Poor Standards at S&P, U.S. Alleges

By Editor Test *Thu, Feb 7, 2013*

The ratings agency that downgraded the federal government's debt in 2011 now finds itself accused of fraud by that same government's attorney general. The credibility of life insurer strength ratings is just one of the issues at stake.

In a civil suit that reopens the wounds of the 2008 financial crisis and tests the potentially conflicted business model that major U.S. crediting rating agencies use, the Justice Department Tuesday charged Standard & Poor's Ratings Services with fraud.

The government—whose own debt was downgraded in S&P in 2011, helping to trigger an equity market correction—alleges that S&P executives knowingly inflated ratings of structured financial products, such as Residential Mortgage Backed Securities (RMBS) and Collateralized Debt Obligations (CDOs), in the years leading up to the crisis.

According to the complaint, S&P, despite claims of objectivity, inflated ratings to please its investment banking customers and to increase or defend its own revenue and market share.

As a result, the suit charged, was that "investors, many of them federally insured financial institutions," lost billions of dollars when the products' weaknesses became public and their value fell. S&P eventually announced a broad downgrade of subprime RMBS in July 2007.

On Wednesday, S&P, a unit of The McGraw-Hill Companies, Inc., responded to the suit with a statement:

> "The DOJ and some states have filed meritless civil lawsuits against S&P challenging some of our 2007 CDO ratings and the underlying RMBS models. Claims that we deliberately kept ratings high when we knew they should be lower are simply not true. … At all times, our ratings reflected our current best judgments about RMBS and the CDOs in question. Unfortunately, S&P, like everyone else, did not predict the speed and severity of the coming crisis and how credit quality would ultimately be affected."

The case may hinge on the content and context of certain internal S&P e-mails sent during 2007, when executives evidently discussed the pressure to mollify their primary customers—the investment banks that underwrote the financial instruments in question—by using "business-friendly" ratings models.

In one internal email quoted in the suit, an executive said:

> I do not believe that market share is our only objective. However, we cannot ignore the real risk of losing transaction revenue… The balance between market share and analytical integrity is complex, as one needs to consider 'long-term' and 'short-term' market share. In the short term it may be more beneficial to use modeling assumptions that are more favorable to transactions that are in the pipeline. In the long-term it may be more beneficial to have a more robust model that can be adapted to new transactions (such as long/short, etc.) so that we don't lose new opportunities to our

> competitors."

Another email that reflected internal debate said:

> "The only way I can see to move this forward is to approach our clients and ask them for pools and levels, but this looks too much to me as if we are publicly backing into a set of levels driven by our clients."

The suit also points to the emergence of gallows humor at S&P when the true value of the RMBS and CDO investments became generally known and a crash began to appear likely:

> "On July 13, 2007 an S&P CDO analyst emailed employees at two banks that issued CDOs a cartoon that depicted asset-backed CDOs as a game of 'Jenga,' where the object is to remove pieces from a structure, creating a more and more unstable structure, until the entire thing collapses."

The government will have to prove that the internal emails at S&P amount to smoking-gun evidence of fraud. S&P has protested that unflattering emails were "cherry-picked" for inclusion in the suit by the Justice Department.

At the least, however, the suit is likely to shed new light on the business model that major ratings agencies use. The agencies earn huge fees from their investment banking customers, who are able to shop among the agencies for the most favorable ratings. That potentially creates pressure for grade-inflation. The emails quoted in the lawsuit suggest that analysts at S&P may have been less insulated from commercial pressures than S&P publicly claimed.

The suit echoes the theme of some of the lawsuits that followed the dot-com crash of 2000, when analysts at major investment banks were accused of purposely inflating the ratings of certain technology stocks and encouraging investors to buy securities that the analysts privately disparaged.