Holding the Rating Agencies Accountable: a Glimpse Behind the Curtain

Daniel S. Drosman
2014
Mumbai
How Moody’s and other credit-rating agencies licensed the abuses that created the

By Roger Lowenstein

In 1996, Thomas Friedman, With Jim Lehrer” that the

Credit agencies face attack in Congress
Groups knew about conflicts of interest

By Alan Beetel in Washington

Credit ratings agencies were fully aware that conflicts of interest were creating bias and were giving away high scores to risky assets, increasing the stability of the entire financial system, testimony from a key Capitol Hill committee said.

Henry Waxman, chairman of the US House of Representatves oversight committee, said that the agencies were wrong to claim that the nature of securities of mortgage-based and other assets during the financial crisis were uninformative.

Questioning executives from the three leading ratings agencies, Moody’s, Standard & Poor’s and Fitch, Mr. Waxman said: “The credit rating agencies occupy a special place in our financial markets. The ratings agencies hold this bond of trust.

High ratings given to high-quality assets, particularly those based in risky mortgages, have been criticized by authorities around the world for contributing to the financial crisis. But the threat of companies’ regulations have not been the same.

Mr. Waxman cited internal documents obtained from Moody’s and Standard & Poor’s, which he said, demonstrated the problem of conflicts of interest.

The committee released a report of such an investigation from Raymond McDaniel, chief executive of Moody’s, that the company’s directors in October 2007, tendered part of the presentation to Congress of interest rates. A theme of the analysis was that the companies’ role in financial markets was crucial.

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“Market share” says the story of the Fitch analysis, “in the world of finance, there was a problem of conflicts of interest.

Mr. McDaniel’s description of the problem was that the market forces were subjective, that the financial crisis required the highest rating. Mr. McDaniel’s report says, “In the wake of the financial crisis, Congress can play a critical role in ensuring that the financial system is secure.”

The company had various mechanisms in place to prevent such conflicts of interest, including assigning ratings by committees and preventing anyone with a ‘market share objective’ from chairing a committee.

“The firms did not solve the problem, though,” writes Mr. McDaniel. “His firm’s analysis of the securities that helped cause the financial crisis were not addressed by the firm.”

While acknowledging that Moody’s did not foresee the speed and scale of the deterioration in the mortgage market, Mr. McDaniel noted that some entities that had the most influence in the crisis. He also praised the company’s efforts to restructure its business to deal with the crisis.

Raymond McDaniel yesterday: “There are no conflicts of interest with regulatory authorities, and the ratings agencies are not controlled by the government.”

Our ratings are not influenced by commercial considerations,” he added.

What they said

Moody’s

What happened in ‘04 and ‘07 with respect to subprime loans is that our competition, Fitch and S&P, were paid. Everything was investment grade. We tried to alert investors that there was a problem, but we couldn’t do it. We were too busy.

Fitch

It is clear that many of the structured finance rating opinions have not performed as expected.

Standard & Poor’s

We have demonstrated that the historical data used in our analysis significantly understated the severity of what has actually occurred.

Mr. McDaniel. An “inexorable” model would give preferential information to bigger and wealthier investors. “Potential conflicts exist regardless of who pays. The key is how well the rating agencies manage the potential conflicts.”

Mr. McDaniel and the other agency executives present yesterday. Devin Sharma of Standard & Poor’s and Stephen Fei of Fitch said their companies were cooperating fully with reviews of the agencies’ performance carried out by the US Securities and Exchange Commission and other authorities.

But they said that many parts of the financial system had improved, and it was time for the rating agencies to resume business.

Republicans on the committee joined in the criticism of the rating agencies, but our ratings are not influenced by commercial considerations.”

Mr. McDaniel, chief executive of Moody’s, said that the government-sponsored mortgage agencies Freddie Mac and Fannie Mae were also to blame. A statement by Tom Price, the House Financial Services Committee chairman, said, “We have reviewed the testimony of the agencies and found no substantive issues that would lead us to change our position.”

Other documents released by the committee show emails and messages between the agencies’ analysts questioning the quality of the ratings process.

One exchange between Standard & Poor’s employees shows our analysis saying, “We rate every deal.” Another memo said, “It could be structured by any means and in any way.”

Mr. McDaniel said that, while the agencies have been criticized, they continue to be valuable to the financial system. He said, “We are the ones who have the right to disagree with us.”

