used by companies to meet SEC rulings. Such letters were received by Duff & Phelps in 1982, and by McCarthy, Crisanti & Maffie in 1983. Subsequently, IBCA (1990), Thomson BankWatch (1991), Dominion Bond Ratings Service (2003), and A.M. Best (2005) also received no-action letters.

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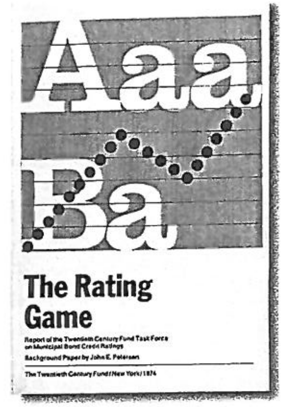
The letters provided some clarity on acceptable rating agency characteristics, including scrutiny of conflict of interest, adequate financial resources and staffing, sufficient training, and appropriate institutional separations to avoid mixing rating judgments with investment advice. But the process was severely criticized by potential new entrants as cumbersome, ill-defined, and anti-competitive.

THE RATING GAME REPORT

Throughout the 1970s, public controversy in the rating business continued to center on the quality of municipal ratings offered by the leading competitors—Moody's, S&P, and smaller Fitch.

The most significant development stemming from the questioning of municipal rating quality in the previous decade was the formation in 1971 of The Twentieth Century Fund Task Force on Municipal Bond Credit Ratings. The task force was a 13-member panel with representatives from across the municipal market, including New York State Senator Roy Goodman. The panel's findings, along with a background paper by John E. Peterson, were published in *The Rating Game*, April 1974.



The Task Force on Municipal Bond Credit Ratings, a 13-member panel organized by The Twentieth Century Fund, New York, released its findings in this report in April 1974. Overall, the task force concluded that "the rating agencies are doing a creditable job." But the report criticized the agencies for "lack of clarity about what ratings actually measure."

Overall, the task force concluded that "the rating agencies are doing a creditable job given the resources they use. The agencies now perform, on balance, a useful service to the public by enhancing the marketability of most of the municipal securities which receive ratings."

The panel members cautioned that "the great power of the ratings to influence market decisions imposes a responsibility on the rating system." If the system failed to live up to those responsibilities it can be changed in a variety of ways, the panel noted, citing potential public ownership of rating agencies, varying degrees of regulation, surveillance of ratings, and the establishment of supplementary services. The panel concluded, however, that "To most, public ownership or full regulation seems an extreme solution to an ill-defined problem."

Among its specific recommendations, the task force advised that rating agencies should be more explicit as to what their ratings were intended to measure and the criteria used in their appraisals. The panel members called for ratings to be regularly reviewed and revised whenever there was a material change, adding that "the agencies, the securities industry, and municipal governments should do more to educate the public on how to use ratings."

Every state, the members agreed, should improve reporting, making available timely, uniform, consolidated financial reports. They concluded further that regulators should avoid excessive reliance on ratings, which "not only places a heavy burden of dependency on the rating agencies, but also erodes competition and innovation in the area of credit analysis."

Likewise, the panel members did not believe that federal or state government oversight or sponsorship of the credit rating process was warranted. And they explained why: "Any element of compulsion in the formulation of credit ratings would be unwise and unhealthy. It would needlessly taint, if not destroy, their acceptability as objective opinions of investment quality."

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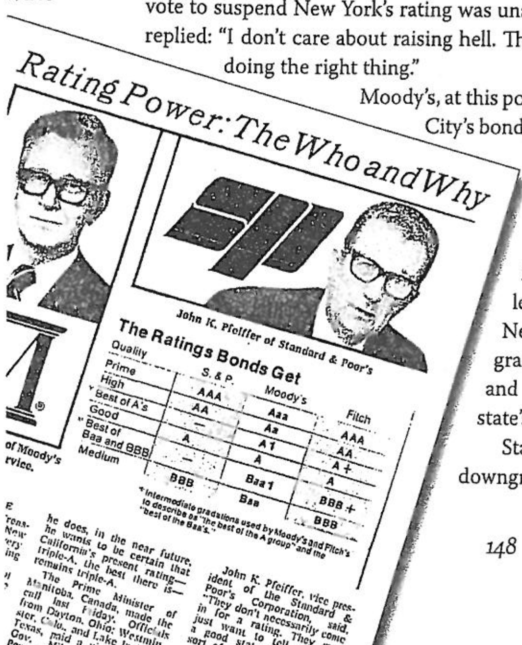
lew York Times,
9, 1975

"DOING THE RIGHT THING" IN NEW YORK

Aside from its rather flippant title, there was nothing in the 20th Century Fund study to suggest that criticism of municipal bond rating actions was soon to become even more vitriolic than it had been in the 1960s. In the 1970s, the controversy extended nationwide, as states and municipalities faced problems stemming from inflation and huge financing needs. As in the past, however, the focus of attention was on the financial woes of New York State and New York City.

Just a year after the "Rating Game" report came out, S&P suspended its single-A rating on New York City's debt securities, citing "the possible inability or unwillingness of the major underwriting banks to continue to purchase the city's notes and bonds." New York Mayor Abraham Beame immediately denounced the move. Controller Harrison J. Goldin called it "unfair." And Ben Weberman, financial editor of the American Banker and a member of the 20th Century Fund Task Force, commented that the suspension "doesn't do the rating agencies credit."

Defending the action, John K. Pfeiffer, head of municipal ratings at S&P, emphasized that eight analysts had participated in the recent rating committee and the vote to suspend New York's rating was unanimous. Asked about the furor, Pfeiffer replied: "I don't care about raising hell. That's part of doing your job. I care about doing the right thing."



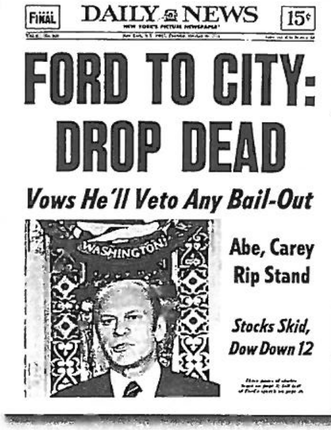
The Ratings Bonds Get

Quality	S. & P.	Moody's	Fitch
Prime	AAA	Aaa	AAA
High	AA	Aa	AA
*Best of A's	—	A1	A+
Good	A	A	A
*Best of Baa and BBB	—	Baa1	BBB+
Medium	BBB	Baa	BBB

*Intermediate gradations used by Moody's and Fitch's to describe as "the best of the A group" and the "best of the Baa's."

Moody's, at this point, maintained its A rating on New York City's bonds, and Jackson Phillips commented: "We haven't found any deterioration in the city's credit that merits a change in rating." But the city faced default in the summer of 1975, Moody's lowered its ratings on New York City bonds two letter grades to speculative-grade Ba. New York State bonds were also downgraded below the double-A category to A1, and Moody's withdrew its ratings on the state's tax and revenue anticipation notes.

State Controller Arthur Levitt called the downgrades "outrageous." But a month later,



New York Daily News, October 30, 1975

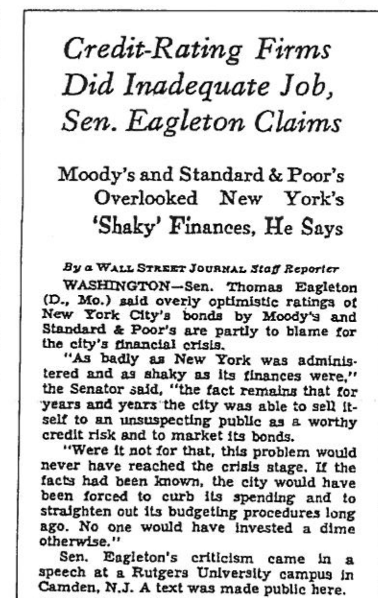
New York's financial problems deepened in October 1975, when President Gerald Ford decided not to provide Federal assistance. Shortly thereafter, New York declared a "moratorium" on repayment of $1.2 billion of short-term notes, and the Municipal Assistance Corporation was set up to address the city's financial woes.

Moody's had downgraded New York City's bonds to the Ba-level months before the crisis. But as reflected in various news reports, the rating agencies were taking heat for being too late to get tough on the bonds of New York City and many other state and local governments that faced similar stresses in the mid-1970s.

after the Ford Administration vetoed a rescue plan and the *New York Daily News* published its famous headline—"Ford to City: Drop Dead," Senator Thomas Eagleton took a different view. Eagleton sharply criticized both Moody's and S&P for not moving fast enough. "Even into 1975," he charged, "as New York was foundering on the financial rocks and was being abandoned by its crew of bankers, Moody's continued to signal 'All is well.'" Yet the strongest indictment was still to come.

On May 26, 1976, Moody's downgraded its rating on bonds of Municipal Assistance Corporation (MAC, the state agency set up to address New York City's financial crisis) from A all the way to speculative-grade B. The rating change occurred without warning, as MAC disclosed that it was preparing to sell $25 million of small-denomination bonds nicknamed "mini-MACs," and it led to immediate markdowns on outstanding MAC bonds. While S&P held its MAC ratings stable, Moody's cited the vulnerability of MAC revenues to New York City's precarious finances at a time when "bondholders' legal rights to security have been recently and repeatedly abrogated by the State legislature."

The Wall Street Journal
November 28, 1975



Credit-Rating Firms Did Inadequate Job, Sen. Eagleton Claims

Moody's and Standard & Poor's Overlooked New York's 'Shaky' Finances, He Says

By a Wall Street Journal *Staff Reporter*

WASHINGTON—Sen. Thomas Eagleton (D., Mo.) said overly optimistic ratings of New York City's bonds by Moody's and Standard & Poor's are partly to blame for the city's financial crisis.

"As badly as New York was administered and as shaky as its finances were," the Senator said, "the fact remains that for years and years the city was able to sell itself to an unsuspecting public as a worthy credit risk and to market its bonds.

"Were it not for that, this problem would never have reached the crisis stage. If the facts had been known, the city would have been forced to curb its spending and to straighten out its budgeting procedures long ago. No one would have invested a dime otherwise."

Sen. Eagleton's criticism came in a speech at a Rutgers University campus in Camden, N.J. A text was made public here.

The Rating Agencies Get Tough

By RICHARD PHALON

The New York Times, March 14, 1976

MOODY'S SLASHES M.A.C. BOND RATING FROM AN 'A' TO A 'B'

State Agency Calls Move 'Irresponsible'— Rohatyn Will Seek a Reversal

By JOHN H. ALLAN

Moody's Investors Service, a leading bond-rating company, sharply downgraded yesterday its rating of Municipal Assistance Corporation bonds, asserting that the state agency's recent moves to restructure its debt would adversely affect the security of the bonds as investments.

The action, a surprise to Wall Street, seemed certain to exert pressure on prices of M.A.C.

New York Times, 27, 1976

When Moody's cut its ratings on The Municipal Assistance Corporation (MAC) by three letter grades to B at the end of May 1976, the downgrade took the municipal bond market by surprise and MAC threatened suit. Jackson Phillips, head of Moody's municipal ratings, went to Washington a month later to explain the agency's position. A Congressional committee was considering a bill that would allow the Securities and Exchange Commission to reverse rating agency opinions, but the resolution died in committee. Phillips commented: "There's no threat that can make me change my mind on the MAC downgrading."

Phillips explained simply that "MAC has failed, and a failure is not going to get as good a mark as success." The first clear indication of that failure came in New York City's quarterly report to the U.S. Treasury, which showed that the city's financial plan was not working, thus bringing MAC's revenue into question. A few days later, MAC distributed a prospectus describing a $500 million exchange offer to city noteholders. Then on May 26, the corporation requested consents for amendments to its General Bond Resolution, without which MAC said it would be in default. Moody's lowered MAC's ratings the same day.

MAC TO MOODY'S: "WE'LL SUE"

The severity of the downgrade took the markets by surprise. MAC called the action "irresponsible," and MAC finance committee chairman Felix Rohatyn complained that Moody's had not given the agency a chance to appeal the decision. Several

MAC Set to Sue Moody's in Bid to Regain Investor Faith After Bond Downgrading

Prices of Recent Issues

The Wall Street Journal, April 9, 1975

After long meetings with Moody's and unsuccessful attempts to get the agency to rescind its rating action, MAC threatened suit.

days later, after long meetings with Moody's and unsuccessful attempts to get the agency to rescind its rating action, MAC threatened suit. The state agency said it would charge Moody's with negligence and misrepresentation and seek damages for bondholders' market losses in a class action in state court.

"The whole city will pay because they [Moody's] didn't do their homework, and I bitterly resent it," Rohatyn told a *Wall Street Journal* reporter. Asked for his response, Phillips said, "We change many ratings, and persons are rarely happy with a downgrading. They may express displeasure strongly, and this is in that category."

On June 24, Phillips was in Washington explaining Moody's recent rating actions and presenting testimony to a Congressional subcommittee on House Resolution 675, a bill introduced by Representative John M. Murphy of New York City just after the MAC downgrade. The resolution sought to require the Securities and Exchange Commission to set standards for making "accurate" ratings of municipal bonds. Under the proposed legislation, aggrieved issuers would also have been allowed to protest their ratings to the SEC, which, after a hearing, could order a revision.

In his testimony, Phillips pointed out that requiring the SEC either to set rating standards or to judge the merits of a protested rating would also require it to conduct the same research as that done by private rating agencies. This, said Phillips

> . . . would put the SEC squarely in the rating business and would do so in a way repugnant to the commonly held view of governmental authority—it would have the government ordering a person to change his opinions and judgments, however honestly held.

Phillips noted further that this was the third time that Moody's had been invited to testify "as a result of ratings that have not been to the liking of certain people in New York." Similar hearings had been held in 1967 and again in 1972. Phillips concluded his comments on H.R. 675 by referring to earlier testimony:

> New York State Comptroller Arthur Levitt spoke rightly at the 1972 hearings, when

he said: "To regulate ratings would eventually mean Federal control of public borrowing. The implications are frightening."

