Senator Schumer Reveals Credit-Ratings Agencies Violated Own Conflict-Of-Interest Rules

By admin - Posted on April 23rd, 2008
Tagged: Business • Charles E. Schumer • Congress • Credit ratings • Investing • Moody's • SEC • Senate • Stock market

Calls For Tighter SEC Oversight Of Firms; SEC Chairman Cox Acknowledges Investigators Have Uncovered Improper Practices At Ratings Firms

April 22, 2008 -- Report: Moody's Curried Favor With Clients To Inflate Firm's Market Share -- WASHINGTON, DC -- U.S. Senator Charles E. Schumer (D-NY) today pressed the head of the Securities and Exchange Commission to crack down on conflict-of-interest violations at the major credit-ratings agencies, which he said conspired to inflate an unsustainable credit bubble. Under questioning by Schumer before the Senate Banking Committee, SEC Chairman Christopher Cox disclosed that the firms disregarded their own internal controls meant to prevent the relationship between the firm and its clients from getting too close.
"There is ample evidence that the credit-rating agencies have embraced a set of practices that stoke conflict-of-interest issues," Schumer said. "The agencies have refused to play by the rules, even those of their own making. The SEC is in the process of exposing these conflicts; the next step is to prevent them from being repeated."
Schumer said that coziness between the firms and the clients whose bonds they grade may have compromised what is supposed to be an objective ratings process. He said the SEC should use its new, year-old authority over the firms to guard against such conflicts of interests. He suggested that the agency articulate a set of criteria that should trigger enhanced scrutiny in the future. Among those criteria, Schumer said, would be significant changes in market share, major turnover in a firm's ranks of analysts, and deviation from historical accuracy averages.
The Wall Street Journal reported earlier this month that Moody's embraced a set of questionable practices intended to win over clients and capture greater market share. On at least one occasion involving Bank of America, Moody's adjusted its initial bond rating after the client complained. Also, the agency frequently rotated analysts at the client's request. Schumer said such practices should at the very least be disclosed to investors, if not outright banned.
Going forward, Schumer has said a return to the investor-funded model may be worth considering, though he has acknowledged that arrangement presents its own challenges.
Source: Senator Charles E. Schumer

THE WALL STREET JOURNAL.

Senators Press SEC Over Rules For Credit-Rating Firms

By KARA SCANNELL
April 23, 2008; Page C5

WASHINGTON -- The Securities and Exchange Commission was on the defensive as **lawmakers pressed the agency to quickly increase its oversight of credit-rating firms in order to bolster confidence in financial markets.**

At a Senate Banking Committee hearing, **lawmakers questioned whether some of the ideas for new rules presented by SEC Chairman Christopher Cox in private meetings and at the hearing would go far enough to fix and proactively stave off problems.** Mr. Cox outlined a series of steps that the agency is considering, most of them focused on greater disclosures. Others being discussed would seek a greater separation of the rating and business sides of the firms.

Sen. Richard Shelby (R., Ala.) noted a recent Treasury Department recommendation to increase the responsibilities of the Federal Reserve. Many have viewed the recommendation as potentially weakening the SEC. "**If the SEC is not going to do the job, somebody else will do the job**," he warned.

Mr. Cox said that 40 SEC staff members were conducting reviews of the seven largest credit-rating firms, including Moody's Investors Service Inc., McGraw-Hill Cos.' Standard & Poor's and Fimilac SA's Fitch Ratings. Between 10 and 20 jobs have been included in its budget for continued oversight, he said.

So far, the SEC has uncovered violations of internal conflict-of-interest policies that occurred earlier this year. Following the hearing, Mr. Cox declined to get into specifics, saying his remark was based on a general briefing from the staff based on preliminary findings.

"Who is rating the rating agencies?" asked Sen. Jack Reed (D., Del). He said he raised questions with Mr. Cox privately as to whether "some of the SEC plans go far enough" and said **regulators needs "to be fluent" in the language of Wall Street and be proactive rather than deal with problems after the fact.**

Congress gave the SEC oversight authority of credit rating firms in September 2006 and last June the agency wrote its first rules. Under the law, the SEC is required to monitor policies and procedures, including conflicts of interest at ratings firms. The law doesn't give the SEC the authority to look back in time and hold rating firms accountable for past deviations from internal policies and it isn't permitted to regulate the quality of the ratings themselves.

Mr. Cox outlined potential new rules to address their findings, which includes requiring rating firms to disclose the level of review conducted of the underlying products, creating different scales for complex structured products compared with corporate debt, separating consulting services and those who work on the business side negotiating fees from ratings analysts.

Mortgage and real-estate organizations have **raised concerns about moving to different scales for different products**, contending that would contribute to volatility and create confusion among investors.

