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Bringing Down Wall Street as Ratings Let Loose Subprime Scourge

By Elliot Blair Smith

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Sept. 24 (Bloomberg) -- **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 called Pinstripe I CDO Ltd., Raiter says. Pinstripe was one of the new structured-finance products driving Wall Street's growth. It would buy mortgage securities that only an S&P competitor had analyzed; piggybacking on the rating violated company policy, according to internal e-mails reviewed by Bloomberg.

``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., according to Raiter. Flawed AAA ratings on mortgage-backed securities that turned to junk now lie at the root of the world financial system's biggest crisis since the Great Depression, according to Raiter and more than 50 former 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 in New York. ``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.''

Gold Standard

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

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

McCain, Obama

``This is appalling,'' says **Douglas Holtz-Eakin**, the former director of the Congressional Budget Office

from 2003 to 2005 who is now a senior policy adviser to the presidential campaign of Republican Senator **John McCain**. ``It is exactly the kind of behavior that has so badly hurt the financial markets.''

Senator **Barack Obama**, the Democratic nominee, said in a Sept. 15 interview, ``There's a lot of work that has to be done in examining the degree to which ratings agencies were involved in making some of this debt -- some of the leverage taken on -- look like it was much safer and less risky than it was.''

S&P, a unit of **McGraw-Hill Cos.**, 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 the underlying collateral. That was the custom of community bankers who extended credit only as far as they could see from their front porch.

`Didn't Want to Know'

``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. ``There is no substitute for fundamental credit analysis.''

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 served on the S&P structured-finance group's executive rating committee until 2000, when he says he was demoted for his clashes with his bosses. The former Marine and community banker retired in March 2005, when he became eligible for company-paid medical benefits.

Beating Exxon's Margin

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

By 2000, structured finance was the companies' leading source of revenue, their financial reports show. It accounted for just under half of Moody's total ratings revenue in 2007.

While prospectuses don't disclose fees, Moody's says it charged as much as 11 basis points for structured products, compared with 4.25 basis points for corporate debt. A basis point is a hundredth of a percent. S&P says its fees were comparable. A typical CDO paid 6 to 8 basis points, according to **Richard Gugliada**, 46, S&P's global ratings chief for CDOs until 2005. That would make rating the Pinstripe deal worth $300,000 or more.

Toughening Criteria

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. In January, S&P reassigned **Joanne Rose**, 51, its top structured-finance ratings executive since 1999, to a new position as executive managing director for risk and quality policy. In May, **Brian Clarkson**, 52, resigned as president of Moody's Investors Service. He was the company's top structured-finance executive for most of this decade.

``Independence, integrity and quality remain the cornerstones of everything we do and everything we stand for,'' S&P Vice President of Communications **Chris Atkins** said last week in a written response to Bloomberg 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.''

``We are certainly not going to respond to a disaffected ex-employee's statements,'' Atkins added in an e-mail, without specifying any individual.

Anthony Mirenda, a Moody's spokesman, declined to respond to questions submitted in writing and by phone.

Rise of the Quants

AAA ratings on subprime mortgage investments can be traced to the rise on Wall Street of quantitative analysts, or quants, with advanced degrees in math, physics and statistics. They developed computer-driven models that didn't rely on historical performance data, according to Raiter and others. If the old rating methods were like Rembrandt's portraiture, with details painted in, the new ones were Monet impressionism, with only a suggestion of the full picture.

S&P and **Moody's** built their reputations over generations, starting with Henry Varnum Poor's publication in 1860 of ``History of Railroads and Canals in the United States'' and John Moody's ``Moody's Manual of Industrial and Miscellaneous Securities'' in 1900. Since the Great Depression, U.S. agencies have relied on the companies to help evaluate the credit quality of investments owned by regulated institutions, gradually bestowing on them quasi-regulatory status. Yet as the 21st century began, much of that knowledge became obsolete.

Moody's Spinoff

Banks were combining thousands of fixed-income assets into custom blends of high-yield bonds, aircraft leases, franchise loans, mutual fund fees and mortgages. These structured investment pools didn't have the performance history that lay behind the corporate bonds.

