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Ratings abuses at root of credit crisis

By Elliot Blair Smith

BLOOMBERG NEWS

Editor's Note: This is the first part of a two-day series.

WASHINGTON — Frank Raiter says his former employer, Standard & Poor's, placed a "For Sale" sign on its reputation on March 20, 2001. That day, a member of an S&P executive committee ordered him, the company's top mortgage official, to grade a real estate investment he'd never reviewed.

S&P was competing for fees on a $484 million deal — one of the new structured-finance products driving Wall Street's growth. But only an S&P competitor had actually analyzed the mortgage loans underlying its bonds, and Raiter says he was asked to "just guess, put anything down."

"I refused to go along with some of this stuff, and how they got around it, I don't know," says Raiter, 61, a former S&P managing director whose business unit rated 85 percent of all residential mortgage deals at the time. "They thought they had discovered a machine for making money that would spread the risks so far that nobody would ever get hurt."

Relying on a competitor's analysis was one of a series of shortcuts that undermined credit grades issued by S&P and rival Moody's Corp., Raiter said. The flawed AAA ratings of mortgage-backed securities that turned to junk lie at the root of the world financial system's biggest crisis since the Great Depression, according to Raiter and dozens of other ratings professionals, investment bankers, academics and consultants.

"I view the ratings agencies as one of the key culprits," says Joseph Stiglitz, 65, the Nobel laureate economist at Columbia University. "They were the party that performed that alchemy that converted the securities from F-rated to A-rated. The banks could not have done what they did without the complicity of the ratings agencies."

Driven by competition for fees and market share, between 2002 and 2007, the New York-based companies gave top ratings on debt pools that included $3.2 trillion of loans to home buyers with bad credit and undocumented incomes. As borrowers have defaulted, the companies have downgraded more than three-quarters of the AAA-rated structured investment pools issued in the last two years. They're known as collateralized debt obligations, or CDOs.

Without those AAA ratings — the gold standard for debt — banks, insurance companies and pension funds wouldn't have bought the products. Banks have now incurred $523.3 billion in writedowns and losses on the investments, leading to the collapse or disappearance of Bear Stearns Cos., Lehman Brothers Holdings Inc. and Merrill Lynch & Co. and compelling20the Bush administration to propose buying $700 billion of bad debt from financial institutions.

Losing battle on credit checks

S&P and Moody's substituted theoretical mathematic assumptions for the experience and judgment of their own analysts. Regulators found that Moody's and S&P also didn't have enough people and didn't adequately monitor the thousands of fixed-income securities they were grading AAA.

Raiter and his counterpart at Moody's, Mark Adelson, say they waged a losing fight for credit reviews that focused on a borrower's ability to pay and the value of underlying collateral.

"The part that became the most aggravating — personally irritating — is that CDO guys everywhere didn't want to know fundamental credit analysis; they didn't want to know from being in touch with the underlying asset," says Adelson, 48, who quit Moody's in January 2001 after being reassigned out of the residential mortgage-backed securities business.

S&P hired him in May 2008 as chief credit officer, responsible for setting the company's ratings criteria as part of a broader management shakeup. Raiter retired in March 2005.

The rating companies earned as much as three times more for grading complex structured finance products, such as CDOs, as from corporate bonds. Through 2007, they had record revenue, profits and share prices. Moody's operating margins have exceeded 50 percent for six years, three to four times those of Exxon Mobil Corp.

Tighter standards

Now facing the threat of lawsuits and tighter regulation, Moody's and S&P say they are adopting tougher criteria to more accurately evaluate and monitor the debt.

"Independence, integrity and quality remain the cornerstones of everything we do and everything we stand for," S&P Vice President of Communications Chris Atkins wrote in a response to questions. "We have an important role to play in helping to restore confidence and increase transparency in the credit markets, and we are determined to play a leadership role."

A Moody's spokesman would not respond to questions.

The spinoff of Moody's by Dun & Bradstreet Corp. in September 2000 changed the focus from informing investors to responding to banking clients and shareholders, say several former Moody's analysts.

"Up until that point, there was a significant emphasis on who's got the right criteria," says Gugliada, the former S&P global ratings chief for CDOs. He retired in 2006.

S&P outlined the alchemy of structured finance in a March 2002 paper for clients entitled "Global Cash Flow and Synthetic CDO Criteria." While arguing that the process wasn't "turning straw into gold," the authors said "the goal" was to create a capital structure with a higher credit rating than the underlying assets would qualify for without financial engineering.