Mr. McDaniel also criticized the government-sponsored mortgage agencies, saying, “We are the ones who have the right to disagree with us.”
Asian Banks' Exposure to Structured Investments at Year-End 2007

Total Exposure = $23.2 billion

- Thailand: $10.0 billion
- India: $3.8 billion
- Hong Kong: $2.9 billion
- Korea: $2.6 billion
- Taiwan: $2.4 billion
- Singapore: $1.8 billion
- China: $1.0 billion
- Philippines: $0.1 billion
- Malaysia: $0.1 billion
Asian Banks' Structured Products/Mortgages Write-Downs in 2007-2008

Total Write-Down = $20.7 Billion
Cheyne Clients:

National Agricultural Cooperative Federation (Korea)
Bank SinoPac (Taiwan)
Abu Dhabi Commercial Bank (UAE)
King County, Washington
deutsche Postbank AG (Germany)
Global Investment Services Limited (New Zealand)
Gulf International Bank B.S.C. (Bahrain)
Bank Hapoalim B.M. (Israel)
Pennsylvania School Employees’ Retirement System (United States)
Florida State Board of Administration (United States)
The Bank of N.T. Butterfield & Son Limited (Bermuda)
Commerzbank AG (Germany)
SEI Investments Company (United States)
A Matter of Opinion?

- THERE will be admirers of Floyd Abrams, the most famous First Amendment lawyer in the country, who are surprised to learn that he represents a corporation widely regarded as Part of the Problem in the economic meltdown. These people are likely to have a passing familiarity with Mr. Abrams’s four-decade career and think of him as a tribune of free speech and a defender of underdogs.

- But legislators have so far been unable or unwilling to truly take on the companies. Now, a number of plaintiff’s lawyers are about to try their luck in court.

- Mr. Abrams will contend that S&P’s ratings deserve exactly the sort of free-speech protections afforded to journalists, on the theory that a bond rating is like an editorial — an opinion based on an educated guess about the future. And for the same reason you can’t sue editorial writers, Mr. Abrams will argue that you can’t sue a bond rater because the economy went into a free fall that few saw coming.

- Variations of these arguments have worked for S.& P. in the past. In fact, aside from a small settlement in an Orange County, Calif., case 10 years ago, no litigant has wrested even token sums from S.& P. Which means that today, the company stands roughly where the tobacco companies stood in the mid-1990s: unpopular in public, virtually undefeated in court.
Judge Limits Credit Firms’ 1st-Amendment Defense

Ruling in Cheyne Finance Case Lifts Protection for Ratings Not Made Public; Moody’s, McGraw-Hill Stocks Fall

Shares in two companies that own credit-rating firms — Moody’s Corp. and McGraw-Hill Cos., declined on Thursday in reaction to a court decision that rejected the companies’ long-time claim that the First Amendment protected them from lawsuits.

By Nathan Koppel, Andrew Edwards and Chad Bray

The ruling is expected to spur more lawsuits and could apply to securities — those that were distributed to a limited number of investors — don’t deserve the same free-speech protection as more general ratings of corporate bonds that were widely disseminated.

The judge’s decision is one of the first to interpret the extent to which the firms can expect First Amendment protection for their ratings of certain securities, which have been the focus of much litigation since the credit crisis. Her decision claiming the two ratings services issued misleading “investment grade” ratings to a $5.86 billion structured investment vehicle, once known as Cheyne Finance, that collapsed in 2007. The suit is seeking class-action status on behalf of investors who had losses from the liquidation of notes issued by Cheyne SIV between October 2004 and October 2007.

SIVs typically used short-term debt to buy long-term assets, largely residential mortgage-backed securities. The judge said ratings are typically protected from liability and subject to an actual malice exception because their ratings are considered matters of public concern. “However, the ruling’s page 52-week share performance chart shows how credit-rating firms’ stocks have performed:

Credit-Rating Firms
- McGraw-Hill (MHP): down 33%
- Moody’s (MCO): down 39%

It also states that the court’s ruling on the First Amendment was based purely on plaintiffs’ allegations, and we are hopeful the court will review the issue once the true facts are before it,” said Michael Adler, a Moody’s spokesman.