No legislation resulted from the 1976 hearings. Nor did MAC carry out its threat of legal action. But in September, the ratings controversy intensified when Rohatyn and George D. Gould, another top MAC officer, wrote a letter to Moody's charging that it was both "unfit" to rate MAC bonds and acting out of "political" motivations. They cited a letter signed by then Moody's president John D. Lockton Jr. that appeared to endorse the view that New York State had committed "one of the biggest fraudulent acts ever recorded" in the handling of the city's fiscal crisis. The MAC officials called Lockton's letter "reprehensible" and demanded that "Moody's should forthwith discontinue its rating of our securities."

Others applauded Moody's forthright stand, however. And many who were then associated with Moody's, including Bill Dwyer and municipals analyst Claire Cohen, later referred to Jackson Phillips' handling of the MAC ratings controversy as "courageous" and "heroic." At the time, despite the threat of suit, Phillips held firm, commenting: "There's no threat that can make me change my mind on the MAC downgrading."

In an editorial in *Barron's* titled "Emperor's New Clothes: the Naked Truth Finally Emerges About MAC," Robert M. Bleiberg called the New York ratings affair a "poignant Fable of Our Time," worthy of Andersen or Thurber. And in a feature article titled "Rating Game: Credit-Rating Firms Wield Greater Power in Public Debt Market," published in the *Wall Street Journal*, October 1976, staff reporter Michael L. Geczi summed up recent developments in this lead sentence: "The credit-rating business has come out of the closet, into the spotlight—and sometimes into battle."

Given that Moody's municipal ratings had been the subject of intense public scrutiny for well over a decade, Geczi's assessment was somewhat belated. It remained to be seen, however, whether Moody's would now be able to get its house in order to meet new competitive challenges across the corporate and municipal segments of the capital markets.

CHAPTER EIGHT

REINVENTING MOODY'S

The Arrival of Tom McGuire (1978–1983)

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"WHEN TOM SHOWED UP, everything changed immediately," recalls Fred Pastore, a commercial paper analyst at Moody's when Thomas J. McGuire joined the firm, December 30, 1977.

McGuire started out as vice president and director of the Commercial Paper Department. But from the beginning, according to Pastore, he began assessing Moody's opportunities and weaknesses across the corporate sector, and managing his staff in line with a larger vision of Moody's potential. Soon he began formulating the market-oriented business strategies in the agency's corporate bond franchise that would lead to a virtual reinvention of Moody's business.

McGuire got his financial training at one of Wall Street's leading investment banks. He came to Moody's directly from Goldman Sachs, where for several years he had served as head of the firm's commercial paper credit department. And he brought with him a direct, hands-on understanding of the fixed-income debt markets and fresh insights into the role of ratings in those markets.


Thomas J. McGuire, vice-president and director, Moody's Commercial Paper Department, December 1977

Although he didn't "stake his life" on sure success, as John Moody did when he launched the first manual of industrial securities in 1900, McGuire certainly saw that the rating business had a bright future—for Moody's, or for any other agency with strong analytic capability and the right understanding of market dynamics.

TECHNOLOGY AND INFLATION DRIVE CHANGE

McGuire's arrival coincided with the first waves in the dramatic growth, globalization, and technical sophistication of the capital markets during the post-World War II era, and he saw from the beginning that these trends would drive a huge global demand for credit ratings and credit risk research.

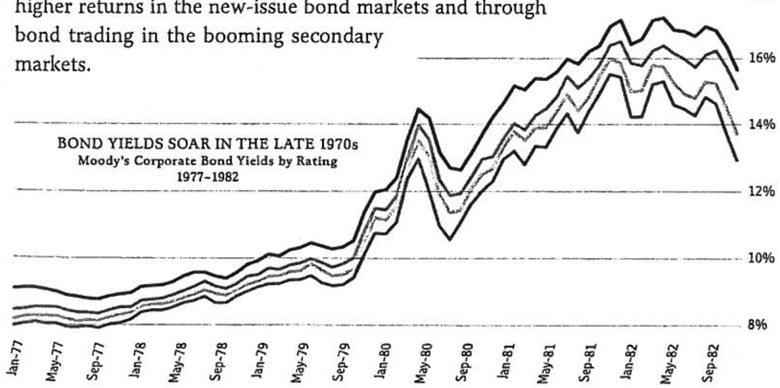
"What we are witnessing," as McGuire put it a few years later, "is a fracturing of the global savings process." It was occurring, he reasoned, as result of an ongoing shift in the pools of savings in economies around the world from their traditional home in the safety of a limited number of banks to a new home in open, less-protected securities markets. By the late 1970s, the early results of that shift could be seen in the resurgence of U.S. and international bond markets, in the rapid growth of commercial paper issuance, in the global increase in securities trading,

and in the development of new financial instruments such as mortgage-backed securities. The risks of open securities markets had already been made plain by the Penn Central Crisis, which had refocused investor attention on credit risk.

McGuire believed that the underlying force driving these developments—advances in information technology—would have an ever greater impact in years to come. As he put it in a later presentation to the D&B board of directors:

> [Technology] permits people to exchange information without the usual limitations of time or distance. It allows the management of vast amounts of data and the distillation of statistically verifiable conclusions needed to make complex decisions. These technological advances are reshaping the formation of capital and the role of financial intermediation. The pace of their exploitation is being accelerated by the speed of government deregulation and by the creativity of the players in the financial markets.
>
> Globalization of the financial markets is the first result of these forces. Financial markets are expanding geographically and are blending into a single, twenty four-hour world capital market. Although this globalization phenomenon is becoming a cliché, it is having a revolutionary impact on the financial markets.

In the late 1970s through the early 1980s, two additional factors served to accelerate these underlying trends: inflation and a sharp accompanying rise in interest rates. As inflation surged, yields on benchmark Aaa-rated bonds rose to 15 percent in 1981, up from 8 percent in 1977. For fixed-income investors, this had the double effect of trimming the value of existing bond portfolios and opening opportunities for investors to compensate for those losses by reaching for higher returns in the new-issue bond markets and through bond trading in the booming secondary markets.



The runaway inflation of the late 1970s and early 1980s had a profound effect on the rating industry. As yields on corporate bonds rose to multi-decade highs, most major bond buyers began managing their fixed-income portfolios day to day. Demand for timely, reliable credit research grew in tandem, while advances in information technology provided new tools for active portfolio management.

To cope, institutional investors were forced to switch from their traditional buy-and-hold investment strategies to active portfolio management and "total return" investing. Where credit ratings had once been consulted mainly when investors made long-term purchase decisions, credit research now came to play a day-to-day role. Rising interest rates had the additional effect of widening credit spreads (the difference in yields between bonds in different rating categories). That, in turn, led to an automatic increase in the monetary value of high-quality credit risk analysis.

Credit research became so important across the debt markets that by the late 1970s, nearly all the major investment institutions were building up their own research functions to support the increasingly time-sensitive management of their fixed-income portfolios. At the same time, investors began to second guess the rating agencies and to anticipate changes in their ratings.

MOODY'S IN 1977

When Tom McGuire arrived at Moody's, he found a company unprepared to meet investor needs in this new market-oriented environment.

When McGuire arrived at Moody's, he found a company unprepared to meet investor needs in this new market-driven environment. In 1977, Moody's Commercial Paper Department consisted of six analysts, among them Pastore, Jim Bray, and Fred Price, who had been brought over from D&B's commercial credit operations by George Keefe. Moody's Corporate Bond Department was headed by Harold Goldberg, who had also been transferred from D&B Credit by Keefe. The team he led included vice president Sam Gordon and five other analysts, including Peter Jadrosich and Scott Douglass, who would later play a key role in helping McGuire to make Moody's more market-oriented.

Together with support staff, the two departments occupied a bit less than half of the ninth floor at 99 Church Street. In total, they rated some 2,000 companies. Credits were assigned to analysts alphabetically. Rating committees were held during lunch around a table in the cafeteria. And Moody's telephone switchboard closed promptly at 5:00 p.m. each day. Write-ups on new and changed commercial paper ratings were mimeographed and mailed to a small group of subscribers, while those on bond ratings were only published weekly in Moody's Bond Survey. No press releases were sent out, and no one at Moody's was allowed to speak with investors for fear of divulging market-moving information. Instead, corporate analysts were required to spend a large portion of their time writing fact sheets for Moody's handbooks and manuals.

Moody's Municipal Bond Department, under Jackson Phillips, occupied the other half of the ninth floor. As Moody's then rated debt of some 18,000 municipalities, the municipal department was larger than Moody's corporate operations, with a staff of around 30 analysts and junior analysts. Municipal rating committees were held twice daily. Write-ups on new and changed ratings appeared in Moody's Municipal Credit Reports, which were distributed daily to subscribers.

Moody's Publications Department, headed by executive vice president and Moody's publisher William O. Dwyer, occupied the seventh floor, with a staff of 50-60, including editors and production people for Moody's manuals, stock guides, and the Bond Survey weekly.

Overall, the agency's primary focus was on publishing ratings, not on meeting investor needs for timely credit research. As McGuire later put it, the company was "a passive organization that saw itself as caretaker . . . suspicious of investors and uninterested in competitors . . . an organization devoted almost exclusively to production of ratings."

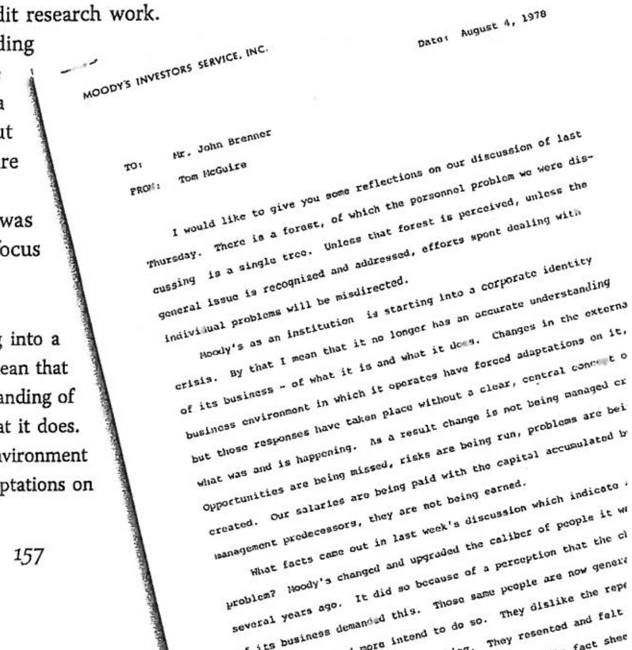
PRESSING FOR CHANGE

In August 1978, McGuire expressed his views in a memo to Moody's president John Brenner, written in response to Brenner's concern over the high level of staff turnover in the Commercial Paper Department. McGuire pointed out that while Moody's had made efforts to upgrade the quality of its analytic staff, salaries were extremely low by Wall Street standards, and analysts received little support in their day-to-day credit research work. "What we have done by simply upgrading our hiring of entry level analysts," he averred, "is the equivalent to building a steel mill in a banana republic. Without roads, electricity and ports, things are bound to go wrong."

What was needed, said McGuire, was a fundamental change in the business focus of the company:

> Moody's as an institution is starting into a corporate identity crisis. By that I mean that it no longer has an accurate understanding of its business — of what it is and what it does. Changes in the external business environment in which it operates have forced adaptations on

A few months after arriving at Moody's, Tom McGuire began pressing for a fundamental change in the business focus of the company, notably in this 1978 memo to Moody's president John Brenner.


MOODY'S INVESTORS SERVICE, INC.

Date: August 4, 1978

TO: Mr. John Brenner
FROM: Tom McGuire

I would like to give you some reflections on our discussion of last Thursday. There is a forest, of which the personnel problem we were discussing is a single tree. Unless that forest is perceived, unless the general issue is recognized and addressed, efforts spent dealing with individual problems will be misdirected.

Moody's as an institution is starting into a corporate identity crisis. By that I mean that it no longer has an accurate understanding of its business - of what it is and what it does. Changes in the externa business environment in which it operates have forced adaptations on it, but those responses have taken place without a clear, central conc o what was and is happening. As a result change is not being managed cr Opportunities are being missed, risks are being run, problems are bei created. Our salaries are being paid with the capital accumulated b management predecessors, they are not being earned.

What facts came out in last week's discussion which indicate problem? Moody's changed and upgraded the caliber of people it w several years ago. It did so because of a perception that the cl of its business demanded this. Those same people are now genera and more intend to do so. They dislike the rep ishing. They resented and felt ite fact shee

t quickly ecame obvious o his managers hat McGuire ossessed ormidable hetorical kills, a forceful ersonality, nd what Bill Dwyer alled a nissionary eal."

> it, but those responses have taken place without a clear, central concept of what was and is happening. As a result, change is not being managed creatively. Opportunities are being missed, risks are being run, problems are being created. Our salaries are being paid with the capital accumulated by our management predecessors, they are not being earned . . .
>
> Corporations that do not recognize and manage change eventually find that reality rears up and hits them in the net income line. Corporations that do succeed in managing change make profit. In doing so they provide services the economy needs, they reward their stockholders with capital growth, they enrich the lives of their employees, and they pay their managers well.

It quickly became obvious to his managers that McGuire possessed formidable rhetorical skills, a forceful personality, and what Bill Dwyer called a "missionary zeal."

QUALITY STAFF AND VALUE-BASED PRICING

McGuire's first move at Moody's was to press for an upgrade of both the firm's analytic staff and the organizational environment in which they operated. He wrote more memos such as the one quoted above and took every opportunity to explain his views on Moody's position in the rating business and the strategic changes needed to take advantage of that position. He hired analysts from outside Moody's, including Kenneth Pinkes and Douglas Watson, who would soon play a critical role in Moody's strategic initiatives. And he let it be known to current analysts that standards were high and that they were in a "sink or swim" situation under his leadership.

