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## Postcrisis, a Struggle Over Mortgage Bond Ratings

By JESSE EISINGER

Two weeks ago, Standard & Poor's put out a news release warning that it was poised to lower its ratings on almost 1,200 complex mortgage securities.

Melissa Golden/Bloomberg News  
Eric Kolchinsky, a former Moody's executive who said he had tried to blow the whistle on ratings problems at the firm.

So what? Isn't that dog-bites-man at this point?

Well, two-thirds of these mortgage bonds were rated only last year, long after the financial crisis. And S.&P. was supposed to have taken the distress of the housing crash and credit crisis into account when it assessed them. But in December, the ratings agency acknowledged that it had made methodological mistakes, including not understanding who would get interest payments when.

As everyone knows by now, the credit ratings agencies played an enormous role in creating the conditions that led to the financial crisis. Their willingness to slap triple-A ratings on all manner of Wall Street-engineered mortgage rot was enormously lucrative for the raters, but a disaster for the global economy.

Unfortunately, as the episode in December shows, the credit ratings agencies are **still struggling** to get it right.

These likely downgrades arose in a small corner of the market called re-remics. What you need to know about them is that they were do-overs. Wall Street took bonds that had collapsed (and that the agencies had rated incorrectly the first time) and rebundled them. Generally, the top half was rated triple A, supposedly exceedingly safe.

The agencies rated billions of dollars worth of these bonds, mostly in the last two

years. With shocking rapidity, even some of those triple A-rated bonds have defaulted. Of the more than \$85 billion of re-remics issued since 2009, an estimated \$30 billion may be under review by S.&P., [according to Bloomberg News](#).

The lesson is that the agencies are still susceptible to problems that plagued them before the crisis.

“What we’ve seen in re-remics truly does encapsulate everything that was wrong not just with ratings agencies, but with banking system as a whole during the boom,” said Eric Kolchinsky, a former Moody’s executive who said he had tried to blow the [whistle](#) on ratings problems at the firm.

During the mortgage securities boom, bankers knew more about their bonds than the ratings agencies did and took advantage. A similar problem occurred with re-remics. “Chances are that if a bond is getting re-remicked, it’s a bad bond and the holder wants to forestall the inevitable reckoning,” Mr. Kolchinsky said. The ratings agencies somehow missed that.

There also looks to have been “[ratings shopping](#),” where issuers seek out the most lenient firms, rather than the best. S.&P., according to Mr. Kolchinsky, was slower to downgrade residential mortgages than Moody’s was. Lo and behold, S.&P. nabbed the bigger market share in new offerings of residential securities. Then came the big debacle.

An S.&P. spokesman didn’t respond to a question about the ratings shopping issue. In an e-mail, he said: “A great deal has changed at S.&P. over the course of the past three years. We have significantly strengthened the ratings process.” One new aspect, he pointed out, is that the firm now has a policy to publicly correct errors.

The state of the ratings agencies might be less worrisome if effective regulatory oversight were coming. Unfortunately, the Dodd-Frank overhaul of credit ratings is in limbo.

Here’s the problem: Credit rating companies have long contended that their conclusions are protected by the First Amendment, much as if their ratings were as

irrelevant to the markets as, say, your average financial columnist. Dodd-Frank tried to change that, designating the agencies as “experts,” like lawyers or accountants, when their ratings were included in Securities and Exchange Commission documents for certain kinds of offerings. That would make them liable for material errors and omissions in their ratings.

But the agencies revolted. They refused to allow their ratings to be used in offering circulars, freezing up the markets. Panicked, the S.E.C. suspended the rule for six months, pending more study. Then in late November, the agency extended the delay **indefinitely**.

“For ratings reform to be successful it needs to provide incentives for rating agencies to be objective,” said Gene Phillips, a former Moody’s analyst who runs a ratings consulting firm. “The Dodd-Frank act achieves some of that, but absent the legal liability, or accountability, it’s much weaker.”

So much for that. And the news gets worse. In early December, the S.E.C. issued a laconic **notice** that it doesn’t have the money to put into effect big parts of the Dodd-Frank reforms. And now that Republicans have taken over the House, the S.E.C.’s budget for fiscal 2011 is an even greater question mark.

One thing on **hold**: creating an “Office of Credit Ratings” to oversee the powerful firms.

This office could wield enormous influence. You see, Dodd-Frank tabled many of the most important ratings agencies controversies, pending **studies** of the issues. If the S.E.C. actually produces the zillions of reports it’s supposed to over the next several years, every employee should be awarded an honorary Ph. D.

But since the S.E.C. can’t afford to create the office in the first place, we’ll probably still be waiting by the time the next crisis hits. Meanwhile, the agencies’ rubber stamp factories are humming, much to the delight of those on Wall Street with very short memories or very deep pockets.

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