Martin Redish, a constitutional-law professor at Northwestern University School of Law, questioned whether the judge is correct in seeing free-

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Holding Rating Agencies Accountable

By GRETCHEL MORGENSEN

Documents in a civil suit in federal court appear to threaten a legal defense that credit ratings agencies have long used to fend off liability for misjudging securities that later cost investors vast sums in losses.

For years, the ratings agencies have contended that the grades they assign debt securities are independent opinions and therefore entitled to First Amendment protections, like those afforded journalists. But newly released documents in a class-action lawsuit in Federal District Court in Manhattan cast doubt on the independence of the two largest agencies, Moody’s Investors Service and Standard & Poor’s, in their work with a Wall Street firm on a debt deal that went bad as the credit crisis began.

The case, filed in 2008 by a group of 15 institutional investors against Morgan Stanley and the two agencies, involves a British-based debt issuer called Cheyne Finance. Cheyne was a structured investment vehicle, created in 2005, that raised $3.4 billion in short-term debt from investors. The company was meant to profit by purchasing longer-term obligations that generated more income than the company paid to its lenders.

But Cheyne collapsed in August 2007 under a load of troubled mortgage securities. The institutions that bought almost $1 billion of its debt, including the Abu Dhabi Commercial Bank and the Pennsylvania Retirement System, lost money. The investors claimed their losses continued to grow.


The New York Times

Documents in a Civil Suit Undercut Ratings Agencies’ Claim of Independence

continue to do so.” Representatives from both Moody’s and S&P. said that the case was without merit and that the documents were taken out of context. They also vowed to defend themselves vigorously in the matter.

A Moody’s spokesman added, “Our ratings are fully independent and based on robust and objective analytical criteria.” The lenders representing the plaintiffs declined to comment on the filing.

When Cheyne issued its various securities in 2005, Moody’s and S&P. rated them all investment grade. Even though Cheyne’s portfolio was hedged with residential mortgage securities, some of its debt received the agencies’ highest ratings, a grade equal to that assigned to United States Treasury securities. About two years later, as mortgage losses began to balloon, both agencies downgraded Cheyne’s debt below investment grade, to what is known as junk.

After the institutions that bought Cheyne’s debt sued Morgan Stanley and the ratings agencies, Moody’s and S&P. immediately mounted a First Amendment defense. But Shira A. Scheindlin, the federal judge overseeing the matter, ruled in September 2009 that it did not apply because the Cheyne deal was a private offering whose ratings were distributed to a small group of investors and not the public at large. Judge Scheindlin agreed with the plaintiffs, who argued that the ratings were not opinions but were misrepresentations that were possibly a result of fraud or negligence.

“The deficiencies in the Information Memoranda that ‘a credit rating represents a rating agency’s opinion regarding credit quality and is not a guarantee of performance or a recommendation to buy, sell or hold any securities’ are unavailing and insufficient to protect the rating agencies from liability for promulgating misleading ratings,” Judge Scheindlin ruled.

The judge also ruled against the defendants’ motion that documents and defenses generated in the case should be sealed. As a result, e-mails and deposition transcripts were filed with the court on Monday, showing how clearly agency officials rated the deal in a conversation with Morgan Stanley, the firm that hired them to rate Cheyne’s securities. For example, when the primary analyst at S&P. notified Morgan Stanley that some of the Cheyne securities would most likely receive a B3 rating, not the A grade that the firm had wanted, the agency received a blistering e-mail from a Morgan Stanley executive. S&P. subsequently raised the grade to A.

And when a Morgan Stanley colleague asked for information about the Cheyne deal, Ramy Moubark, an analyst at Morgan Stanley on the deal, wrote in an e-mail: “I attach the Moody’s NTR (that we ended up writing)” referring to the new issue report published by Moody’s in August 2005.

The court filings also demonstrate a lack of methodology for analyzing the Cheyne debt. For example, an e-mail before the deal was sold, S&P. ‘s head analyst wrote to a colleague: “I had difficulties explaining HOW we got to those numbers since there is no science behind it.” The documents show that the lead analyst at Moody’s noted there was “no actual data backing the current model assumptions” for segments of the Cheyne deal.