The spinoff of Moody's by **Dun & Bradstreet Corp.** in September 2000 changed the service's focus from informing investors to responding to the demands of banking clients and shareholders, say several former Moody's analysts. They requested anonymity because they signed non-disclosure agreements when leaving or because they now do business with the company.

``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. ``Then Moody's went public. Everybody was looking to pick up every deal that they could.''

Clarkson became Moody's group managing director for structured finance in August 2000, a month before the spinoff. He replaced Adelson and other analysts to make the residential mortgage securities unit more responsive to clients, say several former Moody's professionals who requested anonymity because of confidentiality agreements.

`Less Collegial'

The executive visited Wall Street banking customers to pledge a closer, more cooperative relationship and asked whether any of his analysts were particularly difficult to work with, former Moody's managers say.

``Things were becoming a lot less collegial and a lot more bottom-line driven,'' says **Greg Gupton**, senior director of research in Moody's quant group at the time. He is now managing director of quantitative research at New York-based Fitch Solutions, a consulting unit of **Fimalac SA**, based in Paris. Fimalac also owns Fitch Ratings, the third-largest bond analysis company.

Clarkson didn't respond to requests for comment in messages on his home answering machine and in a note left on his door in Montclair, New Jersey.

The efforts initially produced results. Moody's share of rating mortgage-backed securities jumped to 78 percent in 2001 from 43 percent a year earlier, according to the industry publication Inside Mortgage Finance in Bethesda, Maryland.

Rating Pinstripe Deal

It was in this environment that the Pinstripe deal landed on Raiter's desk. The underwriters were units of what now are the investment banks **Credit Suisse Group** AG, based in Zurich, and RBS Greenwich Capital Markets Inc., in Greenwich, Connecticut.

The CDO packaged residential mortgage securities and real estate investment trusts, according to Fitch Ratings, which, unlike S&P, had reviewed the underlying loans, according to Raiter.

``We must produce a credit estimate,'' Gugliada, a member of the structured-finance rating group's executive committee, wrote to Raiter in a March 2001 e-mail. ``It is your responsibility to provide those credit estimates, and your responsibility to devise a method for doing so. Please provide the credit estimates requested!'' he wrote, signing off with his nickname ``Guido.''

``He was asking me to just guess, put anything down,'' says Raiter, interviewed at his home in rural Virginia, 69 miles (111 kilometers) west of Washington. ``I'm surprised that somebody didn't say, `Richard, don't ever put this crap in writing.'''

`Self-Delusion'

Gugliada, like Raiter, now says that he views as flawed many of the ratings S&P and Moody's assigned.

``There was the self-delusion, which hit not just rating agencies but everybody, in the fact that the mortgage market had never, ever, had any problems, and nobody thought it ever would,'' Gugliada says.

Drawing on a competitor's analysis, and assigning a slightly lower rating because of the uncertainty of the judgment, is called ``notching.'' Securities and Exchange Commission Chairman **Christopher Cox** proposed in June 2008 to prohibit a government-recognized rating service from issuing a grade unless it has information on the underlying asset.

``Because credit-rating agencies relied on others to verify the quality of the assets underlying the structured products they rated, it is very likely those ratings were often based on incorrect information,'' Cox said in a statement at the time.

Over Raiter's objections, S&P graded 73 percent of the Pinstripe bonds AAA. Managed by New York-based Alliance Capital Management, now **AllianceBernstein Holding LP**, the CDO paid off investors in November 2004. Other deals wouldn't fare as well.

Not `Straw to Gold'

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, New York-based **Ambac Financial Group Inc.** and **MBIA Inc.** of Armonk, New York.

Strategos Capital CDOs

This way, subprime mortgages with elevated default risks could be pooled into CDOs with top ratings. As lending standards fell, earlier deals performed better than later ones.

Strategos Capital Management LLC, an affiliate of Philadelphia-based Cohen & Co., which manages more than $30 billion in CDOs and other investments, packaged three Kleros Real Estate CDO Ltd. investments between June and November of 2006.

All three Kleros CDOs defaulted after credit downgrades last year. While Strategos liquidated Kleros III, the most recent of the investment pools, in June, it still manages the two earlier ones for investors.

The annual volume of mortgage securities sold to private investors tripled to $1.2 trillion between 2002 and 2005, according to Inside Mortgage Finance. The subprime portion of the CDOs rose fourfold, to $456.1 billion.

