No Standards, Not Poor*

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Early February, the Department of Justice (DoJ) of the US government—represented by the United States attorney general and supported by attorneys general from 16 states—filed civil fraud charges against the ratings giant Standard & Poor's (S&P). S&P is the largest of the big three agencies—the other two being Moody's and Fitch—which, for a fee, take on the task of assessing how risky and robust securities of different kinds issued by financial firms are.

The charges were not minor. The DoJ argues that for more than three years between September 2004 and October 2007, S&P "knowingly and with the intent to defraud, devised, participated in, and executed a scheme to defraud investors" in mortgage-related securities. This was the period when S&P was raking in huge earnings by granting high ratings to complex and opaque derivatives named "collateralised debt obligations" (CDOs) based on mortgage bonds. The DoJ's case reportedly focuses on 40 such CDOs created at the height of the US mortgage bubble, the rating of which gave S&P $13 million in fees. These bonds went bust, resulting in losses to investors. The DoJ not only claims that S&P knew this could happen when it gave them high ratings or left them unrevised, but also that it misinformed investors by arguing that its ratings "were objective, independent, uninfluenced by any conflicts of interest."

Progress on punishing institutions seen as responsible for the 2008 crisis has been slow. So it has not just been business as usual for these firms, but license to do things that seem substantially aimed at regaining the credibility they lost in the aftermath of the crisis. The most controversial of these was its decision to downgrade the long-term credit rating of the United States from AAA to AA+ in August last year during the standoff between the Democrats and Republicans over ratifying an increase in the prevailing ceiling on US public debt.

But now the heat is finally on with the DoJ charging that "contrary to its representations to the public, S&P's desire for increased revenue and market share in the RMBS (residential mortgage-backed securities) and CDO ratings markets, and its resulting desire to maintain and enhance its relationships with issuers that drove its ratings business, improperly influenced S&P to downplay and disregard the true extent of the credit risks."

As of now the US government is talking tough. It refused to settle (without trial) unless S&P agreed to pay a penalty in excess of $1 billion and admitted to wrongdoing on at least one count of fraud. The penalty would have consumed a whole year's profit of McGraw-Hill, S&P's parent. So the rating agency offered to pay $100 million to settle. And fearing that admission of guilt would set off more litigation from investors who lost money, S&P wanted a deal in which there was no admission or denial of guilt. When negotiations fell through, charges were filed. Now the DoJ wants the agency to pay up a hefty $5 billion in penalties to cover losses to investors like state pension funds, federally insured banks and credit unions. That would be many multiples of S&P's earnings.

Moreover the government is being savvy when it comes to choosing its plea. The DoJ has filed a civil, not criminal, suit. Besides the fact that civil suits are easier to win, the prosecution is under the Financial Institutions Reform, Recovery, and Enforcement Act designed (after the Savings and Loan crisis of the 1980s) to protect federally backed financial firms from fraud, which has a low burden of proof.

The substance of the suit is no surprise. The financial crisis of 2008 showed that many instruments, especially mortgage-backed derivatives of various kinds, which had been rated high by the likes of S&P, Moody's and Fitch, could quickly turn into junk. This had badly damaged the credibility of these agencies. To add, an intensifying battle among the big three (besides some new entrants) for a larger share of the ratings business, had led to each accusing the others of shoddy and inadequate research to back the ratings they give. Thus the industry itself gave credence to the view that the scores they award were not to be trusted, even if for partisan reasons. As a result, the rating agencies have little credibility left. But they still ply their business and are routinely quoted, because the financial industry does not want them replaced.

What comes as a surprise, however, is that the DoJ has moved the way it did. Ratings agencies were not brought to book in the past because they build a firewall around themselves. In the fine print containing disclaimers in documents giving their scores, ratings agencies normally indemnify themselves from any claims against losses incurred by investors on investments motivated by these ratings. In addition, they have hidden behind the claim that their ratings were just opinions, and were, therefore, protected by constitutional guarantees of freedom of speech, especially the First Amendment in the US. Above all, it is difficult to establish conscious negligence when assessing a wrong rating, making victory in a case of fraud against a ratings firm difficult to achieve. So courts have tended to dismiss cases alleging fraud on the part of ratings firms.