The ratings agencies were also reluctant to turn down business from issuers of complex securities like Cheyne, the documents show. Terry Legan, a former managing director in S&P.’s structured finance unit, wrote to colleagues in an e-mail in February 2005: “I don’t want to miss one deal because of my model assumptions.” There is any possibility of ‘faking’ the deal itself to get all of this so that we don’t have to compromise!”
Rating Agencies Lacked Reliable Data; They Knew it; But Rated Deals Anyway

--- Original Message ---
From: Gilles, Kai
Sent: 01 September 2005 17:49
To: Inglis, Perry; Bryan, Andrea
Cc: Guadagnolo, Lapo; Van Acoleyen, Katrien; Chandler, Cian; Jobst, Norbert; Wong, Elwyn; Watson, Bob
Subject: Long/Short and time-to-default for ABS

Perry/Andrea,

Given that we are seeing some enquiries involving the above, I wanted to point out that we have not yet developed a robust approach for ABS that would allow us to value the benefit from short or default times (e.g. step-up structures, LevSS). There are several reasons for this:

- paucity of historical data, especially for single ABS sectors
- high correlation assumptions, which are conservative for long
Rating Agencies Lacked Reliable Data; They Knew it; But Rated Deals Anyway

Dear all,

Yes, certainly.

Please appreciate the lack of relevant data backing your proposal in general and therefore a lot of reliance in interpolation. We understood that fact with limited info there are not many alternatives and agree on the methods but it also means that we should all take the results with some care.

Best regards,

---Original Message---
From: Ross, David [David.Rosa@moodys.com]
Sent: Friday, August 06, 2004 12:27 PM
To: Drennan, Gregg (FID); Bouthors, Emilie (FID)
Cc: Adrian Mallinson; Tabe, Henry
Subject: RE: Matrix proposal

Dear all,

Yes, certainly.

Please appreciate the lack of relevant data backing your proposal in general and therefore a lot of reliance in interpolation. We understood that fact with limited info there are not many alternatives and agree on the methods but it also means that we should all take the results with some care.

Best regards,

---Original Message---
From: Drennan, Gregg (FID) [matt.griffin@drennan@morganstanley.com]
Sent: Friday, August 06, 2004 11:09 AM
To: Bouthors, Emilie (FID); Ross, David
Cc: Mallinson, Adrian [CHEYNE CAPITAL MANAGEMENT LTD. (London)]; Tabe, Henry; qgf
Subject: RE: Matrix proposal

David,

Are you available to discuss a few points later today?

Thanks,

Gregg Drennan - Vice President
Morgan Stanley Asia Limited
28 Hongkong Street (Tamariff Building), Floor 31
London, EC1A 4HT
Phone: +44 20 7977 6070
Mobile: +44 7819 898957
Fax: +44 20 7977 6316
Gregg.Drennan@morganstanley.com

---Original Message---
From: Bouthors, Emilie (FID)
Sent: 05 August 2004 14:43
To: Ross, David
Cc: Mallinson, Adrian [CHEYNE CAPITAL MANAGEMENT LTD. (London)]; Tabe, Henry; qgf
Subject: RE: Matrix proposal

David,

please find attached our new capital matrix proposal.

Z0485293
HIGHLY CONFIDENTIAL
Rating Agencies Lacked Reliable Data; They Knew it; But Rated Deals Anyway

--- Original Message ---
From: [redacted] <[redacted]@redacted.com>
To: [redacted] <[redacted]@redacted.com>
Subject: HEL New Product Changes

Dear [redacted],

Please note that in relation to assumed spread vol for the Aa and A there is no actual data backing the current model assumptions and we will for now accept the proposal to use the same levels as RMBS given that this assumption is supported by the analysis of the Aaa data (RMBS versus HEL) and Cheyne’s comments on their views of this asset class. However please note that in case reliable data on these becomes available to Moody's which demonstrates more conservative assumptions are required we will request Cheyne to review current model inputs.

Best,
[redacted]
Analysts at the Rating Agencies Summed it up

Subject: RE: Coverage CREDITFLUX - Agencies rethink ABS correlation
I find it interesting that we have "attracted fierce criticism from rival rating agencies who believe it is assumes too little correlation". If anything I would have assumed the default rates we apply should attract more criticism. The two key points here are that they are applied on a blanket ABS approach (ie the same to each asset class implying that a whole business securitisation is the same as a RMBS deal) and from looking at the numbers it is obvious that we have just stuck our proverbial finger in the air! Is there any move to refine these numbers despite the lack of default data for ABS.