Low interest rates fueled the home-financing boom while investor demand for yields encouraged banks to structure subprime mortgages into higher-paying securities. Between 2001 and 2005, the annual value of asset-backed CDOs surged 11-fold to $104.5 billion, and then more than doubled to $226.3 billion in 2006, according to the industry newsletter **Asset-Backed Alert** in Hoboken, New Jersey.

Basic Conflict

Through it all, the rating companies had a basic conflict: They were paid by the businesses whose products they rated. Moody's told the Paris-based Committee of European Securities Regulators in November 2007 -- in the 49th footnote of a 35-page response to its questionnaire on structured-finance -- that it allowed managers who supervised analysts to ``provide expert input'' on fees ``in a limited range of circumstances.''

SEC Chief Cox said in June that the rating companies engaged in the ``lucrative business of consulting with issuers on exactly how to go about getting'' top ratings.

In a July report that examined the credit rating companies' practices, the SEC said they ``appeared to struggle'' in hiring adequate staff to handle the growth of their business, particularly for evaluating CDOs.

`Spread Very Thin'

The government agency didn't quantify the problem. Moody's annual financial statements show that the company's global employment more than doubled to 3,600 between 2001 and 2007. Its structured-finance revenue more than tripled during that time, peaking at $885.9 million last year.

``It was very difficult to get people in, train them up sufficiently to really understand this stuff -- from structure to quantitative issues -- and then to keep them, because investment banks were very keen to get good people to help them optimize their trade ideas,'' says **Kai Gilkes**, 40, a former S&P quantitative analyst in London who left in April 2006.

``Analysts were getting spread very thin,'' Gilkes says. ``I remember analysts who would keep their phones on voice mail 24 hours a day. They would only check messages and decide who to get back to. It was crazy.''

Some investors became nervous that the rating companies' mathematical models and AAA grades were out of touch with reality.

`Train Wreck Waiting'

``There was no model -- there was nothing -- that could work for modeling interest-only, adjustable, non-payment liar's loans,'' says **Stephen Berger**, 69, chairman of Odyssey Investment Partners LLC, a New York-based private equity firm.

In California, fixed-income investor **Julian Mann** feared the worst as subprime lending fanned out across the country.

``We said this is a train wreck waiting to happen,'' says Mann, 49, a vice president of the Los Angeles-based investment management firm First Pacific Advisors LLC.

The 90-day delinquency rate on subprime mortgages rose from 5.14 percent in 2003 to 6.37 percent in 2004 and 8.63 percent in 2005, according to First American Core Logic Inc., a San Francisco-based data provider.

S&P's Raiter says he was urging management to develop more sophisticated financial models and buy more detailed loan data for monitoring securities the company graded.

``We knew the delinquencies were bad,'' he says. ``The fact was, if we could have hired a supreme being to tell us exactly what the loss was on a loan, they wouldn't have hired him because the Street wasn't going to pay us extra money to know that.''

Subprime Tour Fails

In late 2005, First Pacific's Mann says, he invited East Coast investors to take a subprime mortgage tour up California's main interstate artery, to see the problem for themselves. The I-5 runs from San Diego to Sacramento, passing through Orange County, Bakersfield and Stockton.

``Nobody wanted to do it,'' he says. ``Unfortunately, most of the models were constructed by people who hadn't seen most of America and certainly weren't familiar with the areas they were rating.''

That September, Mann's boss, **Thomas Atteberry**, acted while others hesitated. He told investors in a monthly letter that he was liquidating the highest-risk real estate securities in First Pacific's New Income fund, which held $1.85 billion in bonds.

Atteberry, 55, wrote that he was ``very concerned about the subprime sector'' and ``that these trends may be a very early sign of the emergence of credit quality deterioration in general.'' It was 22 months before S&P and Moody's started downgrading mortgage securities and CDOs that held similar loans.

He had no idea how right he would be.

(Failing Grades on Wall Street: Part 1 of 2. Tomorrow: S&P, Moody's engage in ``race to the bottom'' by easing ratings criteria.)

To contact the reporter on this story: **Elliot Blair Smith** in Washington at **esmith29@bloomberg.net**.

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