Those who were working in the Commercial Paper Department at the time remember the pressure of that mandate. One analyst who would soon leave the firm was overheard downstairs in the D&B lunchroom grumbling that in coming to Moody's McGuire had, in effect, changed places with the previous head of the Commercial Paper Department. He was referring to Dick Davis, who had gone to head up Goldman Sachs' commercial paper credit function. Said the analyst: "We sure got the short end of that trade!"

D&B management would have reason to disagree with that assessment, for McGuire's next move was to bring pricing for Moody's commercial paper ratings more in line with market realities. In 1976, when Moody's began issuing two-page reports on new and changed commercial paper ratings, the issuer fee was raised to $200. Fees had subsequently been raised again. But under McGuire, the agency

began to shift commercial paper ratings fees to what he called "value-based pricing." In an October 1978 memo to Brenner, he argued that fees should be based on the "value derived by the purchaser of those services; i.e., his savings over his alternative borrowing cost." That, said McGuire, would involve pricing on average outstandings.

In other words, major issuers with large volumes of commercial paper outstanding would pay more than those with smaller programs in return for the added value the rating provided in the way of stable access to low-cost borrowing. "For example," he explained, "an issuer like Amgro, with $21 million outstanding during the base period, will be charged $8,000. . . General Motors Acceptance, with $7.8 billion outstanding, will be charged $25,000." As a result of the new fee structure, the operating profit contribution of Moody's commercial paper rating fees increased three-fold.

As a result of the new fee structure, the operating profit contribution of Moody's commercial paper rating fees increased three-fold.

MOODY'S COMMERCIAL PAPER RECORD

A third McGuire initiative would be just as important as staffing and pricing for the future success of Moody's. Shortly after his arrival at the firm, McGuire had set up a New Product Development Task Force. Its purpose was to explore ways to expand rating coverage and to improve research services.

The first step in that process—one that would become the first step in all of Moody's subsequent service extensions—was to meet directly with the major institutional investors and market intermediaries to assess their current research needs. McGuire and key analysts began making personal calls early in 1978. They came away with a variety of suggestions, including requests for rating coverage of bank certificates of deposit, Eurobonds, and Euronotes. Investors also pointed to the need for refinements of rating categories, which would be an aid in bond trading; announcements of Moody's thinking when ratings were placed under review for possible change; and electronic delivery of rating-related information.

Each of these requests would be implemented over the next few years. The first order of business was to improve the way Moody's ratings and research on commercial paper issuers were delivered to market participants. McGuire later described the process this way:

> I sent our analysts out to what were then regarded as the most sophisticated investing institutions in the commercial paper market to ask what information they were using for CP investments and what other information they would like. We then took

all their requests and systematized them. We next went to all the issuers rated by Moody's and requested them to provide us with that information and systemized it into the present Commercial Paper Record Service. We then discontinued the report service we had previously sold to investors. We next requested and received from the large direct users of commercial paper, and from the major Wall Street commercial paper dealers, complete lists of all investors who purchased commercial paper from them.

Next we informed the issuers that their commercial paper rating fees to Moody's would henceforth be used to subsidize the free distribution to all investors in the commercial paper market of the information Moody's thought investors should have—that which we had put into our Commercial Paper Record publication . . .

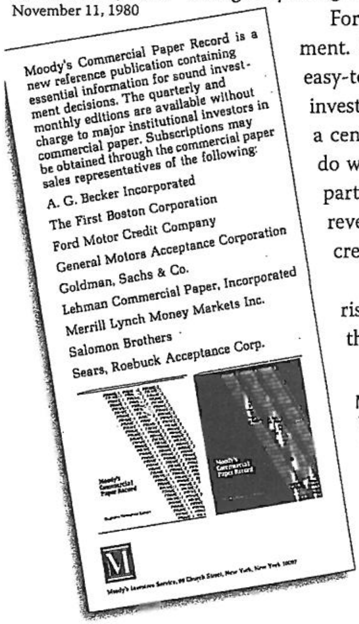
We believe those actions played some small role in the order and stability of the U.S. commercial paper market during a very tumultuous period.

Moody's Commercial Paper Record (CPR) was announced in an ad in the *Wall Street Journal* on November 17, 1980. The monthly publication listed commercial paper issuers alphabetically, along with their ratings and key data. All issuers and their financials were also listed according to their short- and long-term rating levels. A separate quarterly edition of the CPR included a summary opinion on each issuer's short-term credit position, and subscribers received updates on rating changes by mailgram.

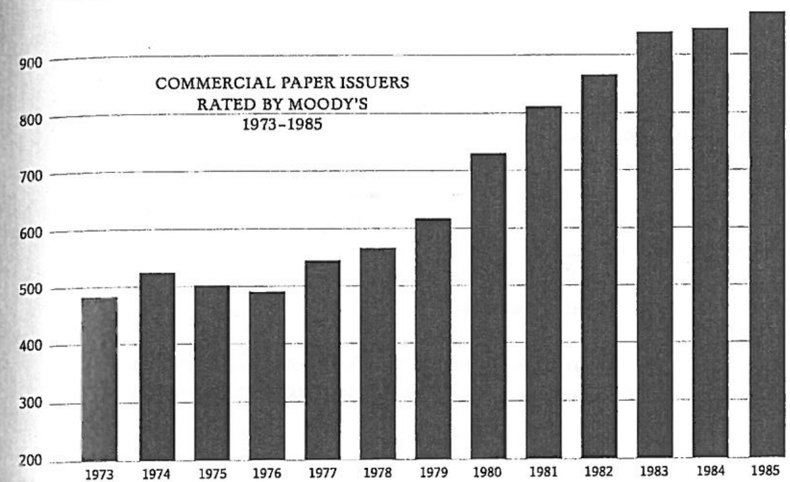
For Moody's, the CPR's format was not a revolutionary development. Moody's stock handbooks were also published in a concise, easy-to-use format tailored to the needs of investors (albeit individual investors). For a company that had spent the last three-quarters of a century selling its manuals and guides, the biggest change had to do with its pricing. Since the CPR was distributed free to all major participants in the commercial paper markets, it did not generate revenues directly. Rather, its purpose was to build the relevance and credibility of Moody's ratings and services.

On the one hand, this meant that Moody's was taking more risk, because faulty analysis would be more readily exposed. On the other hand, the greater transparency would enhance the efficiency of the system, thus adding value for investors, issuers, and the markets as a whole.

The Wall Street Journal, November 11, 1980



Moody's launched its new *Commercial Paper Record* with this ad. To build the value of Moody's ratings, the monthly publication was carefully tailored to meet current credit research needs and mailed free of charge to a list of 10,000 commercial paper market participants in 5,000 institutions.



Moody's rating coverage in the commercial paper markets began to rise sharply beginning in the late 1970s, due in part to increased demand for a low-risk, short-term investment vehicle and in part to improvements in Moody's commercial paper research services.

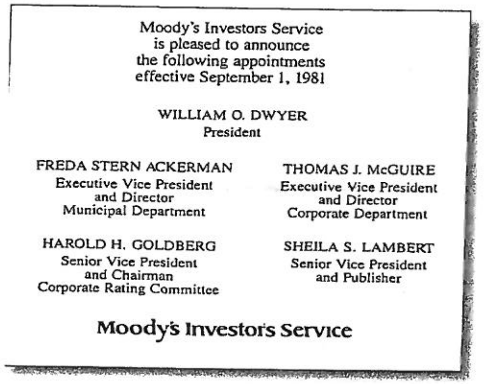
As a result of the CPR initiative Moody's did in fact remain relevant in the commercial paper market. Investors welcomed the publication. Rating revenues increased. And the number of Moody's-rated issuers of commercial paper rose to nearly 1,000 by 1985, up from 545 in 1977.

As a result of the CPR initiative Moody's did in fact remain relevant in the commercial paper market.

MOODY'S REGROUPS AS COMPETITION MOUNTS

In 1981 Moody's merged its bond and commercial paper rating departments. Running the departments separately had led to internal redundancy and external confusion. Since most major companies were borrowing in both markets, there were two separate Moody's analytic groups rating their credit, often with poor coordination between them. Further, the Product Development Task Force had been researching market needs across both portions of the corporate markets for several years, and McGuire had many ideas on how the departments could work as one.

On September 1, William O. Dwyer was named president of Moody's and John Brenner moved back to Dun & Bradstreet to head its Credit Services division. McGuire was named executive vice president and director of the new



As part of a major reorganization of Moody's announced August 5, 1981, William O. Dwyer was named president. Freda Stern Ackerman was named director of Moody's Municipal Department. Thomas J. McGuire became the director of Moody's Corporate Department, which combined the firm's commercial paper and bond rating operations.

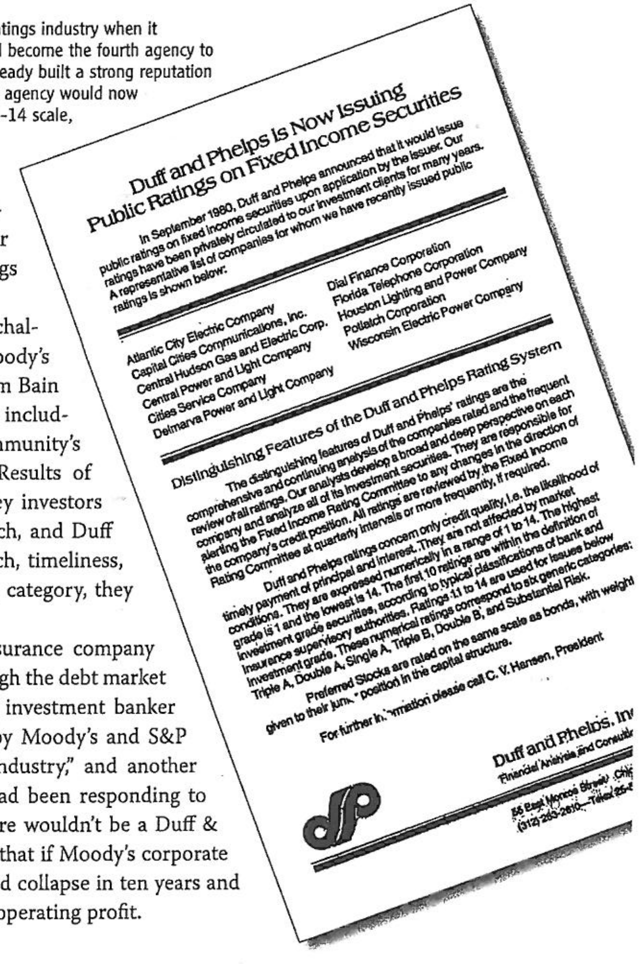
Corporate Department. Harold H. Goldberg, who had been head of the Corporate Bond Department, became chairman of Moody's Corporate Rating Committee. Freda Ackerman was named executive vice president and continued on as director of Moody's Municipal Department. (Ackerman had been named director of Moody's Municipal Bond Department in 1979, after Jackson Phillips died suddenly in February of that year.)

Both new departments faced strong competitive challenges. Two months after the reorganization, the Municipal Department came under fire in a feature story in the *Wall Street Journal:* "The Rating Game: Moody's Dominance in the Municipals Market is Slowly Being Eroded." The article cited Moody's slow response to New York City's financial crisis in the mid-1970s, staff turnover, and a focus on production over analysis. Municipal market participants were also unhappy, the *Journal* reported, with what they saw as an inadequate response by both Moody's and S&P to developing credit issues at Washington Public Power Supply System—WPPSS, soon to be dubbed "Whoops." (Moody's activities over the next fifteen years in the U.S. municipals markets are discussed beginning page __.)

Meanwhile, Moody's corporate rating franchise was facing a far bigger challenge. Duff & Phelps, a research house out of Chicago, had begun to leverage its high-quality equity analysis to provide bond research to institutional investors, using the same sort of market-oriented strategy that McGuire had introduced in the commercial paper market. Although not yet named by the SEC as a Nationally Recognized Statistical Rating Organization, Duff had been offering bond ratings as a part of its private research service since 1976. Its ratings were being widely used by institutional investors for bond pricing and by investment bankers for selling the bonds of their issuer clients.

In September 1980, Duff announced that it would "issue public ratings on fixed-income securities upon application by the issuer." On December 22, the agency ran an ad in *The Wall Street Journal* promoting its strengths over the established rating firms. The ad stressed Duff's "comprehensive and continuing analysis" of rated companies, along with its "broad and deep perspective" on each issuer. The

Duff and Phelps heated up competition in the ratings industry when it announced on December 22, 1980 that it would become the fourth agency to issue publicly available credit ratings. Having already built a strong reputation with its private ratings and research services the agency would now rank corporate bonds and preferred stock on a 1-14 scale, and it promised frequent reviews of all ratings.



firm emphasized finer rating distinctions than offered by either Moody's or S&P and promised reviews of all ratings at least quarterly.

The strength of Duff's competitive challenge was not fully recognized until Moody's brought in management consulting firm Bain & Company to do a strategic review, including a survey of the investment community's opinions about the rating agencies. Results of that survey came as a huge shock. Key investors were asked to rank Moody's, S&P, Fitch, and Duff on attributes such as quality of research, timeliness, and overall reputation. In nearly every category, they viewed Duff as the industry leader.

An investment manager at an insurance company said that "Moody's and S&P drive through the debt market looking in the rear-view mirror." One investment banker commented that "Poor performance by Moody's and S&P has made credit research a growth industry," and another observed that "If Moody's and S&P had been responding to the market in any reasonable way, there wouldn't be a Duff & Phelps." Overall, Bain & Co. predicted that if Moody's corporate business did not change course it would collapse in ten years and cost Dun & Bradstreet millions in lost operating profit.

MAKING THE RATING PROCESS MORE TRANSPARENT

Moody's did change course. McGuire tapped bond analyst Scott Douglass to coordinate the effort, working closely with directors Ken Pinkes and Sam Gordon, and associate director Doug Watson. With Bill Dwyer's support, they began to mobilize the Corporate Department to defend Moody's position. "We developed a strategy,"

"We developed a strategy for repositioning our business to be in touch with customers, to understand their needs, and then to supply those needs at a lower cost than our competitors."