Stephen
The Investment Banks Applied Pressure

The Current Reality

Model development somewhat “ad-hoc”

- Too much reliance on bankers’ models
- Lack of consistency between quite similar transaction types
- Freedom to innovate is constrained by “legacy” approaches
- Difficult even to “keep up” with the market, much less develop new ideas
- Our competitors are ahead of us in bringing their analytics to the market

Little or No Strategic Research

- We are almost purely “reactive” to the market
- We create new model risks every day
- We can produce a rating, but have very little idea how sensitive those ratings are to market developments or model assumptions
To Rate or Not to Rate: Market Share

From: Snailer, Joseph <snailerj@dnb.com>
Sent: Thursday, November 20, 2003 8:39 PM
To: Clarkson, Brian <clarksonb@dnb.com>
Cc: Silver, Andrew <silvera@dnb.com>; Kirnon, Noel <kironnn@dnb.com>; May, William <mayb@dnb.com>; Harris, Gus <harrisg@dnb.com>; Bankole, Ed <bankole@dnb.com>; Kanef, Michael <kanefm@dnb.com>; Eisbruck, Jay <eisbruckj@dnb.com>; Robinson, Claire <robinso@dnb.com>; Stesey, Linda <stesneyl@dnb.com>; Kriegler, Andrew J. <krieglera@dnb.com>; Gupta, Pramila <guptap@dnb.com>; Siegel, Jay <siegelj@dnb.com>; Philipp, Tad <philippt@dnb.com>; Duca, James <ducaj@dnb.com>
Subject: SF Market Share Commentary

Brian,

Attached is the updated version of the SF market share commentary. I have updated it to reflect what I have received from the MDs.

Joe

---

Brian,

Attached is the updated version of the SF market share commentary. I have done some editing and formatting but this basically reflects what I have received from the MDs.

Joe

---

We at all times attempt to have our models proactively on the frontier between “aggressive” and “correct”.

- To the extent there is a pattern to the deals we have missed, we analyze it and quickly determine if either there is any merit to changing our approach, or whether we should engage the market and point out the differences between our approach and our competitors.

- We feel, as usual, that currently we are near the edge with our models and continue to have concerns that since the other agencies do not seem to be able to effectively compete with us on research, analytics or service that they will turn to lowering levels further.
To Rate or Not to Rate: Market Share

We are meeting with your group this week to discuss adjusting criteria for rating CDOs of real estate assets this week because of the ongoing threat of losing deals. I am much less concerned about whether it is an actual investor attack or not. Whatever the reason, the fact is, bonds below ‘AAA’ are pricing wider which impacts the weighted average pricing on the deals. Ultimately issuers will react by taking the path of least resistance and making sure Moody’s is on the deals. Thereafter, it’s only a matter of time before their rating is also mandated for the primary deals as well.
To Rate or Not to Rate: Market Share

that an LGD model must incorporate forecasted default rates for property values on a market segment-by-segment basis.

As far as rating real estate cash flow and synthetic CDOs go, clear and comprehensive information is key. The Moody's or Fitch's Real Estate Loss rates are not always equal. I am not criticizing their work. I think they do create a more simplified scenario or scenario model that would be useful. I suppose you could try to do a rating based on the loan level basis of the information. But this is a more complex task. If you are going to be using LGD forecast models, I think there is little empirical evidence on this.

Also need to discuss with both you and Charlie the immediate need for a solution to rating real estate cash flow and synthetic CDOs. Evaluators in our current state is not adequate for these deals and we have been applying makeshift solutions but are in need of a more scientific or robust solution at this point. There isn't any empirical data which supports purely statistical solutions so what we come up with will be subjective which is very typical of this asset class. We have been working with the CDO group here but no solution to date.

Moody's and Fitch have become very competitive and the volume of these deals has increased significantly. If we were using Evaluators in its current state without the tweaks, we would not be rating these deals right now. As you know, if we don't rate the CDOs, we will lose the primary deals as well. I am appealing to you for your assistance as I am afraid that if we do not come up with something we will lose ground. I will be away at the CMSA conference today thru Friday but will set up a time to speak to both of you next week.
To Rate or Not to Rate: Market Share

From: Gilkes, Kai
Sent: Monday, August 16, 2004 9:20 AM
To: Inglis, Perry; Collingridge, Simon
Subject: RE: Cash flow model for CDO Online

I don't think a one-day offsite can achieve anything more than a rehash of the issues, and perhaps some arguments over the details. How can we possibly solve these problems in 1 day, when we haven't even been able to get some people to recognise them in over a year? As usual, things reach crisis level due to competitive pressures, rather than being properly thought-out and debated over time. I fear that "Quick" and "Decisive" are two words which seem to be absent from NY S&P vocabulary...

