INVESTING

Study Accuses Moody's Of Ratings Bias Toward Corporate Owners

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I cover finance, the law, and how the two interact.

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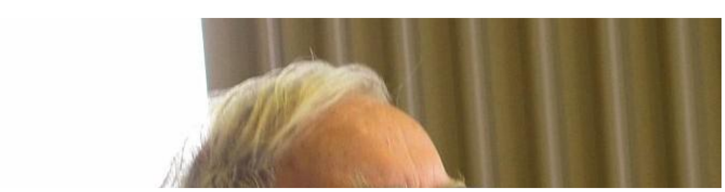
A new study concludes that Moody' ratings on bonds and derivatives is investment portfolios of its two largest shareholders, including Warren Buffett's Berkshire Hathaway and took longer to downgrade them than its rival Standard & Poor's.

The study joins a large body of literature probing the effects of ownership on supposedly objective business decisions, including how managers cater to activist investors who buy large stakes in their companies. It doesn't prove analysts at Moody's deliberately fiddled with the ratings on companies owned by *its* owners, said co-author Shivaram Rajgopal of Emory University's Goizueta Business School, "but there's a lot of statistical smoke."

"As social scientists and empiricists there is no way I can tell you the answer" to the question of whether the higher ratings were due to conscious bias, Rajgopal told me. "We're not Congress, we can't subpoena emails."



If I own it, it must be good. (Photo credit: Wikipedia)

In the study to be presented at the American Accounting Association meeting next week in Atlanta, Rajgopal and coauthors Simi Kedia and Xing Zhou of Rutgers Business School examined Moody's ratings over the 10 years after it went public on the New York Stock Exchange in 2000. They identified two large and consistent shareholders over that period: Berkshire Hathaway, which owned 16.5%, and Davis Selected Advisors, which owned 7.5%.

The researchers then examined some 900 bonds issued by companes they considered significant holdings of Berkshire or Davis, representing at least 0.25% of either company's portfolio for at least three years. For Berkshire, this was an easy task: Buffett runs a tight portfolio with an average of 32 firms. Davis holds more than 180. The researchers called these "related firms."

The result? Moody's ratings on bonds issued by related firms were a statistically significant 0.46 notches higher than S&P ratings on the same paper. This translated into an average savings of $500,000 a year per bond in borrowing costs, Rajgopal said, as well as a lower overall cost of capital, important advantages in highly competitive capital markets.

The researchers considered alternative explanations. Could Berkshire and Davis be such good investors that the fact they own a company means it deserves higher ratings? No, because Moody's showed no such favoritism toward companies owned by Berkshire and Davis before the Moody's IPO.

"This finding suggests that ownership in Moody's, as opposed to potentially omitted common firm characteristics, is more likely to account for the results," the authors said. They found weaker but supportive evidence in the ratings of Goldman Sachs bonds during the brief period when it was a major owner of McGraw-Hill, the parent of S&P. And they found additional evidence of bias in the fact that Moody's downgraded bonds of related companies an average of 71 days after S&P.

Moody's declined to comment on a copy of the paper sent to them via e-mail on Friday. The company criticized Rajgopal's methods in an earlier study, telling Bloomberg in February that evidence of bias disappears when looking at ratings for individual issuers, instead of bonds. Issuer ratings better reflect the opinion of analysts about a company's finances, a Moody's spokesman said then.

Rajgopal and his colleagues focused on corporate bonds because they were most likely to be rated by both firms. They also looked at commercial mortgage-backed securities issued by related companies and found Moody's ratings were again significantly higher. Once again, the effect only appeared when the issuing companies were in the portfolios of Berkshire and Davis, the researchers said. As another check, they looked at the prices of credit default swaps on the underlying bonds and those, too, reflected lower estimated quality than the Moody's ratings indicated.

“It doesn’t look like information – we use the word bias,” Rajgopal said.

Ratings firms have long complained that such data-mining studies fail to acknowledge the importance they place on their own reputation as guardians of the multitrillion-dollar credit markets. But if the credit crisis weren’t enough evidence, other academic studies have shown S&P and Moody’s appear to relax their ratings when facing stiff competition from smaller players like Fitch.

Critics like Frank Partnoy of the University of San Diego say lawmakers have exacerbated the problem of ratings bias by requiring investors like banks and insurance companies to rely on them when selecting supposedly investment-grade securities. In the runup to the financial crisis, big banks and brokerage firms engineered mortgage-backed securities with supposedly secure streams of income based on "waterfall" structures that guaranteed top-rated tranches would be paid first. What they didn't plug into their models was the possibility of defaults rising to previously unseen levels, wiping out even the most secure tranches. Investors who looked only at the investment-grade rating on the label lost billions in the collapse.

"Any time you have a situation where you give an oligopolistic industry this much power, you're going to have a problem," said Rajgopal. "Regulation has baked the role of these ratings into law."

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