McGuire recalled later, "for repositioning our business to be in touch with customers, to understand their needs, and then to supply those needs at a lower cost than our competitors."

Beginning with market research, the program involved the creation of an entirely new, investor-focused research service; greater access to Moody's analysts for investors, investment bankers, and the financial media; refinement of Moody's ratings and rating practices; and a build-up in the staffing and computer-based infrastructure needed to support both Moody's analytics and its move toward greater market transparency.

Moody's first-ever press releases on rating actions began to come out in late 1981. The releases were written by analysts using a standard front-loaded format, beginning with a statement of exactly which ratings were involved, and followed by a concise description of Moody's analytical rationale as agreed by the relevant rating committee members. The releases were messengered or faxed to key financial journalists, and the associate director and lead analyst following the credit were identified on each release. Journalists were invited to call for further clarification, and a press desk was set up to help them get through to the analysts they wanted to speak with.

By early 1982, the financial media began playing an important role in disseminating timely rating information to the bond markets. Most rating actions were being picked up immediately by the wire services and rating news was beginning to be a regular feature in the bond pages of *The Wall Street Journal* and *The New York Times.* In a release on March 21, 1982, for example, Moody's announced that it had

The Wall Street Journal, March 22, 1982

Moody's Cuts 9 Big Bank Firms' Ratings On Senior Long-Term Debt to Double-A

By Julie Salamon
Staff Reporter of The Wall Street Journal

NEW YORK—Moody's Investors Service Inc. lowered ratings on the senior long-term debt of nine big bank holding companies, saying that deregulation and inflation have weakened bank balance sheets and "permanently altered the competitive environment of the industry."

Ratings were lowered to double-A from triple-A for BankAmerica Corp., Chase Manhattan Corp., Chemical New York Corp., Continental Illinois Corp., First Bank System Inc., Manufacturers Hanover Corp., Mellon National Corp., National City Corp. and Northwest Bancorp. Moody's lowered

to repay their loans, which are among a bank's assets. "The reason for concern with asset quality is obvious," said Moody's. "If enough borrowers fail to repay, then the bank's ability to meet its own creditors will be jeopardized."

Loan quality has declined steadily for the past 35 years, Moody's said. Net charge-offs averaged 0.4% in the 1970s compared with 0.2% in the 1960s, and "There are already indications of a deterioration related to the current recession," Moody's said, citing a large increase in nonperforming assets at big banks.

BankAmerica's nonperforming loans nearly tripled last year, as did those of J.P.

lowered the long-term debt ratings of nine money center banks to Aa. The banks had held Aaa status for nearly a decade, since Moody's began rating bank holding company debt in the mid 1970s. *The Wall Street Journal* reported that the move surprised few traders, one of whom said, simply, that "Everyone's concerned about the banks . . . Continued high interest rates, foreign exposure, and the weakness in the economy all indicate that bad loans will increase." Chase Manhattan Bank held a different view, commenting through a spokesperson that "We completely disagree with the rating change."

Harold Goldberg, chairman, Moody's Corporate Rating Committee

As chairman of Moody's Corporate Rating Committee, Harold Goldberg was well aware of the impact the move would have on bank management. "Many of us didn't sleep the night before," he said at the time, "but we knew it was the right move." In any case, it had become clear to participants in the corporate bond markets that Moody's culture was changing and that analysts were now willing to "do the right thing" in public.

In a release on April 26, Moody's announced the refinement of its corporate bond rating categories, using the numbers 1, 2, or 3 to indicate that a credit was in the upper, middle, or lower range, respectively, of rating categories Aa through B. (S&P and several other rating agencies had begun making similar distinctions several years earlier.)

In effect, the refinements increased the number of rating categories in Moody's corporate bond rating system to nineteen from nine. As the agency began issuing releases on all rating changes, the volume of press releases likewise doubled. Over the next year, Moody's also began making announcements by press release whenever ratings were placed on review for possible rating change. And in subsequent years, press coverage mushroomed with the expansion of rating coverage geographically and by sector. Today Moody's issues some 300 to 400 press releases each week, up from one or two a week in late 1981.

Moody's Adds Numbers To Bond-Rating System

By a Wall Street Journal Staff Reporter

NEW YORK—Moody's Investors Services Inc. has added numbers to its letter system of rating corporate bonds.

If the number one is added to the letter rating, it means the bond ranked at the high end of the rating category. The number two denotes a mid-range ranking and the number three designates the low end of a rating category.

Five of Moody's nine corporate bond-rating symbols are affected: double-A, single-A, Baa, Ba and single-B. About 1,200 companies have had their ratings modified, Moody's said.

Thomas J. McGuire, executive vice president of Moody's said the numbers are designed to provide investors with "a better assessment of corporate credit quality." In effect, Moody's increased the number of possible credit ratings to 19 from nine, he said.

On April 26, 1982, Moody's announced the refinement of its corporate bond rating categories, using the numbers 1, 2, and 3 to indicate that a credit was, respectively, in the upper, middle, or lower range of rating categories Aa through B.

RATING CHANGE NEWS COVERAGE

After Moody's began issuing rating change press releases in late 1981, press coverage by the financial wire services and print media soon played an important role in timely communication of rating opinions to the fixed-income marketplace.

Continental Illinois Rating on Senior Debt Is Lowered by Moody's

By a Wall Street Journal Staff Reporter

CHICAGO — Moody's Investors Service Inc. said it lowered the senior-debt rating of Continental I... double-A-3.

Moody's Lifts Ratings On Debt of Chrysler And Its Finance Unit

By a Wall Street Journal Staff Reporter

NEW YORK—Moody's Investors Service Inc. said it raised its ratings on several debt issues of Chrysler Corp. and its automotive finance subsidiary.

GM Debt Rating Cut One Notch From Triple-A

Moody's Acts as Firm Plans To Seek Up to $6 Billion In Public Debt Offering

By John Koten

Baxter Rating on Debt Is Raised by Moody's

By a Wall Street Journal Staff Reporter

NEW YORK—Moody's Investors Service Inc. said it raised its rating on the convertible subordinated debentures outstanding of Baxter Travenol Laboratories Inc. to double-A-3 from single-A-2.

Moody's cited the company's cost-reduction and asset-management programs, which it said "should lead to the continuation of the improving profit margins and return measurements." It said the Deerfield, Ill., ...

Moody's Cuts Ratings On Bethlehem Steel, Amax Inc. Debt Issues

By a Wall Street Journal Staff Reporter

NEW YORK—Moody's Investors Service Inc. lowered by one level its ratings on several Bethlehem Steel Corp. debt issues.

Minnesota Gas Paper Gets Highest Rating By Moody's Investors

By a Wall Street Journal Staff Reporter

NEW YORK—Moody's Investors Services Inc. assigned a prime-1 commercial paper rating to Minnesota Gas Co. ...

Rating of Citicorp's Senior Debt Is Lowered By Moody's Investors

By a Wall Street Journal Staff Reporter

Moody's Cuts Ratings On RCA Securities

By a Wall Street Journal Staff Reporter

NEW YORK—Moody's Investors ... Inc. said it lowered its rating ... Corp.'s preferred stock and conver... bentures to BA from BAA.

Moody's Raises Rating On Mortgage Bonds Of Consolidated Edison

By a Wall Street Journal Staff Reporter

NEW YORK—Moody's Investors Service Inc. said it raised its rating on Consolidated Edison Co.'s first and refunding mortgage bonds to double-A-2 from single A-1.

The ratings service said the change reflects Con Edison's "ability to achieve and maintain a high degree of financial strength and stability." Moody's last raised the utility's rating in August 1979. "The company's capital structure is among the best in the industry," the analysis said. "The stable pattern of demand for electricity in the company's service territory is forecast to continue."

The rating increase affects about $2.5 billion in long-term debt. Con Edison provides electricity, natural gas and steam to customers in New York City and Westchester County, N.Y.

Moody's Cuts Rating On Woolworth Debt

By a Wall Street Journal Staff Reporter

NEW YORK—Moody's Investors Service Inc. lowered its rating on F.W. Woolworth Co.'s senior debt a notch from single-A to Baa, its lowest investment grade.

Moody's said the move reflects continued weak operating results, particularly in the U.S. Woolco division. Woolworth executives weren't available for comment.

"Although the company has begun to take corrective measures," the rating agency said, "significant improvement in this important segment's earnings is not foreseen for the intermediate term."

In recent quarters, Woolworth's variety and discount stores in the U.S. have experienced declining profits and lackluster sales.

Most recently, the company reported net income of $15 million, or 49 cents a share, for the fiscal second quarter ended July 31, but only after $29 million of nonrecurring credits.

BUILDING A "HIGH-TOUCH" RESEARCH SERVICE

Of all the efforts to better communicate Moody's ratings and analysis to capital market participants, the introduction of Moody's Corporate Credit Research service was far and away the most important. It was not launched formally until 1984, but service development began much earlier.

As it had been with the Commercial Paper Record service, McGuire's aim from the outset was to create a corporate bond service that would do the best job possible of meeting the research needs of investors, thereby building the credibility of Moody's ratings and enhancing their securities placement value for issuers. Analysis of the corporate bond market participants in 1981 showed plainly and simply how that aim could be achieved.

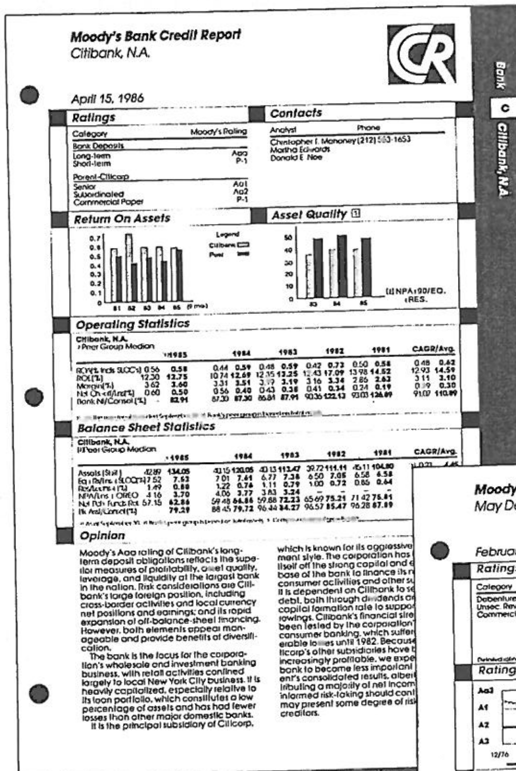
Notably, the research revealed that Duff & Phelps had been capitalizing on the market's increasing concentration. On the sell-side, it was found that the top 400 issuers accounted for 80 percent of outstanding debt. "By concentrating high-quality analysis on these issuers rather than the 2,000 companies Moody's was following," McGuire later explained, "Duff had been able to meet the bulk of the information needs of institutional bond purchasers with a limited and focused investment."

On the buy-side, likewise, the largest 400 institutions were purchasing 80 percent of corporate bonds sold each year. By focusing on the major investors, Duff had been marketing their research and ratings through a "high-touch" service that had started to move bond prices.

McGuire's concern was not the loss of investor revenues to Duff. Subscriptions then represented less that 10 percent of revenues and had a low growth rate. His concern, rather, was the loss of rating fees when bond issuers realized, as he put it, "that they were paying an emperor who had no clothes on, one who had little influence over the investors who purchased their bonds." In response, Moody's representatives conducted a series of meetings with the largest investor institutions to assess their research needs in the corporate sector. "We went out with the bare rudiments," said McGuire, "a chassis and four wheels, and let those investors tell us how they wanted their car built."

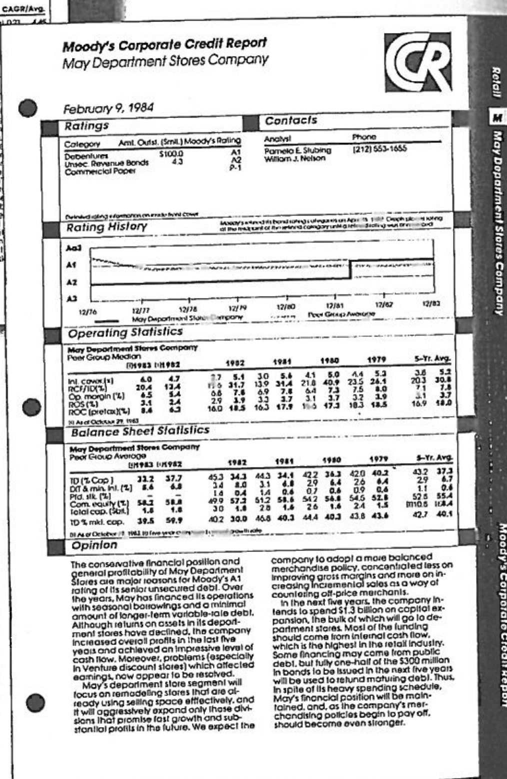
"We went out with the bare rudiments, a chassis and four wheels, and let those investors tell us how they wanted their car built."

