REUTERS

Connecticut sues top credit rating agencies

July 30, 2008

By Martha Graybow

NEW YORK (Reuters) - Connecticut's attorney general said on Wednesday he was suing the three leading credit rating agencies, saying they assigned lower ratings than necessary to bonds issued by cities, schools and other public entities, driving up costs for taxpayers.

The case is the latest headache for ratings firms, which have been assailed by critics who have blamed them for helping to fuel the subprime mortgage crisis by giving high ratings to risky securities that later collapsed.

The lawsuits against Moody's Corp, McGraw-Hill Cos Inc's Standard & Poor's ratings unit and Fimalac's Fitch ratings are the first court actions resulting from the state's ongoing probe into raters, bond insurers and other organizations, said Attorney General Richard Blumenthal.

The rating firms, whose independence has also been questioned by lawmakers and politicians, are accused of underrating public bonds compared with corporate debt.

Blumenthal said towns and school districts have been forced to buy bond insurance to improve their ratings or pay higher interest costs on their lower-rated bonds.

"We are holding the credit rating agencies accountable for a secret Wall Street tax on Main Street -- millions of dollars illegally exacted from Connecticut taxpayers," he said.

Moody's, Fitch and S&P said the suits were without merit.

The cases, being filed in state Superior Court in Hartford, accuse the rating agencies of violations of Connecticut's unfair trade practices law.

Bond issuers hire ratings agencies to assess their debt.

The lawsuits seek the return of money to municipalities as well as penalties and disgorgement of funds, Blumenthal said.

He said the raters' own studies have shown that states and cities pose little default risk, but the agencies nevertheless give them lower ratings than comparable corporate bonds.

UPHILL BATTLE

The lawsuit against Moody's quotes an August 2006 internal e-mail from a senior credit analyst, which said: "I think there is clearly a mismatch between the default data and people's perception of the risk associated with municipal credits."

The ratings firms said they would fight the lawsuits. Fitch called the litigation "an unfortunate development." It also said it has been working on a review of municipal finance ratings that is expected to be released on Thursday.

S&P parent McGraw-Hill said the lawsuit "is simply a case of a state attempting to use litigation to dictate what bond rating it receives." It said Connecticut's claims violate its First Amendment rights and if successful, the state suit would erode analytical independence.

Bringing court cases against ratings agencies has long been seen as an uphill battle for plaintiffs. The companies have successfully argued that their ratings deserve the same kinds of First Amendment protections that shield journalists because their work is essentially an opinion and not a guarantee.

The number of public officials critical of how municipal debt is rated has grown this year and some have gone after municipal bond insurers in court. Among the most vocal critics is California Treasurer Bill Lockyer. He wants municipal debt rated on the same scale used for far riskier corporate bonds.

Such a move would likely raise ratings for most municipal debt, while lowering borrowing costs and reducing the need for bond insurance.

The difference between corporate and municipal ratings entered the spotlight after several bond insurers began losing their top "Triple-A" ratings as a result of their exposure to subprime mortgage-related securities.

The agencies have justified their separate system for municipal debt as a way to distinguish different quality levels.

Still, Moody's announced a proposal in June for a unified ratings scale, while S&P has said it uses a single scale for all structured finance and has been raising ratings on some municipal debt.

Last week, the City of Los Angeles sued municipal bond insurers, accusing them of engaging in a scheme to prop up the market for bond insurance. Ratings agencies were not named as defendants, but the city's complaint said rating agencies have "interlocking business relationships" with bond insurers that help underpin the market for bond insurance used by municipalities with less than sterling credit ratings.

Stockton, California also has sued bond insurers, while Oakland and San Diego are considering bringing similar cases.

(Reporting by Martha Graybow; Additional reporting by Karen Pierog in Chicago, Jim Christie in San Francisco and Jonathan Stempel in New York; Editing by Ted Kerr and Andre Grenon)