--- Original Message ---
From: Gilkes, Kai
Sent: Monday, August 16, 2004 9:20 AM
To: Inglis, Perry; Collingridge, Simon
Subject: RE: Cash flow model for CDO Online

Simon and Kai,

Guido just gave me a call on this to talk about the issues.

His belief is that some of these notional contents (looking at the list below, I think he is spot on with 2 and 3) and it may help to have a facilitated meeting on these before deciding on this or deciding what cash flow model to adopt (recognising that the outcome of 2 and 3 can mean sacrifice the ability to use existing model suite currently on offer) and then answering such issues as grandfathering/surveillance/terra etc.

I am actually not sure how contentious any of this actually is as I never David is a supporter, but anyway, I suggested to Guido that Sept 9th worked best for us and would ask you both to pencil it into your diaries. Of course I say this should have all been sorted out years ago - but I suspect it will come out at some point.

Perry

--- Original Message ---
From:Gilkes, Kai
Sent: 26 August 2004 14:12
To: Inglis, Perry; Collingridge, Simon
CC: Gilkes, Kai; Collingridge, Simon

Dear Perry, Gary, Carolee, Money, Effie,

As I mentioned to those of you who are in, at the SFLT Strategic Planning session this week, SFLT has decided to include a cash flow model in CDO Online. It is imperative that this cash flow model be the model that S&P uses for their model ratings and surveillance, and it would be difficult to justify using different models in different offices. We must move quickly on deciding which model to choose so that we can be ready for programming once IT is freed up from the first phase of CDO Online implementation. This is going to be a charge that will require us to address some difficult issues including:

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S&P-ACC 097791
To Rate or Not to Rate: Market Share

**Global Real Estate Finance Offsite**
**June 18-20 2007**

**Kim** - Bankers pushing out boundaries.....is this temporary? Probably not if there is no negative response from S&P and others. Bankers say, “Why not originate bad loans, there is no penalty.”

**Gale** - The consequences when we push back is that we don’t rate a deal.

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**What does this all mean?**

**How did we get here?**

![Diagram](image)

**Definition of Success—Rating the Deal**

The process for rating a deal is well mapped out, whereas the path for not rating a deal is not very clear. It is analogous to having to choose between a superhighway vs. a narrow dirt path.
The End Result

From: Wong, Elroye
Sent: Wednesday, November 23, 2005 10:34 AM
To: Chief, Belinda; Kaufman, Peter
Subject: FW: Disclosure - Help

Only get better.

--- Original Message ---
From: Ryan, Andrea
Sent: Wednesday, November 23, 2005 10:27 AM
To: Wong, Elroye
Subject: Re: Disclosure - Help

You. What happens when they learn that cash deals won't be using it.

Sent from my BlackBerry Wireless Handheld.

--- Original Message ---
From: Wong, Elroye <Elroye.Wong@us.ensagen.com>
To: Ryan, Andrea-Carolee <Ryan@us.ensagen.com>
Subject: Re: Disclosure - Help

Lord help our fucking scam... this has to be the stupidest place I have worked at. Marc Steinberg is selling us a cash CDO of ABS portfolio to check as we speak. I can't see that we will not provide them any signoff.

Sent from my BlackBerry Wireless Handheld.

--- Original Message ---
From: Wong, Elroye <Elroye.Wong@us.ensagen.com>
To: Ryan, Andrea-Carolee <Ryan@us.ensagen.com>
Subject: FW: Disclosure - Help

I guess we have got based bon from FAs.

--- Original Message ---
Then, two weeks ago, a major milestone was reached. Standard & Poor's Rating Services and Moody's Investors Service decided for the first time to pay up and settle allegations over their flawed ratings of subprime securities. With trial quickly approaching, the defendants agreed to shell out a reported $225 million to resolve two suits brought by investors who claim they lost hundreds of millions of dollars in a couple of investment vehicles called Cheyne Finance and Rhinebridge that crashed in 2007.
Thanks to a mountain of evidence gathered for a pair of major lawsuits by the San Diego-based law firm Robbins Geller Rudman & Dowd, documents that for the most part have never been seen by the general public, we now know that the nation's two top ratings companies, Moody's and S&P, have for many years been shameless tools for the banks, willing to give just about anything a high rating in exchange for cash.