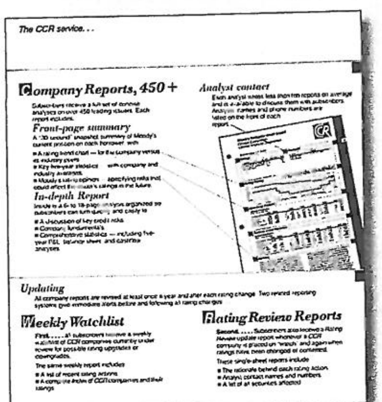
The centerpiece of the resulting vehicle was a series of annual, in-depth research reports—called Corporate Credit Reports (CCRs)—on the 400 largest issuers in the U.S. capital market. The front page of each CCR listed Moody's ratings on the issuer, along with a brief Rating Opinion summarizing the analysis underpinning the ratings. Following a carefully crafted format, each front page also included a snapshot history of the issuer's rating trends over the preceding five years, along with key five-year financials for the company compared with averages for its peer

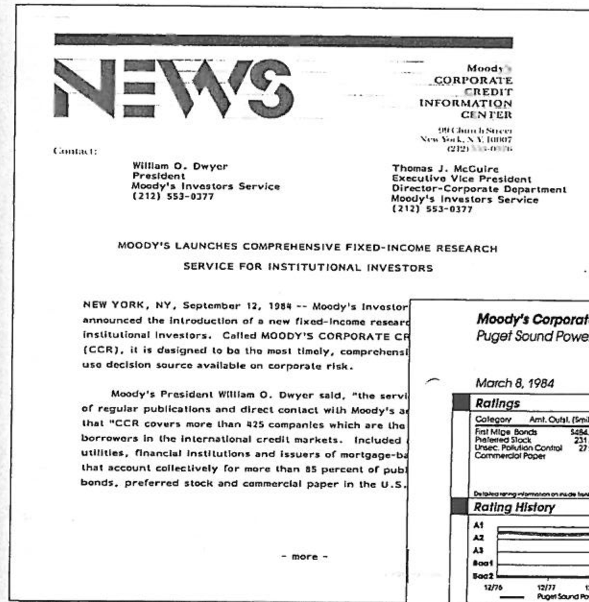


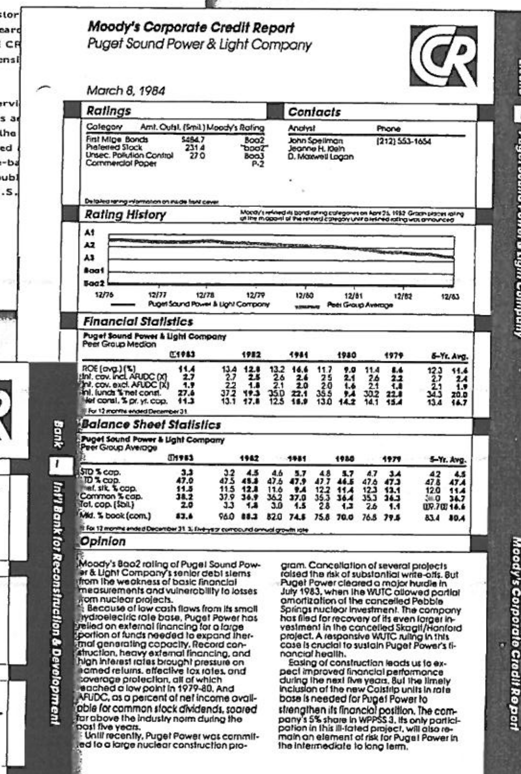
MOODY'S CORPORATE CREDIT REPORTS

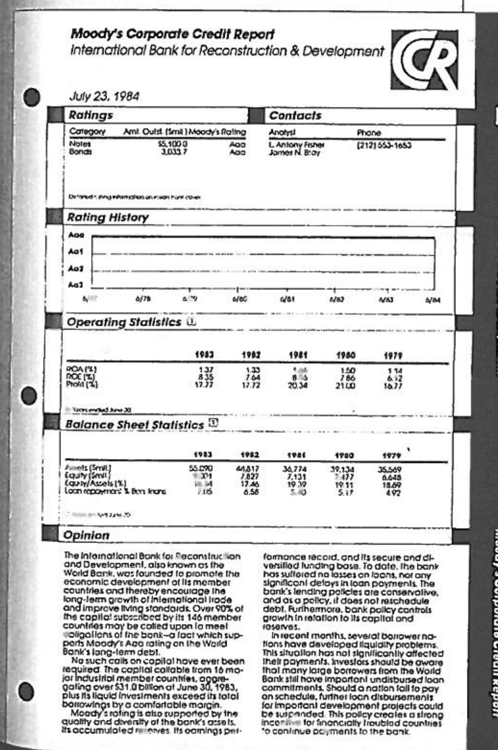
THE SERVICE was the centerpiece of Moody's drive to build the value of its corporate ratings and research in the early 1980s. Each issuer report featured a concise Summary Opinion and credit statistics on page one, followed by a forward-looking review of company fundamentals. The service also included direct access to Moody's analysts, a weekly ratings watchlist, and immediate faxes on all rating actions. Formally announced in 1984, an early version of the service was placed with 500 of the nation's largest institutional investors a year earlier.











group. Inside was a concise discussion of company fundamentals, a financial analysis, and statistics drawn from Moody's corporate database.

The CCR service was marketed to all the major corporate bond buyers across the United States, first by a team of Moody's analysts, then through a newly established sales force. Behind the scenes, there was a substantial investment in the infrastructure needed to support the service, including computer staff to build and refine Moody's databases on corporate issuers and the editorial and print production staff needed to produce the reports.

SELLING QUALITY AND INTEGRITY

By early 1983, a critical mass of 100 CCRs and associated Industry Outlook reports was ready. Within nine months, Moody's representatives called on and placed the service with over 500 institutions in 46 states—a group that represented $2 trillion of assets under management and 85 percent of corporate bond market activity.

ling the CCR was just xcuse to get us an ortunity to sell the quality integrity of Moody's ysts and of its ratings."

That market outreach was critical to Moody's developing strategy. McGuire put it this way: "Selling the CCR was just an excuse to get us an opportunity to sell the quality and integrity of Moody's analysts and of its ratings. Our real purpose was to secure our hold on the billions [of dollars worth of investor assets], to make sure that Moody's ratings continued to affect bond prices and that bond issuers continued to value those ratings."

At the same time, the CCR provided a vehicle for disclosure, helping to dispel much of the mystery surrounding the rating process. Names of the analysts and directors most responsible for research on each company appeared on the front of the reports, and a CCR customer service desk was set up to make sure that clients got through to analysts they wished to speak with.

To reinforce personal relationships, analysts met frequently with investors and investment bankers, and investor briefings were held in key cities around the country. In weekly mailings, CCR clients received new and updated reports, along with a watchlist of companies under review for potential rating change and copies of press releases on all rating actions. Clients could also receive copies of rating action releases by fax, distributed at the same time as they were sent to financial media.

Overall, the CCR service and accompanying press release program succeeded not only because it created a high-quality analytic product but also because it helped to bring about a culture shift at Moody's. From an inward focus on publishing, the Corporate Department now had the products and the discipline to meet investors' growing needs.

RE-RATING THE BELL SYSTEM

If there was any question that the "green-eye-shade" era was over at Moody's or that Moody's corporate analysts had yet to "come out of the closet" as had their municipal counterparts during the 1970s, the agency's response to the Bell System breakup served to remove all doubt.

The AT&T accord was announced on Friday, January 8, 1982, when the Department of Justice agreed to a settlement of its antitrust allegations under which the Bell System's 22 operating companies would be spun off into separate, standalone companies. Moody's telecommunications analysts rushed to meet with AT&T management, then headquartered just two blocks away in lower Manhattan.

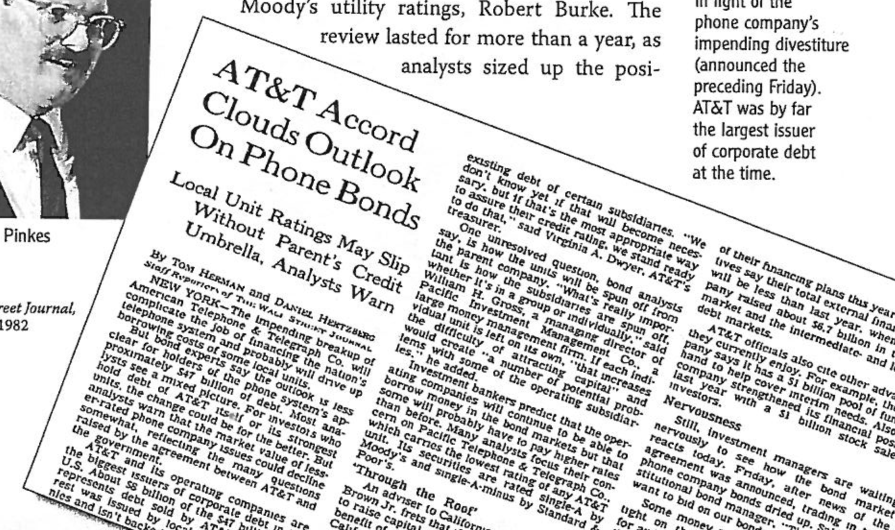
On January 10, a Sunday, Moody's issued its first-ever rating review announcement. The press release stated that, for the time being, Moody's would retain its long-standing Aaa ratings on AT&T's senior debt (some $47 billion worth) and its Prime-1 rating on the company's commercial paper. Moody's said, however, that it would begin a review of all Bell System ratings, stating that "The absence of the AT&T umbrella and divergences in local rate regulation will lead to greater differences in credit quality than has been seen in the past."

Asked for its opinion, Standard & Poor's echoed the comments of many credit analysts across Wall Street: "To say the least, this is a little mind boggling," said Jack Hardy, an S&P vice president. "It's literally too soon to tell what all this means for bond holders. This is a whole new set of ground rules."

There ensued one of the largest rating research projects ever undertaken by Moody's. Ken Pinkes was tapped to head the project, along with the head of Moody's utility ratings, Robert Burke. The review lasted for more than a year, as analysts sized up the posi-

On January 10, 1982, Moody's issued its first rating review press release. Citing the "absence of the AT&T umbrella," Moody's said it would review ratings of AT&T and all Bell System companies in light of the phone company's impending divestiture (announced the preceding Friday). AT&T was by far the largest issuer of corporate debt at the time.

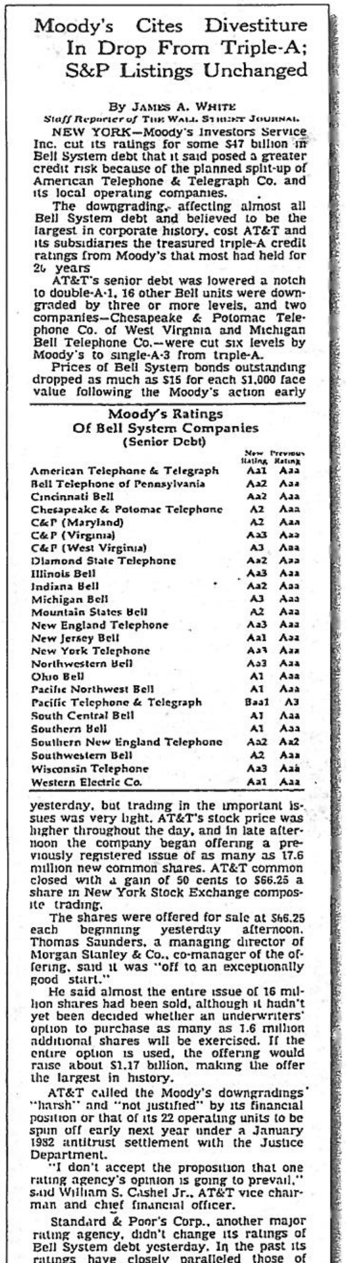
Ken Pinkes



AT&T Accord Clouds Outlook On Phone Bonds

Local Unit Ratings May Slip Without Parent's Credit Umbrella, Analysts Warn

The Wall Street Journal, January 11, 1982



Moody's Cites Divestiture In Drop From Triple-A; S&P Listings Unchanged

By JAMES A. WHITE
Staff Reporter of THE WALL STREET JOURNAL

NEW YORK—Moody's Investors Service Inc. cut its ratings for some $47 billion in Bell System debt that it said posed a greater credit risk because of the planned split-up of American Telephone & Telegraph Co. and its local operating companies.

The downgrading, affecting almost all Bell System debt and believed to be the largest in corporate history, cost AT&T and its subsidiaries the treasured triple-A credit ratings from Moody's that most had held for 26 years.

AT&T's senior debt was lowered a notch to double-A-1, 16 other Bell units were downgraded by three or more levels, and two companies—Chesapeake & Potomac Telephone Co. of West Virginia and Michigan Bell Telephone Co.—were cut six levels by Moody's to single-A-3 from triple-A.

Prices of Bell System bonds outstanding dropped as much as $15 for each $1,000 face value following the Moody's action early

Moody's Ratings Of Bell System Companies (Senior Debt)

	New Rating	Previous Rating
American Telephone & Telegraph	Aa1	Aaa
Bell Telephone of Pennsylvania	Aa2	Aaa
Cincinnati Bell	Aa2	Aaa
Chesapeake & Potomac Telephone	A2	Aaa
C&P (Maryland)	A2	Aaa
C&P (Virginia)	Aa3	Aaa
C&P (West Virginia)	A3	Aaa
Diamond State Telephone	Aa2	Aaa
Illinois Bell	Aa3	Aaa
Indiana Bell	Aa2	Aaa
Michigan Bell	A3	Aaa
Mountain States Bell	A2	Aaa
New England Telephone	Aa3	Aaa
New Jersey Bell	Aa1	Aaa
New York Telephone	Aa3	Aaa
Northwestern Bell	Aa3	Aaa
Ohio Bell	A1	Aaa
Pacific Northwest Bell	A1	Aaa
Pacific Telephone & Telegraph	Baa1	A3
South Central Bell	A1	Aaa
Southern Bell	A1	Aaa
Southern New England Telephone	Aa2	Aa2
Southwestern Bell	A2	Aaa
Wisconsin Telephone	Aa3	Aaa
Western Electric Co.	Aa1	Aaa

yesterday, but trading in the important issues was very light. AT&T's stock price was higher throughout the day, and in late afternoon the company began offering a previously registered issue of as many as 17.6 million new common shares. AT&T common closed with a gain of 50 cents to $66.25 a share in New York Stock Exchange composite trading.

The shares were offered for sale at $66.25 each beginning yesterday afternoon. Thomas Saunders, a managing director of Morgan Stanley & Co., co-manager of the offering, said it was "off to an exceptionally good start."

