The New York Times

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December 8, 2009

Back to Business

Debt Raters Avoid Overhaul After Crisis

By DAVID SEGAL

When the financial crisis began, few players on Wall Street looked more ripe for reform than the Big Three credit rating agencies.

It wasn't just that Moody's Investors Service, Standard & Poor's and Fitch Ratings, played a crucial role in the epochal housing market collapse, affixing their most laudatory grades to billions of dollars worth of bonds that went bad in the subprime crisis.

It was the near universal agreement that potential conflicts were embedded in the ratings model. For years, banks and other issuers have paid rating agencies to appraise securities — a bit like a restaurant paying a critic to review its food, and only if the verdict is highly favorable.

So as Washington rewrites the rules of Wall Street, how is the overhaul of the Big Three coming? It isn't, finance experts say.

"What you see in these bills are Botox shots," says Joseph A. Grundfest, a professor of securities law at Stanford Law School. "For a little while, everyone is going to be frozen into a grin, and then the shots are going to wear off."

What explains the timidity of Congress' proposals? This is not a case of lobbyists beating back ideas that might hurt their clients, say those close to the discussions. Instead, Congress is worried that bold measures may backfire. The Big Three, by allowing companies and public entities to raise money by issuing debt, are an essential engine in the country's vast credit factory, and given the still-fragile condition of the equipment, lawmakers are reluctant to try anything but basic repairs, patches and a new alarm system.

In addition, legislators say, there is little consensus about what a top-to-bottom renovation should look like.

Under bills that legislators are currently considering, the rating agencies will have to contend with greater oversight, stiffer rules about disclosure and a provision that would make it easier for plaintiffs to sue the firms. But nothing in the laws tackles the critic-for-hire problem or threatens the 85 percent market share that Moody's, S.& P. and Fitch now enjoy.

"It's fair to say we knew we were taking on a problem with no silver bullet," said Representative Paul Kanjorski of Pennsylvania, the chairman of the Financial Services subcommittee that has led reform efforts in the House. "I'm convinced that we're getting more control over the rating agencies than ever before but not at all sure we've developed the perfect system."

Dozens of Lawsuits

While Congress may be happy with cosmetic surgery, law enforcement officials are getting more aggressive. Dozens of lawsuits have been filed against the rating agencies, including a case filed on Nov. 20 by the Ohio attorney general on behalf of public pension funds. The Ohio suit, as well as the earlier suits, seeks billions of dollars in damages from the rating agencies and accuses the firms of negligence and fraud.

When he filed his suit, Ohio's attorney general, Richard Cordray, said that the "rating agencies' total disregard for the life's work of ordinary Ohioans caused the collapse of our housing and credit markets and is at the heart of what's wrong with Wall Street today."

After the suit was filed, Richard Blumenthal, Connecticut's attorney general, said he planned to join the suit and thought that a "coalition of states" would also jump on the legal bandwagon — a potentially grim development for the rating agencies, which could find themselves contending with a phalanx of state officials like the one that aimed at big tobacco in the 1990s.

The Big Three object that the legislation proposed by Congress could make them more vulnerable to legal action. But they otherwise do not sound particularly exercised about much else that is likely to become law.

"Moody's shares the committees' goal of increased transparency for the ratings process," said Michael Adler, a

Moody's spokesman.

S.& P. is equally sanguine. "We support globally consistent, nondiscriminatory regulation that will help restore investor confidence and bring more transparency to the capital markets," said Catherine J. Mathis, a spokeswoman for Standard & Poor's. A spokesman for Fitch declined to comment.

Without question, the credit rating system is one of the capitalism's strangest hybrids: profit-making companies that perform what is essentially a regulatory role. The companies serve the public, which expect them to stamp their imprimatur on safe securities and safe securities alone. But they also serve their shareholders, who profit whenever that imprimatur shows up on a security, safe or not.

To make matters more complicated, rating agencies are deeply entrenched in millions of transactions. Statutes and rules require that mutual fund and money managers of almost every stripe buy only those bonds that have been given high grades by a Nationally Recognized Statistical Rating Organization, as the agencies are officially known.

But even if there is no foolproof way to reform the rating agencies, the measures that Congress is now backing are strikingly weak, a number of critics say. There is no talk, for instance, about creating a fee-financed, independent credit rating agency, one modeled along the lines of the Public Company Accounting Oversight Board, which was established to oversee auditors after the Enron debacle — an idea floated by Christopher J. Dodd, the Senate Banking Committee chairman as recently as August.

That approach would attack the conflict of interest problem head on.

Nor is anyone on Capitol Hill suggesting a rewrite of all those rules that put rating agencies in the middle of so much Wall Street action. Instead of cajoling the Big Three into producing more accurate ratings, why not take away the special status of those ratings and make them less important?

"There are a lot of complicated issues that nobody knows how to deal with, like water shortages in different parts of the world," says Jonathan Macey, a deputy dean at Yale Law School and a member of a bipartisan task force that has conferred with lawmakers about rating agency reform. "But this isn't one of them. We could solve this one pretty easily with a modicum of political will. It's just mortifying."

Meantime, to the consternation of detractors, the companies are now earning fees from a new source: re-Remics, an acronym for resecuritization of real estate mortgage investment conduits. These are transactions that take downgraded mortgage securities and separate the riskiest assets from the strongest, making the strongest easier to sell.

The companies do not break out re-Remic revenue in financial reports, but to some, it seems to be a way for rating agencies to profit from a mess they helped make.

Academics and former rating agency employees who have been warning lawmakers about the Big Three for years say Congress is tiptoeing when it ought to be charging ahead. But for now, and for the foreseeable future, the market for ratings is sure to look uncannily similar to the one that helped usher in the crisis: three rivals, all of them paid by issuers, bestriding the market.