By estimating the percentage of a debt pool that would pay off, the raters could assign AAA grades to the safest portion of the investment and lower marks on the rest. About 85 percent of structured finance CDOs qualified for the top grade, according to Moody's.

The deal sponsors could bolster the structure by buying protection from the two largest bond insurers Ambac Financial Group Inc. and MBIA Inc..

This way, subprime mortgages with elevated default risks could be pooled into CDOs with top ratings.

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Business

Credit-rating switch ushered in turmoil

By Elliot Blair Smith
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Second of a two-day series
In August 2004, Moody's Corp. unveiled a new credit-rating model that Wall Street banks used to sow the seeds of their own demise. The formula allowed securities firms to sell more top-rated, subprime mortgage-backed bonds than ever before.
A week later, Standard & Poor's moved to revise its own methods. An S&P executive urged colleagues to adjust rating requirements for securities backed by commercial properties because of the "threat of losing deals."
The world's two largest bond-analysis providers repeatedly eased their standards as they pursued profits from structured investment pools sold by their clients, according to company documents, e-mails and interviews with more than 50 Wall Street professionals.
It amounted to a "market-share war where criteria were relaxed," says former S&P managing director Richard Gugliada.
"I knew it was wrong at the time," says Gugliada, 46, who retired in 2006 and was interviewed in May near his home in Staten Island, N.Y. "It was either that or skip the business. That wasn't my mandate. My mandate was to find a way."
Wall Street underwrote $3.2 trillion of loans to home buyer with bad credit and undocumented incomes from 2002 to 2007. Investment banks packaged much of that debt into investment pools that won AAA ratings, the gold standard, from New York-based Moody's and S&P. Flawed grades on securities that later turned to junk now lie at the root of the worst financial crisis since the Great Depression, says economist Joseph Stiglitz.
"Without these AAA ratings, that would have stopped the=2 0flow of money," says Stiglitz, 65, a professor at Columbia University in New York who won the Nobel Prize in 2001 for his analysis of markets with asymmetric information. S&P and Moody's "were trying to please clients," he said. "You not only grade a company but tell it how to get the grade it wants."
SEC places some blame
The Securities and Exchange Commission in July identified S&P and Moody's as accessories, finding they violated internal procedures and improperly managed the conflicts of interest inherent in providing credit ratings to the banks that paid them.
S&P and Moody's earned as much as three times more for grading the most complex of these products, such as the unregulated investment pools known as collateralized debt obligations (CDOs), as they did from corporate bonds. As homeowners have defaulted, the raters have downgraded more than three-quarters of the AAA-rated CDO bonds issued in the last two years.
Facing the threat of lawsuits and tighter regulation, Moody's and S&P now say they are adopting tougher requirements to more accurately evaluate and monitor debt.

Starting in 1996, Moody's used a framework known as the binomial expansion technique for rating CDOs — structured funds consisting of aircraft leases, franchise loans, high-yield bonds, hotel mortgages and mutual-fund fees. On the theory that diversification reduced risk, the BET formula rewarded balanced portfolios and punished concentrations of assets.

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On Aug. 10, 2004, Moody's managing director Gary Witt introduced a new CDO rating method that dispensed with the diversity test and made other adjustments to the evaluation of structured-finance products.

As a tradeoff, bankers got more flexibility, says Jeremy Gluck, 52, a former Moody's managing director, who worked with Witt. "They could put together a deal with greater concentrations in one area or another." In September 2005, Witt and colleagues published a follow-up analysis. Compared with the BET, the new model now projected that the likelihood of collateral defaults affecting CDO bonds rated at least Aa could be 73 percent lower.

"The effect that had on structures was to create more Aaas," says Thomas Priore, 39, chief executive officer of Institutional Credit Partners LLC in New York, which oversees $13 billion of fixed-income investments.

Underwriters made obtaining a top grade from one or both raters a condition for the sale of the investment pools.

The reckoning swept Wall Street in 2007. On July 10, Moody's cut its grades on $5.2 billion in subprime-backed CDOs. That same day, S&P said it was considering reductions on $12 billion of residential mortgage-backed securities.

Still, they continued stamping out AAA ratings.

"The greed of Wall Street knows no bounds," says Stiglitz. "They cheated on their models. But even without the cheating, their models were bad."