He said almost the entire issue of 16 million shares had been sold, although it hadn't yet been decided whether an underwriters' option to purchase as many as 1.6 million additional shares will be exercised. If the entire option is used, the offering would raise about $1.17 billion, making the offer the largest in history.

AT&T called the Moody's downgradings "harsh" and "not justified" by its financial position or that of its 22 operating units to be spun off early next year under a January 1982 antitrust settlement with the Justice Department.

"I don't accept the proposition that one rating agency's opinion is going to prevail," said William S. Cashel Jr., AT&T vice chairman and chief financial officer.

Standard & Poor's Corp., another major rating agency, didn't change its ratings of Bell System debt yesterday. In the past its ratings have closely paralleled those of Moody's. An S&P spokesman said its ratings

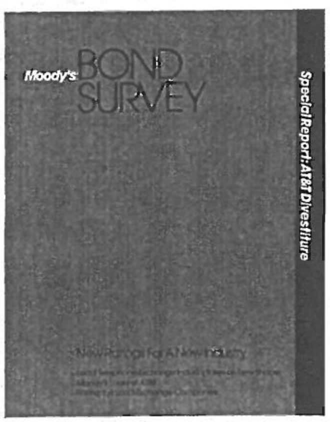
The Wall Street Journal, March 4, 1983

tion of each new company and its prospects in the wholly new post-breakup environment. In early March the following year, one of the Bell Operating Companies said that it planned to issue its first debt offering following the breakup accord. Because it was, and is, Moody's practice to assign ratings before issues are sold, analysts and support staff sped up the timing of the agency's rating announcement.

TAKING A STAND

On March 10, 1983, Moody's took its stand on the Bell System breakup. After nearly all involved had worked around the clock on the effort, the revised ratings and rationales for each company were released to the media, faxed to investor clients, and hand-delivered to AT&T management. Stating that "the sum of the parts does not equal the whole," Moody's lowered AT&T's senior debt rating by one notch to Aa1. Most of the other 24 Bell System units were moved from Aaa into the Aa or A categories.

As these were the days before e-mail, it took much of the rest of the day for the Dow-Jones Newswires to receive, retype, edit, and distribute stories on each of the press releases and associated commentary to their subscribers via the Telerate



Moody's was the first agency to release new ratings for AT&T and the 22 Bell System companies. The announcement came in a long series of press releases issued on March 3, 1983, after more than a year studying the credit implications of the AT&T divestiture. Moody's rationale was further detailed in a special report (shown) and in the agency's first series of investor briefings. The high-profile announcement helped to publicize ongoing improvements in the agency's credit research services.

"broad tape" news ticker. At the same time, the press releases and an 86-page Moody's Special Report—"AT&T Divestiture: New Ratings for a New Industry"—were mailed to all current and prospective CCR clients, to Bell System issuers, and to a wide range of managers across the telecommunications industry, as well as to regulators and bankers serving the industry. Moody's analysts were deluged with phone calls. And over the next several weeks, the agency's first-ever series of investor briefings was organized to explain the rationale behind the new ratings in person.

Market reaction was mixed. Many investors welcomed the move. Others said it was too soon to tell what the future would hold. William S. Cashel, AT&T's vice chairman and chief financial officer, called Moody's downgrades unjustified, noting that the Bell System's overall debt-to-equity ratio had shown steady improvement over the previous five years. He added, however, that AT&T would not ask Moody's to reconsider.

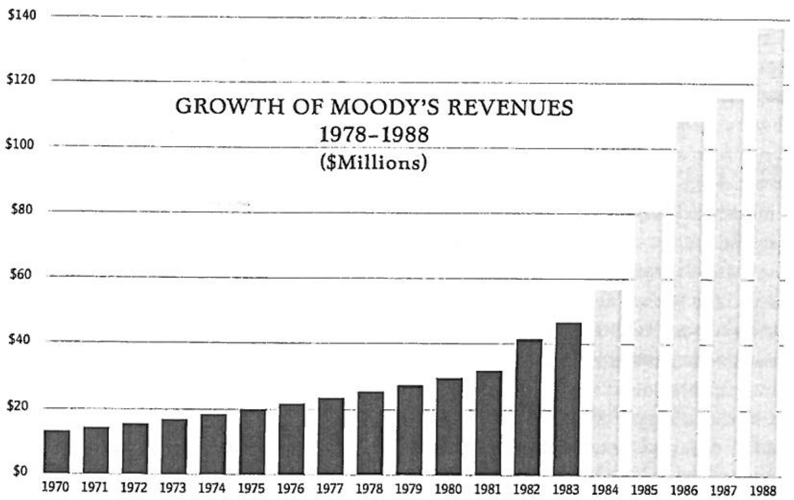
CLOTHING THE EMPEROR

Moody's continued to conduct follow-up research on its competitive market position throughout this period; and in early June of 1984, the agency received its first report card on the success of the CCR program. A few days later, McGuire gathered the entire Corporate Department at the nearby Vista Hotel to deliver the news.

"You have all been told repeatedly over the last three years that Moody's should talk about the future, not the past" he told the assembled department members. "In spite of that, the reason we have invited you all here today is to talk with you, not about the future, but about the past, and to share with you some historical statistics."

The market perception of Moody's had changed dramatically. In the first investor research study in 1981, the agency had come out at the bottom, below Duff and below S&P on every characteristic of rating agency performance but one: market impact. In short, McGuire recalled, using what had become a cliché at the firm, Moody's was "an emperor who had no clothes on, and we were afraid that the issuers who paid us rating fees would find out, and find themselves a better-clothed emperor."

Three years later, it was clear that Emperor Moody's was in fact well dressed. The same institutional investors who had been polled in 1981 had again been surveyed by Opinion Research Corporation. In 1984, 72 percent of them said that Moody's had improved more than any other agency over the last three years. The caliber of Moody's people was viewed as even with Duff's, and Moody's was seen as



Moody's revenues grew each year after the Penn Central Crisis in 1970, fueled by increasing demand for credit ratings and research. Revenues began growing at a faster pace in the early 1980s with the introduction of *Moody's Commercial Paper Record* and *Corporate Credit Reports* services. By 1988, revenues would grow fourfold over 1980 levels, as the agency extended research coverage to new sectors in the U.S. and globally.

the leader in quality and objectivity of analysis and voted "the best rating agency."

The overall success of the CCR program was also evident in Moody's financials during the period. After growing at a moderate clip through the mid-1970s, the agency's revenues more than doubled from $25 million in 1978 to over $56 million in 1984. Over the next four years, revenues would more than double again, to $137 billion in 1988. In large part, this continuing improvement came as a result of ongoing efforts beginning in 1984 to extend the CCR program approach into new markets—most notably, the Euromarkets, global banking, the emerging structured finance market, and a resurgent high-yield bond market.

CHAPTER NINE

BUILDING A POWERHOUSE

Groundwork for Universal Rating Coverage (1984-1988)

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Today, the challenging vision we share is to grow from a narrow focus on U.S. bonds and commercial paper to a major force in the global capital mar- kets. We want to play the dominant role in determining the cost of capital whenever fixed income instruments with credit risk change hands. If we can accomplish this, Moody's will be a powerhouse for the next fifty years.

TOM McGUIRE laid out the above challenge in a presentation to The Dun & Bradstreet Board of Directors in 1986. To put things in perspective, he explained that the agency's core business in the U.S. markets then included ratings on an expected $200 billion of new corporate bonds plus ratings on another $300 billion of outstanding commercial paper. He then listed more than $1 trillion of ratable securities in new markets where Moody's coverage was either nonexis- tent or just beginning to grow. That amount may seem small by present day stan- dards (Moody's assigned new ratings to more than $8 trillion of debt securities in 2006); but in the mid-1980s, it represented an opportunity to triple Moody's business.

Among the new opportunities, McGuire pointed to the Euromarkets (then including $170 billion in annual Eurobond volumes and $100 billion of Euro- commercial paper), where ratings were still a new phenomenon. He cited another $600 billion worth of securities in sectors including bank certificates of deposit and structured financings, where demand for ratings was growing rapidly. In the $125 billion specualtive-grade bond market, investment banking firm Drexel Burnham Lambert was building a lucrative stream of new high-yield bonds that aimed to bypass the rating agencies entirely. McGuire aimed to extend rating coverage there as well.

The groundwork for maintaining Moody's core business had been laid in 1984, as the agency was rolling out its *Corporate Credit Reports* (CCR) service in the U.S. markets. Moody's expansion into new markets, already well under way by 1986, unfolded along similar lines.

In each case, development efforts began with market research, including per- sonal meetings with market participants and regulators. Consultative research ser- vices were created specific to the needs of each market. Appropriate analytic staff was brought in, supporting infrastructure was built up, and the new services were placed personally with major investors. The resulting relationships were helpful in providing feedback for further service improvements, and along the way speaking engagements and media relations were employed to underscore Moody's presence in each new market.

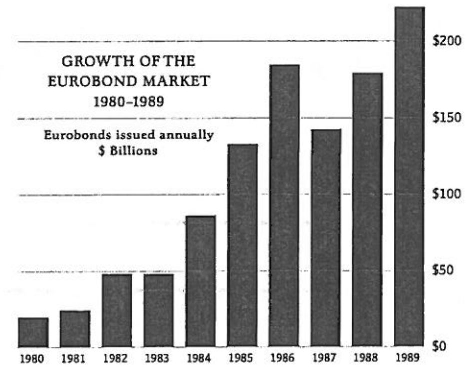
Now, in addition, service expansion would require a new network of offices in

key financial centers. It would also require the extension of universally consistent rating coverage across all fixed-income markets, often at the request of investors rather than issuers.

TAKING ON THE EUROMARKETS

Moody's had introduced the first Eurobond ratings in the early 1970s, but a decade later the agency was lagging in a weak second place to Standard & Poor's. Then the Tax Reform Act of 1984 was passed, dramatically broadening the playing field for U.S. debt issuers. Effective in July of that year, foreign investors no longer had to pay a withholding tax on interest from U.S. securities, and U.S. issuers could bor- row directly in the Euromarkets without first setting up a foreign subsidiary for the purpose.

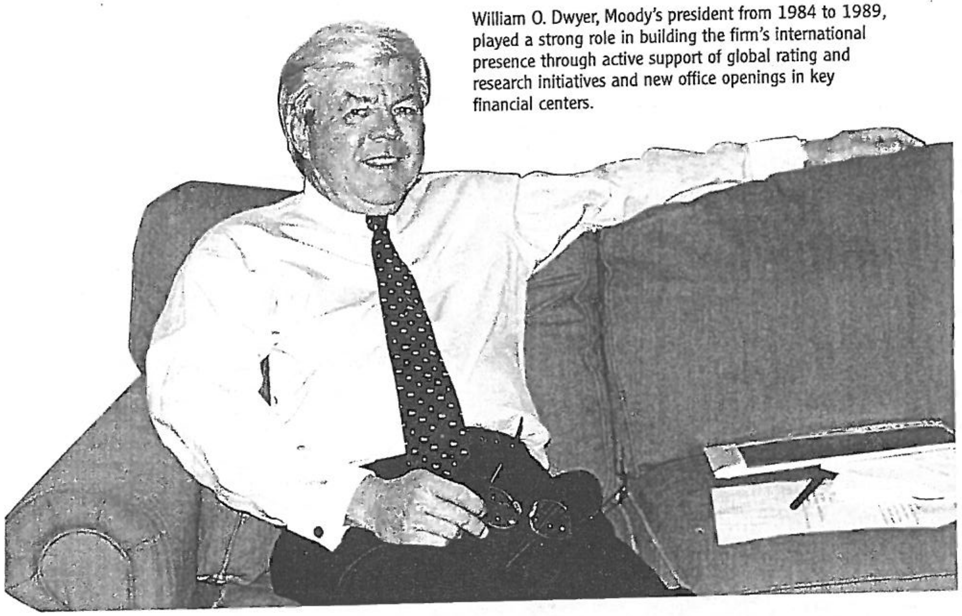
Eurobond issuance surged almost immediately. Credit ratings were not yet playing a central role in the Euromarkets, where investors relied on name and reputation for bond pricing. But in 1983 Standard & Poor's had opened an office in London, the center of Euromarket activity; and Duff & Phelps was offering credit research to major international investors. In addition, S&P had begun assigning ratings to all Eurobonds issued by companies for which the agency had existing rating relationships. By the middle of 1984, the agency would maintain ratings on 1,000 Eurobonds issued by governments, financial institutions, and industrial companies, covering some 35 percent of the market. Moody's estimated that issuance of unrated Eurobonds represented an opportunity cost of $4 million in 1984 and $6 million in 1985—or something on the order of 10 percent of Moody's projected revenues for those years.



Issuance of new Eurobonds surged when the Tax Reform Act of 1984 allowed more U.S. issuers to borrow directly in international markets. Moody's launched a global marketing and rating program the same year, including an international research service and formation of Moody's Sovereign Risk Unit in the Corporate Department.

Being the second or even third agency to enter new market segments can have its advantages. In the Euromarket, Moody's managers noted that S&P and Duff were helping to prepare the way for ratings by educating market participants on the value of the rating process. But with Eurobond issuance rising to record levels each month, it became obvious that Moody's would have to enter the market in a big way soon. In early 1984, Tom McGuire and Ken Pinkes received approval from Bill Dwyer to mount a global marketing and rating program.

Their first step was to market the international portion of Moody's existing



William O. Dwyer, Moody's president from 1984 to 1989, played a strong role in building the firm's international presence through active support of global rating and research initiatives and new office openings in key financial centers.

research services overseas, so senior managers and analytic staff began meeting with investors in Europe, the Middle East, and Japan. And during 1984, Moody's Corporate Credit Reports service was placed with investment institutions accounting for half of the purchasing power of the Euromarkets.

Extending rating coverage was the next logical step. Working with Pinkes, Moody's associate director Jolene Larson developed a strategy for assigning unsolicited ratings to Eurobonds (along with foreign bonds in the U.S. markets) that were issued or supported by Moody's-rated entities. The first such ratings started coming out in 1985. Although S&P had initiated the practice, this was Moody's first unsolicited rating program since John Moody had extended rating coverage to nearly all international issuers in the Yankee Bond market during the 1920s.