Thanks to these documents, we now know how that happened. And showing as they do the back-and-forth between the country's top ratings agencies and one of America's biggest investment banks (Morgan Stanley) in advance of two major subprime deals, they also lay out in detail the evolution of the industrywide fraud that led to implosion of the world economy — how banks, hedge funds, mortgage lenders and ratings agencies, working at an extraordinary level of cooperation, teamed up to disguise and then sell near-worthless loans as AAA securities. It's the black box in the American financial airplane.
U.S. ACCUSES S&P OF FRAUD IN SUIT ON LOAN BUNDLES
HIGH RATING FAULTED
First Big Federal Action Against Industry on Sour Mortgages

By MARY WILLIAMS WALSH and ANDREW ROSS SORKIN
The Justice Department late

U.S. to sue S&P for fraud in mortgage case

Justice Dept. to sue S&P

TARGETS ROLE IN FINANCIAL CRISIS
Civil action to be first vs. major ratings firm

BY JIA LYNN YANG

The Justice Department is preparing to file a civil lawsuit against the ratings agency Standard & Poor's that will allege the company gave its seal of approval to toxic investments at the heart of the financial crisis, according to the company and people briefed on the case.

Kevin McCoy
USA TODAY

Standard & Poor's Ratings Services expects to be the first major rating firm hit with fraud charges by the government over its appraisals of securities that led to the national financial meltdown, the firm said Monday.

S&P said the U.S. Department of Justice had alerted the firm that the federal government plans to file a civil lawsuit focused on the firm's ratings of subprime mortgage-backed bonds in 2007.

S&P said such a lawsuit — which would mark a significant expansion of government efforts to hold financial firms accountable for the crisis — "would be entirely without factual or legal merit."

"It would disregard the central facts that S&P reviewed the same subprime mortgage data as the rest of the market — including U.S. government officials who in 2007 publicly stated that problems in the subprime market appeared to be contained — and that every mortgage-backed bond that the Department of Justice has cited to us also independently received the same rating from another rating agency," the company said.

Investors relied on the high ratings on the bonds that signified low default risk, but the Financial Crisis Inquiry Commission's report in 2010 said the ratings were wrong and added "we conclude the failures of credit-rating agencies were essential cogs in the wheel of financial destruction."

Department of Justice spokesman Adam Andy declined to comment on the S&P lawsuit disclosure. Spokesmen for the attorneys general offices in California and New York declined to comment on whether they planned to join the expected federal action.

Shares of McGraw-Hill, S&P's parent firm, closed down nearly 13.8% at $50.30 Monday.

It was not clear whether the government plans similar action against S&P's credit-rating rivals, Moody's and Fitch Ratings. Moody's did not respond to a Wall Street Journal request.

Fitch spokesman Daniel Noonan said, "We have no reason to believe Fitch is a target of any such action."

S&P argued that a number of court decisions had "made with 20/20 hindsight to a credit agency's opinions of creditworthiness." As a result, the government plans to sue under a 1989 statute enacted to stabilize and reform the savings and loan industry, a move the ratings firm called an "end run" around "established legal precedent."

"If DOJ does bring suit, we will vigorously defend our company and our ratings against such meritless litigation," S&P said.

Defending pre-crisis actions, the firm said it acted ahead of peers in downgrading residential mortgage-backed securities included in debt obligations. Those actions required posting of additional collateral or other protection to maintain AAA ratings on debt obligations, S&P said.

The company said it has spent roughly $400 million since 2007 to tighten safeguards against potential conflicts of interest with entities it rates, improve methodologies and monitor risks to global credit systems.

USA TODAY 02.05.13

THE WALL STREET JOURNAL
Some private lawyers agree. "While the Justice Department targeted S&P in its lawsuit, we believe that Moody's is equally culpable," said Dan Drosman, an attorney representing institutional investors in a jury trial against S&P and Moody's set for May. The plaintiffs claim the rating firms issued fraudulent ratings that triggered investors' losses. The defendants have denied wrongdoing.