Martin Weiss on the CalPERS Suit

By Editor Test *Wed, Jul 22, 2009*

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Martin Weiss, Ph.D, who founded Weiss Ratings and later sold it to Street.com, has been called a “gadfly” in financial circles. As the current president of Weiss Research Inc. and publisher of *Safe Money*, he is now out of the ratings industry. But he remains a critic of grade-inflation, group-think, and the misuse of incentives within it.

RIJ asked Weiss, whose new book, *The Ultimate Depression Survival Guide* (Wiley, 2009) reached sixth place on the New York Times Hardcover Business Best Sellers list on June 5, to share his thoughts on the California’s state pension fund’s suit against Standard & Poor’s, Moody’s, and Fitch Ratings. Here’s the result of our Q&A:

RIJ: What was your reaction to the news of the lawsuit against the big three Nationally Recognized Statistical Rating Organizations, or NRSROs?

WEISS: I think CalPERS is very much justified in taking this action. I believe there’s abundant evidence already revealed, and in Congressional investigations and testimonies, that will give them a good paper trail for discovery. Their richest vein in that discovery, in my opinion, will be the depositions of individual analysts-both those who are currently employed and those who have left Moody’s and S&P.

RIJ: And what do you think those depositions will show?

WEISS: I’ve spoken to quite a few analysts, and those have disclosed egregious manipulations and conflicts of interest that go beyond what is generally known. There’s the typical thing, where an analyst felt that bonds should be downgraded and was overruled by principals.

That’s number one. Number two is compensation made over and above published fees, with the understanding that it would result in a better grade. There are payoffs tacitly or implicitly tied to a higher grade. There’s a higher bar to proving that, but I don’t think they will have to prove that to prevail.

The defense will be, ‘We did our best to cover all the available fact. There’s always a judgment we have to make based on our experience.’ So it will be important to depose ex-analysts or analysts, to ask, if the analysts have all those years of experience, why are the principals overruling the them?

RIJ: The suit says the rating agencies helped design the structured investment vehicles, or SIVs. Why shouldn’t the ratings agencies help their clients produce the safest possible product?

WEISS: Consider *Consumer Reports*, which is the standard to which the rating agencies should be held. Suppose you wanted to build the ultimate cell phone, a phone that would beat the iPhone. Then, suppose *Consumer Reports* says, ‘We know exactly how to get the ultimate rating from us.’

The cell phone manufacturer asks how, and *Consumer Reports* says 'We'll design it to the specs that meet our standard, and you'll get the perfect package.' Any consumer, even without legal training, would say that's hanky panky. No matter how you spin it, it doesn't pass the smell test.

RIJ: During the Enron scandal, didn't the rating agencies successfully defend themselves from these types of accusations?

WEISS: In this case there's more evidence than there was in Enron, and I don't believe ratings agencies helped design Enron's derivatives. This business of designing products and rating them has 'hit the fan.'

RIJ: I can understand the incentive for a rating agency to improve the rating of its own client's SIV. But why would the other agencies give that SIV the same high rating?

WEISS: It's 'scratch my back I'll scratch your back.' There has always been very little variation in the ratings between the three top NRSROs. All three use the same conflicted business model. They're the 'three musketeers.' If you had more entrants into the field who aren't conflicted, and if they had some inroads into market share, you might see more variation and more accurate ratings. But the barriers to entry in that business are too high.

RIJ: The system seems to have worked until now.

WEISS: The general assumption has been that Moody's, S&P, and Fitch are very smart and know what they are doing. I don't think anyone realized the depth of the conflicts and the severity of the consequences, in terms of the size of the losses that could accrue. In normal times they get away with it. People don't notice it because growth reduces the risk and it doesn't show up. Those fault lines and weaknesses only appear when there are major earthquakes.