Larson and her associates acquired information on new Eurobonds through the London Stock Exchange and Extel International; and arrangements were made with several investment houses of the International Primary Market Association to receive offering telexes and circulars prior to the date of sale. As a result, Moody's ratings coverage grew to encompass about half of the fast-growing Euromarket over the next two years, up from 23 percent in 1984.

RATING SOVEREIGNS AND SUPRANATIONALS

Moody's next move was to extend its rating coverage of sovereign nations and supranational agencies, which then accounted for more than two-thirds of new issuance volumes in the Euromarkets. Sovereign ratings would be essential for maintaining the global consistency of the agency's rating opinions. This is because they accounted for the power of sovereigns to limit all foreign-currency transfers (including debt payments), and thus served effectively as an upper limit, or "sovereign ceiling," for ratings on all cross-border debt issued by corporations and municipalities domiciled within a given nation.

At the time, Moody's sovereign research was conducted in the Municipals Department. But aside from the dollar-denominated bonds issued by the sovereigns themselves and by supranational agencies such as the World Bank, most Eurobonds were being issued by corporations. McGuire maintained that by building strong sovereign research capability on the corporate side of the business, Moody's could avoid inter-departmental confusion and in the process do a better overall job of rating issuers outside the U.S. Bill Dwyer agreed.

In 1985, the agency moved all sovereign and supranational rating research to a newly configured Sovereign Risk Unit in the Corporate Department, reporting to Larson. This would lead to staff departures and to friction between the Municipals Department and what some began to refer to as "Fortress Corporate," but Dwyer felt the move was necessary to develop Moody's global rating franchise.

Larson began to hire economists and political scientists of diverse nationalities from academia and international organizations. Among them was David Levey, who would head sovereign rating operations during the 1980s and 1990s.

Members of Moody's Sovereign Risk Unit meet in New York during 1985 with representatives from New Zealand to discuss the country's debt rating. From left: Moody's sovereign analyst David Levey and associate director Jolene Larson; with Hon. Roger Douglas, Minister of Finance, and Bernard Galvin, Secretary of Treasury, New Zealand.

MOODY'S SOVEREIGN RATINGS, JANUARY 1988

	Long-Term	Short-Term
NORTH AND SOUTH AMERICA		
Argentina	B2	-
Brazil	B1	-
Canada	Aaa	P-1
United States	Aaa	P-1
Venezuela	Ba3	-
EUROPE		
Austria	Aaa	P-1
Belgium	-	P-1*
Denmark	Aa1	P-1
Finland	Aaa	P-1*
France	Aaa	P-1
Germany	Aaa*	P-1*
Ireland	Aa3	P-1
Italy	Aaa	P-1*
Netherlands	Aaa	P-1*
Norway	Aa1	P-1
Portugal	A1	-
Spain	-	P-1
Sweden	Aaa	P-1
Switzerland	Aaa*	P-1*
United Kingdom	Aaa	P-1
PACIFIC RIM		
Australia	Aa1	P-1
Japan	Aaa	P-1*
Korea	A2	-
Malaysia	Baa1	-
New Zealand	Aa3	P-1
Hong Kong	-	P-1*

* Implied rating

oody's Sovereign Risk Unit began operation in ie Corporate Department in 1984. Beginning ith ratings on 13 nations in early 1985, the unit cpanded rating coverage to 26 sovereigns over e next two years, as listed above.

A Sovereign Credit Report product was developed to support Moody's international research, and meetings were held with key purchasers of sovereign securities around the world to determine how best to expand and enhance the ongoing service. Beginning with ratings on 13 nations in early 1985, coverage was extended rapidly to include all major sovereign issuers within a few years.

GOING IT ALONE IN TOKYO

Moody's had planned to open an office in London during 1985. But the agency shifted its attention to Tokyo in the middle of 1984, after Japan's Ministry of Finance (MOF) removed the withholding tax on interest earned from Euroyen bonds issued by Japanese corporations. This promised to extend a whole new segment of the Euromarket into Japan.

Press reports in the fall of 1984 suggested that only MOF-sponsored agencies—most likely Nippon Investors Service and Japan Credit Rating Agency—would be allowed to rate Euroyen bonds or any securities issued in Japan. At the same time, Japanese media were critical of the MOF's approach, citing the local agencies' conflict of interest and their lack of both rating experience and cross-border acceptance. A rating action by a third agency vying for MOF recognition—Japan Bond Rating Institute (JBRI), established by *Nihon Keizai Shimbun,* Japan's leading business newspaper—brought the problem of rating objectivity into focus in November 1984. In a report that month, *Japan Finance Review* opined that JBRI had "made what appears to be a 'political' decision to rate the Bank of China triple-A in the absence of supporting research."

Despite these events, in the spring of 1985, the MOF said it would allow issuers rated above A2 (or the equivalent) to borrow in the Euroyen market, without specifying whose ratings would be eligible. It was then

clear that establishing a presence in Japan had become a strategic imperative for Moody's. The volume of securities flowing through Tokyo was small compared with that going through London. But in London, said McGuire, "there is no threat from disadvantageous regulation or government-sponsored competition."

With the assistance of independent Japanese consultants, three avenues of market entry were explored: to align with a MOF-sponsored rating agency, to establish a joint-venture with a Japanese partner, or to set up operations as an independent agency. Around the same time, word came that S&P was considering a joint venture with JBRI, while Duff & Phelps had announced an alliance with Diamond, Inc., a Japanese publishing company. Meanwhile, McGuire had found a Japanese director who could lead Moody's into Japan as part of a joint-venture, and many at Moody's argued that such an alliance would be essential for success.

Still, both Dwyer and McGuire were leery of any tie-up that could compromise the independence of Moody's ratings. So when a Japanese advisor said that a joint venture was in fact not necessary, Moody's decided to go it alone in Tokyo.

The opening of Moody's Japan, K.K., a wholly owned subsidiary, was announced by Bill Dwyer in a press conference in Tokyo in April 1985. The new office, said Dwyer, would "expand Moody's service to investors and issuers in the world's

Moody's president Bill Dwyer announced the opening of Moody's Japan, K.K. in a press conference in Tokyo in April 1985. This was Moody's first office to open outside the United States since John Moody established an office in London in 1925. (That subsidiary had been transferred to D&B in 1962 and was closed in 1976.)

FT FINANCIAL TIMES
World business newspaper

Moody's To Set Up Japanese Rating Agency

By Our Tokyo Staff
4 April 1985

Moody's Investors Services, the US debt rating agency, yesterday announced plans for a Japanese subsidiary scheduled to begin operations in June.

Mr William Dwyer, Moody's president, said in Tokyo that the new company means 'our capital markets, and our worldwide system of ratings will now be available for the increasingly important Euroyen sector of the Euromarkets." He added that the office would be staffed with Japanese analysts, who would participate in Moody's rating committees in New York to rate Japanese issuers; would be responsible for disseminating Moody's global ratings and analysis to Japanese investors; and would respond to inquiries from corporations, underwriters, regulators, and the press.

The strategy worked. Over the following decade, Moody's Japan grew to include some 40 staff members, half of whom were analysts. Rating coverage was extended to 85 percent of all debt issued by Japanese entities in the domestic market, and a Japanese credit research service was developed and placed with investment institutions accounting for most domestic bond purchases.

DOING BATTLE ABROAD

Meanwhile, the international press had begun to notice the outburst of global competition in the ratings industry. In an article published May 6, 1985, "The Big Two Bond Raters Do Battle Abroad," *BusinessWeek* reported that "Moody's and S&P are tilting at each other around the world to make U.S.-style ratings the standard in foreign markets." If the American agencies were to succeed in con-

BusinessWeek

International Business
THE BIG TWO BOND RATERS DO BATTLE ABROAD
Sarah Bartlett in New York, James B. Treece in Tokyo, and Richard A. Melcher in London
6 May 1985

For decades, Americans have relied on Moody's Investors Service Inc. and Standard & Poor's Corp. to help them steer clear of companies with soggy balance sheets and banks whose loans have soured. But in many other corners of the world, there is no rating scorecard—investors rely on their familiarity with company names. Now, after a successful attempt to make ratings stick in Europe, Moody's and S&P are tilting at each other around the world to

THE WALL STREET JOURNAL.

S&P to Base Foreign Ratings in London, in Move to Meet Competition in Europe

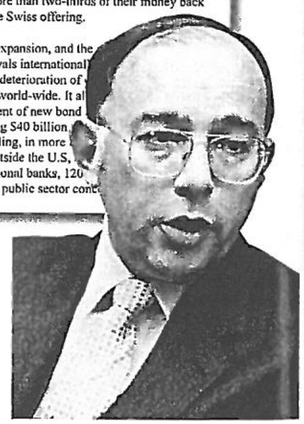
By Matthew Winkler
Staff Reporter of The Wall Street Journal
6 April 1988

NEW YORK -- Standard & Poor's Corp. is shifting its international department to London in a major expansion of the credit rating concern's European business.

S&P, a subsidiary of McGraw-Hill Inc., said

merger with Texas Air Corp., bondholders got little more than two-thirds of their money back from the Swiss offering.

A May 1985 article in *BusinessWeek* highlighted the rating agencies' competitive efforts to expand ratings and supporting offices in the global capital markets. Standard & Poor's had opened an office in London in 1983. After opening in Tokyo, Moody's established a London subsidiary in 1985. In 1987, Tom McGuire moved to London, while remaining director of Moody's Corporate Department. Moody's opened offices in Paris and Sydney in 1988, and S&P shifted its international research operations to London the same year.



Tom McGuire

verting overseas markets to their global standards, said *BusinessWeek*, "foreign ratings could become big business. Last year $25 billion, or more than one-third of all U.S. corporate debt, was issued in the Eurobond market." The article noted further that S&P was planning to "establish a beachhead in Tokyo," while Moody's was moving to secure a presence in Europe.

Moody's Investors Service Ltd. did in fact open its doors in London in June of 1986. The same year, Tom McGuire moved to London, while continuing to serve as global director of Moody's Corporate Department. In an apparent response to Moody's, S&P announced in April 1988 that it would shift its international department to London. Simultaneously, the agency announced that it would form a Swedish rating concern, Nordisk Rating AB, a joint venture with the Stockholm School of Economics.

"This has become a very competitive business," Leo O'Neill, executive managing director and head of S&P's debt rating division, told *Wall Street Journal* reporter Matthew Winkler. "You can't operate in Europe without actually doing the work there. That means for the first time we are moving control, management and a profit center offshore." Until recently, observed O'Neill, ratings had not figured prominently in European credit markets, but he believed that the world-wide stock market crash in October 1987 had changed the thinking of many investors. "I'd be surprised," he said, "if ratings didn't become much more important in the next five years within the European Community."

Moody's would open two more international offices in 1988—Moody's France S.A., in Paris, and Moody's Investors Service Pty. Ltd., in Sydney. The timing of office openings was generally based on the outlook for development of local capital markets. In both France and Australia, banking systems still accounted for the bulk of lending, and participation in securities markets had not yet taken off; but, as had been the case in Japan, office openings in both countries were accelerated due to the threat of competitive entry and regulatory exclusion.

S&P would establish a strong local presence in these markets in 1990, when it acquired Australia Ratings Pty. Ltd., in Melbourne, and a 50 percent stake in France's only local rating agency, Agence d'Evaluation Financier, Paris. The latter agency was then renamed Standard & Poor's-ADEF.

MOODY'S *BANK CREDIT REPORTS* SERVICE

When Moody's began extensive meetings with major capital market participants and intermediaries in the late 1970s, many had requested not only that Moody's rate Eurobonds but also bank certificates of deposit (CDs), particularly those issued by foreign banks.

McCarthy Crisanti & Maffei was the first agency to meet this demand, when it began supplying private ratings on bank credit quality to its subscribers in 1978. By the mid-1980s, several smaller competitors—including IBCA and Keefe Bruyette & Woods—also had substantial bank research programs in place. And in July 1985, Duff & Phelps became the first agency to announce that it would assign public ratings specifically to bank CDs, allowing for direct risk comparisons between rated banks and their holding companies. They promised 20 such ratings by year's end.

The New York Times

Moody's Rates C.D.'s

January 17, 1986
Moody's Investors Service announced yesterday that it had begun rating bank certificates of deposit and other bank instruments, such as obligations to deliver foreign exchange, bankers' acceptances and interbank placements.

Rating firms such as Moody's have begun paying more attention to bank obligations in recent years, as financial problems at some large banks caused corporate treasurers and other depositors to pay closer attention to the quality of the banks holding their money.

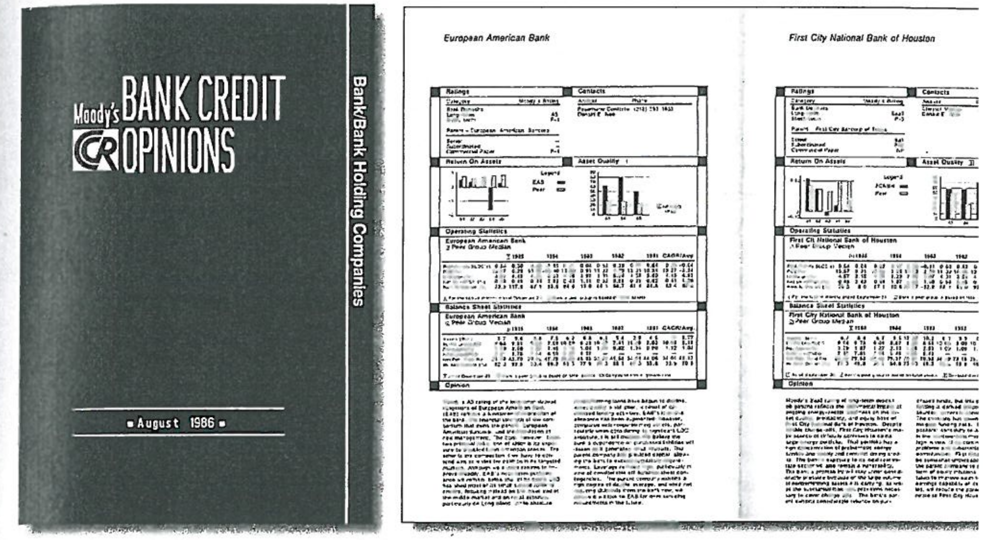
Kenneth J. H. Pinkes, a vice president at Moody's, said the firm planned to make its ratings available to the public, which could "help reduce the impact of rumor in the global credit markets."