It is a picture of the future so rosy and so rife with the potential for profits that some investors see a buy sign.

"I've had a few hedge funds call and ask me what I think of the rating agencies as investments," said Frank Partnoy, a professor of law and finance at the University of San Diego school of law, who has written extensively on the rating agencies. "If the dysfunctional regulatory structure stays put, the rating agencies soon will be back to business as usual, which will mean a continuing monopoly and sky-high operating margins approaching 50 percent."

In November 2005, the structured finance department of Moody's held its annual off-site meeting at Chelsea Piers, a sports and entertainment complex in Manhattan. The day, according to several attendees, started as it always did, promptly at 8 a.m. There were hours of presentations, trust-building exercises and near dinnertime, a small concert by three top executives dressed as the Blues Brothers.

Their song, an original called "The Compliance Blues," was all about the problems of dealing with Moody's compliance department, the group in charge of maintaining the company's ratings standards. A photo of the faux Blues Brothers later showed up in Moody's in-house magazine.

The performance, according to several former Moody's employees who requested anonymity because they have

signed severance agreements, turned the company's quality control team into comic fodder. And it came just as the Securities and Exchange Commission was publicly devising the Credit Rating Agency Reform Act of 2006. One of the act's major new initiatives: bulking up the compliance departments.

Mr. Adler, the Moody's spokesman, says that the Blues Brothers skit "poked fun at the intensity of our own compliance efforts," and was meant to underscore "that while dealing with these compliance obligations could be cumbersome and time-consuming for analysts, it was nonetheless crucial to our business."

Others remember it differently. Scott McCleskey, a former F.B.I. agent and the man Moody's hired as its "designated compliance officer," in accordance the 2006 act, testified on Capitol Hill last summer that he was marginalized almost from the start and excluded from important meetings at Moody's, including those with the S.E.C. when it examined the company.

He was fired in 2008, having been told little more than that he had lost the confidence of his bosses.

The ease with which Moody's side-stepped provisions of the 2006 law — which also gave the S.E.C. more authority to inspect the agencies, among other measures — has some critics arguing that Washington is now simply pushing a stronger version of old and ineffective medicine. At minimum, much of what is in the House and Senate bills sounds familiar.

Both bills enhance the power of the S.E.C. to supervise the rating agencies and both require the companies to bulk up their compliance teams. The Senate bill allows individuals to sue a rating agency for a "knowing or reckless failure to investigate or to obtain analysis from an independent source."

Mr. Kanjorski and Senator Jack Reed of Rhode Island, who led the Senate's look at rating agencies, said in interviews that they thought their bills went as far as possible to change the system in a judicious manner.

"We all understand the outrage," Mr. Reed said, "but our priority is to prevent this from happening again, rather than looking backwards and punishing."

Mr. Reed has listened in recent months to lots of proposals that would have aimed at the issuer-pays system and promoted alternatives. He also looked at the idea of curtailing the importance of ratings by rewriting rules

and laws that require mutual fund and money managers to stick to triple-A securities.

But he was concerned about the huge numbers of professional investors out there — like those working for small towns — who don't have the resources to research every bond they buy.

Mr. Kanjorski said he worried about remedies that undermined the Big Three because they were pretty much the whole system right now.

"We want to do as much correction as we can," he said, "but we don't want to kill the institutions because we have nothing to replace them with."

One senior Senate aide, who requested anonymity because the aide was not authorized to speak, said that the bill that would reach President Obama's desk early next year would merely be a beginning.

"Look at what happened in the 1930s," this aide said, "they passed bill after bill after bill. Now, we're not going to do that, but credit rating agencies are so tied into the way business is conducted, so tied into rules, it's going to be incredibly complicated to unwind, and we're not going to fix it all in one bill."

Still, there is worry that if Congress doesn't think ambitiously now, it never will. Mr. Macey of Yale Law School, who advocates rewriting the rules that now require nationally recognized statistical ratings organizations to bless countless deals, says that the ratings system as it currently stands encourages bubbles.

"You have to ask yourself this question, in any matter of financial reform: Does the change increase the chances of lemminglike behavior?" he said. "Because that is the root of all great busts. The price of tulips doesn't soar because a newspaper says that tulips are undervalued. It soars because everyone is buying them. And that's the problem with ratings. They turn investors into lemmings."

Business Is Down

Even after the disastrous performance of recent years, the Big Three remain deeply entrenched. In September, four companies — Bank of America, Nissan, Discovery and American Express — issued structured finance bonds, worth more than $6 billion, and paid Moody's to rate them. None of the companies would comment on

their transactions with the rating agencies.

Business, of course, is down for the rating agencies compared with the boom years. Revenue at Moody's will this year come in at approximately $1.8 billion, predicted Michael Meltz, an analyst for J.P. Morgan Securities, down about 20 percent from the peak in 2007. Shares that traded in the 70s two years ago now trade in the mid-20s.

"The brands have been hurt in the last five years, that's a factual statement," Mr. Meltz said. "But when I look at these stocks and see where they're trading relative to the market, given their earnings generating capacity, I find them attractively valued."

Given how entrenched the ratings giants already are, some worry that the current legislative proposals will solidify their positions.

"I think these bills are misguided and wrongheaded because they will have the ironic effect of making the incumbents even more important," said Lawrence J. White, an economics professor at the Stern School of Business at New York University. "They're going to encrust the procedures already in place and discourage new business models."

The paradox is that everyone — even the Big Three — insist that the current system has to change. But somehow, what looked like the low-hanging fruit of financial reform is still dangling, right where it hung at the start of this calamity.

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