Recently, these protective walls have been breached. In 2009 a case was admitted by Manhattan District Judge Shira Scheindlin, in which a set of institutional investors, including Abu Dhabi Commercial Bank and King County in Washington state, accused Moody's and S&P of having engaged in fraud by giving inflated ratings to a set of derivative products backed by subprime mortgages issued by Morgan Stanley through a structured investment vehicle called Cheyne. The admittance places the burden of assessing whether the ratings agencies were misleading investors on a jury. The case was admitted on the basis of evidence in the form of instant messages between two S&P analysts, which seemed to suggest that they were in the know that they were inflating ratings for poor products. "That deal is ridiculous," one analyst reportedly messaged, declaring that "We should not be rating it." "We rate every deal," the other analyst reportedly replied, leading to a response from the first analyst which said, "It could be structured by cows and we would rate it."

Even though it is not certain that this conversation was about Cheyne, it does suggest that analysts were being pressured into rating and offering good scores on products they held worthless. The judge ruled that the First Amendment did not apply in a lawsuit over ratings, because the relevant mortgage-backed securities had not been offered to the public at large and that the "plaintiffs have also offered sufficient evidence from which a reasonable jury could infer that the rating agencies did not believe the ratings when they issued them." She also noted that, "Morgan Stanley manipulated the Cheyne SIV modelling process to create the ratings it desired," and "can be liable for aiding and abetting fraud."

The result of the weakening defence has been a spate of efforts to bring down the ratings business. Standard & Poor's has been sued by states like Illinois and Connecticut besides numerous angry investors. It managed to get some of these suits dismissed on First Amendment grounds, but judges have admitted several, including the one by Illinois. Other government agencies are getting into the act. S&P is being investigated by the Securities and Exchange Commission over a complex mortgage security called Delphinus issued in 2007, when the housing market had begun to collapse. New York Attorney General Eric Schneiderman has launched a broader investigation of credit rating agencies and his office has subpoenaed S&P and requested information from Moody's and Fitch.

All this matters because the evidence against S&P, though challenged by the agency, seems strong. Particularly damaging is some among the 20 million pages of emails sent by S&P employees, and procured as evidence. As early as December 2006, one executive had warned about mortgage-related investments, saying: "This market is a wildly spinning top which is going to end badly." Another S&P employee is reported to have noted the same month that: "Rating agencies continue to create an even bigger monster — the C.D.O. market," and expressed the "hope we are all wealthy and retired by the time this house of card falters." The documents also indicate that there was a debate of sorts going on within the company between those who wanted to have less demanding rating models to garner business and increase profits and those who opposed dilution of standards for market considerations.

Evidence like this could stick because of the obvious conflict of interest involved in the ratings system. Issuers of financial products turn to private firms to provide 'independent' certificates of the safety and strength of their offers. That certificate is useful when canvassing buyers for these products among investors. In time, regulators made the rating given by a recognised agency mandatory, especially because products became more complex and beyond the ken of investors or asset managers to fully comprehend and assess. In fact, in many instances those with fiduciary responsibilities (such as managers of pension funds) are required to invest only in triple-A or similar rated products. So a rating determines the market an issuer has. Finally, in many contexts, ratings are used to calibrate the risk-weights attached to financial instruments, when implementing the capital adequacy requirement for banks under the of Basle norms. Banks would be more willing buyers of highly-rated securities because they are required to set aside less regulatory capital against them. In sum, the ratings system and, therefore, the ratings firms have become a part of the regulatory framework in many countries.

There is a catch here, however. The independence of the agency could in principle be compromised because the issuer pays for getting the rating done, especially since ratings agencies are corporates treating their work as a source of revenues and profits. Having a reputation of being strict when awarding a rating could see business shifting to competitors. On the other hand, having a reputation for being lenient could damage reputations among investors, making issuers turn to agencies with a better reputation. As a result, the agencies perform a tightrope walk between colluding with issuers to win business, and winning a reputation among investors of being independent to attract issuers seeking their certificate for its value. The evidence seems to be that during the pre-crisis boom they had fallen off the rope, erring on the side of being excessively optimistic.

Clearly it is time to resolve the fundamental conflict of interest involved in making scores provided by a paid examiner the basis for financial regulation. That was a conclusion forced on the system by the 2008 crisis . Hopefully, the rising tide of litigation would force an end to or at least the reform of the ratings system.

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