Until then, the major agencies had rated debt securities of bank holding companies, but not the banks themselves. This had led many investors to favor commercial paper issued by rated holding companies; yet the $270 billion bank CD market was then about as large as the entire commercial paper market. Recognizing the market potential, S&P soon began rating CDs using a 1-through-10 ranking system. By year end, the agency had assigned its numerical rankings to the CDs of 127 U.S. banks and 55 international banks.

Around the same time, intermediaries complained that Moody's bond and commercial paper ratings on bank holding companies were being applied to bank CDs without consideration for the risk differentials involved. In addition, the near-default by Continental Illinois in 1984 had caused a run on the bank's CDs and sent shock waves through the global bank deposit markets. As a result, corporate treasurers and other depositors began paying closer attention to the quality of the banks holding their money, and market participants were requesting public ratings that could help to reduce the impact of rumor in those markets.

In response, McGuire put together a project team headed by Ken Pinkes and Moody's bank analyst Don Noe to meet with key players in the global banking markets. After a typical meeting, Pinkes reported back that one investment banker had recommended "an aggressive, across-the-board, rate-without-request policy—starting with, say, all Swedish banks over $1 billion." Believing that greater discipline was needed in the Euromarkets, the banker suggested that Moody's take more risk in assigning ratings. "He felt," said Pinkes, "that it fits the rating agency's role to take the heat."

The result of that and many other meetings was *Moody's Bank Credit Reports* (BCR) service—an extension of the agency's existing CCR service for corporates—



Moody's Bank Credit Reports (BCR) service was developed in 1985 by associate directors Ken Pinkes and Don Noe. The service was launched in January of 1986, along with ratings on 158 US and foreign banks. Included were in-depth analyses of major banks, rating review alerts, a rating watch list, industry reports, and analyst access. Moody's *Bank Credit Opinions* handbook, featuring single-page reports on all rated banks, was added to the service shortly thereafter.

initially aimed at covering 250 institutions in the global bank deposit market with assets over $1 billion. Pinkes and Noe designed and developed a product suite that included in-depth analysis on each bank, rating review alerts, a rating watch list, industry reports, and analyst access. At the same time, they dramatically increased the number and quality of Moody's bank analysts. A new class of ratings, Moody's Bank Deposit Ratings, was developed to apply Moody's traditional Aaa-C long-term and Prime short-term debt ratings to CDs, as well as to other bank obligations. And an unsolicited ratings program was conducted to extend rating coverage to major banks globally.

Moody's BCR service was announced on January 16, 1986, along with Bank Deposit Ratings on 96 domestic banks and 62 foreign banks. By 1988, rating coverage was extended to all major OECD banks. To meet the requests of BCR clients for a summary reference book on bank ratings, Moody's *Bank Credit Opinions* was also introduced. The publication later served as a template for rating and research handbooks in all key sectors covered by Moody's in-depth research services.

MOODY'S "BECAME AN OUTLAW"

The research underpinning Moody's BCR initiative soon attracted wide attention and some criticism from participants and regulators in the global banking market. To the surprise of the analysts who wrote it, for example, Moody's first report on the money center banks, published in early 1987, was widely covered in the financial media and was reprinted in full in the *American Banker.* The agency's first report on Japanese banks elicited a similar response.

In both cases, Moody's analysts pointed to credit pressures stemming from loss of the banks' traditional corporate lending business to the capital markets. Credit risks were also rising as the banks attempted to compensate for lost business by lending to lower-quality customers and by entering into new lines of business. "Almost every bank is saying that they're going to become heavily involved in investment banking," commented Don Noe in an interview, cautioning that "It's a very narrow group of people who will be able to pull that off."

These and other pressures led to rating reviews then downgrades of several major Japanese banks in 1987. Early the next year, Moody's lowered its ratings on several of the U.S. money center banks, bringing its average rating for the sector to the A range, down from Aaa six years earlier.

Most bankers and industry observers did agree that Moody's bank ratings were on target. But one of them, David C. Cates of Cates Consulting Analysts Inc. in New York, took issue with the timing and severity of the downgrades. "Moody's Investors Service became an outlaw last week," he wrote, in a guest comment published by the *American Banker* in February 1988. Calling for public scrutiny of rating agency worldviews and methods, Cates drew on American literature to make his point:

THE WALL STREET JOURNAL.

Money-Center Banks Credit Quality to Fall, Moody's Report Says
9 January 1987

NEW YORK -- U.S. money-center banks will have a "continued downward drift" in their credit quality, according to a new report by Moody's Investors Service Inc.

The credit rating concern cited erosion of the industry's core commercial lending and the risks of diversification and deregulation as reasons for the decline.

Moody's first report on the credit quality of money center banks, published in early 1987, highlighted credit pressures stemming from the loss of the banks' lending business to the capital markets. When the agency downgraded several money center institutions the next year, one observer criticized the timing and severity of the moves and called for a "peer review of rating agency world views and methods."

AMERICAN BANKER.
THE FINANCIAL SERVICES DAILY

COMMENT

Moody's Actions Point Up Need for Agency Scrutiny

DAVID C. CATES; Mr. Cates is president of Cates Consulting Analysts Inc., New York.
26 February 1988

MOODY'S INVESTORS Service became an outlaw last week, in my opinion. In its severe downgrades of most New York bank holding companies, the rating agency violated the public trust that its earlier reputation had earned for it. If there is a bright side to the damage, it is that peer review of rating agency world views

In "The Scarlet Letter," Nathaniel Hawthorne described the 17th century insensitivity of theocratic Puritan elders who had designated Hester Prynne a single-A. The pipeline to deity prevented any appeal, at least in Massachusetts (Rhode Island would have given a more tolerant second opinion). Today, the rating agencies are delivering similar humiliations in the absence of any review other than informal private pleading.

STRUCTURED RATINGS IN THE SPOTLIGHT

Credit problems in the banking industry were among the key factors driving rapid growth in another key market segment in the early 1980s: structured finance.

Essentially, structured financings are a way of taking assets off of a company's balance sheet. The assets—which may include anything from mortgages to auto loans and credit card receivables—are placed in a separate, bankruptcy-remote trust. Their future cash flows are then sold to capital market investors in deals structured with various levels of credit protection to achieve the desired credit ratings, depending on the risk appetite of the investor. As the credit quality of banks softened and capital regulations tightened in the 1980s, many institutions looked to these transactions as a means to both strengthen balance sheets and reduce funding risk.

The markets looked to the rating agencies for risk assessment guidelines as new classes of structured financings were developed.

Questions remained, however, as to just how much issuers would need to provide in the way of collateral and other credit enhancements to achieve the highly rated transactions that most investors were demanding. The markets looked to the rating agencies to provide guidelines on how to answer these questions as new classes of structured financings were being developed. This placed all rating agencies in a new and somewhat ticklish position.

Writing in the *Wall Street Journal* in 1986, staff reporter Ann Monroe aptly described the situation. In an article titled, "Moody's, S&P Are Thrust Into New Role—Rating Complex Issues Poses Challenges," she led with this account of a dilemma the rating agencies had already been facing for several years:

> Before a speech last winter, Moody's Investors Service Inc. vice president Douglas Watson asked that a bank of glaring floodlights be turned down. They dimmed for a moment, but then brightened again and, despite several more requests, he couldn't get out of the spotlight.
>
> These days Mr. Watson's employer and its chief rival, Standard & Poor's Corp., are squirming in an unaccustomed glare, too. The growing complexity of corporate debt offerings is turning the two largest U.S. rating concerns, once simply judges of credit-worthiness, into the rulemakers of the financing game.

THE WALL STREET JOURNAL.

Moody's, S&P Are Thrust Into New Role — Rating Complex Debt Issues Poses Challenges

By Ann Monroe
Staff Reporter of The Wall Street Journal
16 September 1986

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THE WALL STREET JOURNAL.

Invited or Not, Moody's Begins Rating Securities Backed by Assets, Mortgages

By Ann Monroe
Staff Reporter of The Wall Street Journal
22 December 1987

Moody's Investors Service Inc. has been handing out some unexpected presents. And the recipients are pretty unhappy about it.

Moody's, which is pushing for a bigger role in rating mortgage-backed and asset-backed securities, has begun rating issues without being

As issuance of mortgage- and asset-backed financings began to take off in the mid-1980s, market participants looked to the rating agencies for credit risk guidelines. That, as one Wall Street Journal reporter put it, thrust Moody's and S&P into a new role as "rule makers of the financing game." Around the same time, Moody's began issuing unsolicited ratings on structured financings where it believed that investor risk perceptions were being skewed by the ratings of other agencies.

It was mainly for these reasons—the technical complexities and uncertainties involved, and especially the uncomfortable position as "rulemaker"—that Moody's declined to rate structured deals during the late 1970s and only developed a small letter-of-credit and mortgage-backed bond business in the early 1980s. But to meet the rapidly growing demand, both Moody's and S&P began to publish reports describing not hard, fast rules, but rather what S&P called "criteria" and what Moody's referred to as "guidelines" for rating new types of transactions proposed by investment bankers.

THE STRUCTURED FINANCE GROUP IS FORMED

In March of 1984, Moody's broke out a separate structured finance team under Doug Watson to begin rating mortgage-backed securities using the agency's traditional letter rating categories. The agency published its first special report on the subject in April. Its introduction, by Tom McGuire, stated that "Moody's believes that mortgage-backed securities, when properly structured, are strong instruments, eligible for our highest ratings." He emphasized, however, that "despite the high quality of assets used to support these instruments, mortgage-backed securities are often structurally and legally complex."

Doug Watson, head of Moody's Structured Finance Group, explains the agency's approach to rating mortgage-backed securities and the outlook for U.S. mortgage default rates in 1986. The group, formed in 1984 to rate mortgage- and asset-backed securities, would extend rating coverage to 90 percent of the structured finance markets globally over the next four years.

For the year, Moody's Structured Transactions Group (subsequently renamed the Structured Finance Group) rated 126 financings with a total value of more than $15 billion. About a third of that volume consisted of collateralized mortgage obligations. These innovative structures—which are issued in distinct classes, or "tranches," each rated separately and tailored to the needs of specific investors—had been introduced the year before and helped greatly to fuel growth of the structured finance markets. Also in 1984, the agency rated 70 builder bonds, along with eight asset-backed commercial paper programs collateralized with trade receivables, and 10 shell preferred transactions that many troubled savings and loan associations were then using to sell off their mortgage assets.

The first asset-backed securities (ABS, as distinguished from mortgage-backed securities, MBS) came to market in 1985 with the introduction of auto loan-backed transactions. In 1987, S&P rated the first financing backed by credit-card receivables, and both S&P and Moody's issued special reports outlining their approaches to rating ABS deals that would soon be backed by such assets as recreational vehicle loans, home equity loans, and health care receivables.

Also in 1987, Moody's introduced its *Structured Finance* monthly and announced rating reviews or downgrades on $13 billion of structured deals, with credit concerns relating mainly to pressures on the creditworthiness of third-party support providers in the banking and automotive sectors. Moody's also began an unsolicited rating program in the structured finance market; provided sufficient information

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Moody's Approach to Rating Mortgage-Backed Securities

Moody's believes that mortgage-backed securities, when properly structured, are strong instruments, eligible for our highest ratings. These securities have been priced to sell at yields that are attractive relative to other securities of comparable risk. Furthermore, with the explosive growth of mortgage-backed securities issues, liquid trading markets have also developed. It should be emphasized, however, that despite the high quality of assets used to support these instruments, mortgage-backed securities are often structurally and legally complex.

To address these complexities in the rating process, Moody's has assembled a team of highly qualified mortgage-backed securities specialists. This group analyzes each transaction to ensure that all identified risks or weaknesses are either covered or corrected before the transaction is rated. The rating review process includes testing all the transaction's variables to ensure that the structure will work under highly adverse economic conditions. When incremental support is required from third parties, this support must come from entities of sufficient quality to assure that the risk to the security holder is consistent with the transaction's rating.

Thomas J. McGuire
Executive Vice President
Corporate Rating Department

Moody's first methodology report in the structured finance sector, published in April 1984, provided guidelines on the agency's approach to rating mortgage-backed securities.

Moody's Investors Service

STRUCTURED FINANCE
Research & Commentary

JUNE 1987

Highlights

Moody's issues prospective ratings which will serve as an early warning credit indicator for investors. Prospective ratings are issued in advance of the sale of a security. 5

Residential Funding Corp. as seller and servicer, issued a whole loan mortgage-backed pass-through where mortgage default loss protection is provided by a subordinated class of pass-throughs. Moody's rates the senior class pass-throughs Aa2 13

Aaa rated Union Bank of Switzerland is supplying a 12% LOC for RepublicBank Dallas' auto receivable-backed pass-through. Moody's rates the transaction Aaa based on the quality of the collateral, the LOC, and the overall structure. 16

Moody's assigned a Aa2 to Mechanics and Farmers principal and interest senior class of senior/subordinated pass-through certificates as well as their interest only senior class. 18

A Aaa rating was assigned to collateralized Euroyen-denominated notes issued by Sabre Limited. The transaction is structured much like a standard collateralized medium-term note with a significant twist–the collateral includes a currency and interest rate swap agreement. 19

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Moody's *Structured Finance* monthly was introduced in 1987; the first issue of its sister publication, *Global Structured Finance*, came out in 1988.