Capital markets

Moody's in new conflict of interest claim

Tracy Alloway in New York JULY 30 2014

Moody's appears to show favouritism towards its top shareholders – including Warren Buffett's Berkshire Hathaway – when rating the bonds of companies, a new academic study has found.

The study's conclusion – which Moody's disputes – could revive concerns over potential conflicts of interest at credit rating agencies, which are paid to evaluate the riskiness of trillions of dollars worth of bonds.

These concerns zoomed into focus in the years following the financial crisis, with rulemakers working to decrease the link between credit ratings and financial regulation and even pressing for limits on Moody's ability to rate Berkshire-related products.

The study, due to be presented at the American Accounting Association's annual meeting this week, looks at ratings made by Moody's between 2001 and 2010 and compares them to ratings issued by Standard & Poor's, its larger competitor.

It finds that Moody's had a "tangible bias" in favouring firms in which Berkshire or Davis Selected Advisors – its two biggest shareholders – owned at least a 0.25 per cent stake.

On average, Moody's ratings of these bonds are almost half a notch higher than ratings on the same bonds given by S&P.

That would equate to interest savings of roughly half a million dollars for the issuing firms per year, according to the authors of the paper.

"All we can show is some kind of statistical circumstantial evidence," said Shivaram Rajgopal, a professor at Emory University and one of the study's authors.

"Even if you discounted the financial incentive it could simply be subconscious or it could be driven by the firm that's being rated. It's hard to know as an outsider what is really going on."

A Moody's spokesman said: "Moody's ratings are based on a thorough, independent analysis of credit quality by our ratings committees, conducted according to publicly available methodologies. Any coincidental ownership of Moody's Corporation shares has absolutely no bearing on our ratings actions, and we have long had measures in place to maintain a strong separation between the analytical and commercial aspects of our business."

The rating agency became a publicly traded company in 2000 with Berkshire Hathaway and Davis – the New York-based asset manager – taking large stakes in the company.

The initial public offering has previously been highlighted as a turning point in Moody's more than century-long history. In testimony made to the US Congress in late 2008, Jerome Fons, a former Moody's director, said "management's focus increasingly turned to maximising revenues" in the post-IPO period.

The new study – by Simi Kedia, Mr Rajgopal and Xing Zhou – builds on their previous work analysing credit rating agencies and finds that Moody's was slower than S&P by an average 71 days to downgrade bonds related to its long-term large shareholders.

It also identifies a similar pattern in the ratings awarded to commercial mortgage-backed securities, which bundle together loans secured by shopping malls, office buildings and the like.

S&P is owned by McGraw Hill but the study's authors contend that its single large shareholder may lead to less of a statistical bias in its ratings.

"S&P is no Mother Teresa," said Mr Rajgopal. "But its biases are less extensive than those of Moody's."

He added: "Rating agencies are interesting animals. On the one hand they have a fiduciary responsibility to stakeholders and society at large, on the other hand they have a responsibility to their shareholders if they happen to be public."

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