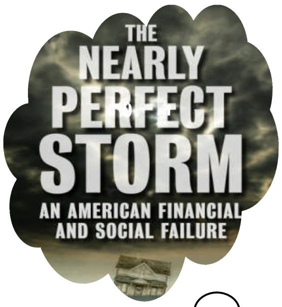

Your on the Street Reporter

Uyless Black

Epilogue III to *The Nearly Perfect Storm*
Suing the Rating Agencies

Table of Contents

Preface

My intent in writing *The Nearly Perfect Storm: An American Financial and Social Failure,* and these epilogues is to spark your ire. I am not one to compose inflammatory compositions. I began my studies of the 2008 financial crisis with a neutral view of the subject, perhaps even skewed toward the financial world (specifically, the investment banking industry), reflecting my former employment at the Federal Reserve.

No longer. The more I learned about the institutions and individuals who were involved in the meltdown, the more disgusted I became. I wish this turn of events had not come about. I wish I had found the Great Recession occurred because of a downturn in a conventional business cycle. It did not.

Do not expect this series to be light-hearted, although I will attempt some gallows humor to lighten the load.

The Nearly Perfect Storm: An American Financial and Social Failure
Epilogue III: Suing the Rating Agencies

March 12, 2013

These epilogues are written on occasion as follow ups to *The Nearly Perfect Storm: An American Financial and Social Failure*, available at Amazon, Barnes & Noble, and other book stores. Epilogue III discusses the recent Justice Department lawsuit against a credit rating agency (Standard and Poor's is the target now. Perhaps Moody's and Fitch later).

Quotes from *The Nearly Perfect Storm* about the issue.

Page 31:

For many years [credit rating agencies]---through both sloth and greed described in Report 9---incorrectly rated thousands of mortgage backed securities and associated financial instruments.[1] Many of these bonds were owned or were being sold by investment banks. The majority of these instruments were given the highest rating: AAA. We will learn that some of mortgages contained in these bonds were little more than junk, yet the rating agencies awarded them an AAA rating.

Page 102:

Credit Rating Agencies

I have included the credit rating agencies in this part of the book because I believe they take on the responsibilities of what Uncle Sam should be doing: Assessing the worth of financial instruments and associated financial institutions. The SEC should be the organization that oversees the credit worthiness of bonds, securities, and financial institutions, but the SEC stands by the sidelines. To gain a sense of the absurdity of this situation, consider the following.

Like many people, I had assumed a high credit rating of a company's bond by Moody's or Standard and Poor's meant just that: the company's bond was sound. My assumption was incorrect. An example is Enron. Four days before the company went bankrupt, its securities were rated at "investment grade (AAA, or triple-A)," the highest rating.[2]

These agencies (and Fitch) are sanctioned by the SEC to police the American business industry for credit worthiness and financial soundness. Consequently, they have immense influence in America's markets.

Yet they also act as consultants to the very companies they rate, and they charge these companies for their ratings. Once again, I am not making a joke. We discover the fox is in the hen house. These organizations "did exactly the opposite of what they were meant to do: rather than expose financial risk, they systematically disguised it."[3]

[1] "Wall Street and the Financial Crisis," 30.
[2] Amy Borrus, "The Credit-Raters: How They Work and How They Might Work Better," *Business Week*, April 8, 2002.
[3] Michael Lewis and David Einhorn, "The End of the Financial World as We Know It," *The New York Times*, January 4, 2009, 9.

Page 103:
Why has such a vital cog in America's financial wheel failed? Here's a clue:[4]

> …a downgrade…was not in their short-term interest. A downgrade of [a security and similar securities] would force the rating agencies to go through the costly and cumbersome process of re-rating tens of thousands of credits that bore triple-A ratings…It would stick a wrench in the machine that enriched them.

In early February 2013, the Department of Justice filed a lawsuit against Standard and Poor's (S&P), alleging the company engaged in fraudulent practices that cost investors billions of dollars by issuing purposely incorrect appraisals of various Wall Street bonds and securities.

This writer believes the amount of "billions of dollars" is more accurately "trillions of dollars." The losses were huge and spread-out into hundreds of thousands of investors. They included professional investors but also (as examples) inexperienced school district officials who had purchased a bond as a supposedly safe investment, with local county and city governments doing the same.

Maybe you were taken in. I was. I thought the ratings from these three organizations were impeccable. After all, they are an extension of the U.S. Government in that they are sanctioned by the SEC to evaluate the worthiness of America's financial institutions and even the financial soundness of nations.

Here is S&P's reaction to the suit:[5]

- The company denies any wrongdoing and claims the lawsuit is unwarranted.
- It states it misjudged the risk of mortgage-backed securities, but so did the other two credit rating firms, as well as the Treasury Department, and the SEC.
- S&P's lead attorney says, "We will be presenting the norm, a fair picture of the day–to-day effort of hundreds and hundreds of people at Standard and Poor's just trying to get it right."

Malarky. But what else can a defense attorney say?

There are documented instances in my book where employees of these rating agencies exchanged emails among themselves, writing about the need to keep their business with banks and investment banks. If they did not rate a security high, they were concerned they would lose business. Here is another quote from McCoy and Johnson's article (underlines are mine):

> …government lawyers charged the [ratings] appraisals were instead tainted by conflicts of interest and weak for <u>deliberately inadequate</u>

[4] Ibid.
[5] Kevin McCoy and Kevin Johnson, "Justice's S&P Case: You've Got Mail," USA TODAY, February 6, 2013, B1-B2.

> research---all part of the firm's drive to reap higher profits by pleasing bond investors at the expense of investors.

Aside from this blatant unethical approach to doing business, the agencies demonstrated they were incompetent in their evaluation of some Wall Street instruments, ones they were specifically tasked to evaluate .

Here is another quote from my book (thanks to Michael Lewis, *The Big Short*):

> Page 158-159:
> What if I were to tell you that a few very smart investors asked Standard and Poor's what was in the contents of a credit default swap, and this rating agency responded, "Oh yeah, we're working on that." They were working on at least $400 billion of financial instruments that were in the process of being bought and sold in Wall Street's secret netherworld.

The Justice Department is bringing the case as a civil action. This means if the company is found guilty, it will be required to pay millions of dollars in penalties. To whom? The money will go to the U.S. government, not a school district, etc.

Not one person will go to jail for committing crimes of such magnitude that they resulted in thousands of bankruptcies, failed companies, and failed citizens.

Not only will no one go to jail, the fines will come out of the stockholder's pockets, but not the thieves' wallets.