Sen. Christopher Dodd, the chairman of the committee, and Sen. Shelby **pushed the SEC to take a hard line, asking Mr. Cox repeatedly if he would revoke a rating firm's charter if it consistently resulted in poor ratings.**

"You don't believe that is an appropriate role of the SEC?" asked Sen. Dodd.

Mr. Cox responded that Congress didn't give the SEC authority to revoke a license for getting ratings wrong. If ratings were consistently wrong because firms weren't following internal procedures, "then [the registration] could be revoked," he said.

(end)

*Here is a question for SEC Chairman Christopher Cox from Sovereign Advisers: What is the SEC's duty in instances (e.g., China) where the rating agencies knowingly depart from their **published criteria** (e.g., see definitions of rating classifications, esp. "Selective Default") and their **published metrics** (e.g., evaluation of a debtor's <u>willingness</u> to repay debt) and assign a contrived sovereign credit rating which has the force of law and misstates the credit risk to investors purchasing full faith and credit sovereign obligations of the Chinese Government?*

InvestmentNews
The Leading News Source for Financial Advisers

SIFMA mounts probe on credit ratings
By **Aaron Siegel**
April 22, 2008
The Securities Industry and Financial Markets Association has formed an industrywide task force that will take a "broad, global view" in examining the way that credit ratings are currently issued.
"Ensuring an open, competitive and more transparent credit rating system will be an important step towards restoring investor confidence and trust in our markets," said T. Timothy Ryan, president and chief executive of SIFMA, which is based in New York and Washington, according to a statement.
Mr. Ryan added that the task force will take an "integrated approach" to exploring the credit rating system, including key issues such as the current use and quality of ratings, and rating-agency independence.
SIFMA seeks to formalize and to advance the dialogue between its members and rating agencies that took place during the past year.
Additionally, the task force will consult with government officials, legislators, regulators, multilateral authorities and key credit rating agencies, according to SIFMA.
Boyce Greer, president of the fixed income and asset allocation division at Fidelity Investments of Boston, and Deborah Cunningham, chief investment officer at Federated Investors Inc. of Pittsburgh, will lead the task force.

www.baltimoresun.com/business/investing/bal-bz.sec23apr23001520,0,6896322.story

baltimoresun.com

SEC weighs credit rating rules

Conflicts of interest by agencies targeted

Associated Press
April 23, 2008
WASHINGTON
The Securities and Exchange Commission is considering new rules to limit conflicts of interest in the credit-rating industry, which is under scrutiny for not sounding the alarm about risky mortgage investments soon enough.

SEC Chairman Christopher Cox said yesterday at a hearing of the Senate Banking Committee that the government might soon create rules to ban credit-rating agencies from doing consulting work for issuers of debt.

The rules haven't been developed, but Cox told lawmakers that he saw no reason that such consulting "could not be prohibited."

The industry, dominated by Standard & Poor's, Moody's Investors Service and Fitch Ratings, has

been widely criticized for failing to accurately assess - and warn investors about - the risks that mortgage investments posed to financial markets. The credit crisis has led to more than $200 billion in write-downs by banks and other financial businesses over the past year.

Critics say the credit-rating agencies are vulnerable to conflicts of interest because they are paid by the companies whose bonds they rate. In response, the agencies say, they are strengthening protections against conflicts. For example, S&P says it is establishing an ombudsman's office.

Only Fitch sent its chief executive to the Senate hearing, which irked several lawmakers. The other two sent lower-level executives to Capitol Hill.

Senators suggested yesterday that the government suspend credit-rating agencies' government licenses if they consistently give ratings that turn out to be inaccurate.

Sen. Richard Shelby of Alabama, the committee's senior Republican, compared the rating agencies to doctors. "If they're incompetent, they jerk their licenses," Shelby said, adding that by being "consistently wrong" on mortgage investment risks, credit-rating agencies have contributed greatly to the financial crisis.

Cox told lawmakers that the SEC plans to issue a report by early summer on the rating agencies, focusing on how they managed conflicts of interest and whether their ratings of risky investments were too high.

The SEC, which has assigned about 40 staff members to look at rating agencies' activities, is reviewing hundreds of thousands of pages of agency records and e-mail messages.

The staff members have found several cases in which rating agencies failed to disclose conflicts of interest, some as recently as this year, Cox said.

In 2006, President Bush signed a bill designed to encourage the SEC to allow more competitors in the field and to boost government oversight of the credit-rating agencies. The SEC is developing rules to expand oversight of the agencies under that law.

Cox said the industry is hampered by a lack of competition among rating agencies, but he expressed hope that increased competition in the industry - as encouraged by the 2006 law - would improve the quality of ratings.

Copyright © 2008, The Baltimore Sun

Financial Post

--
The financial crisis: Greed run amok
Posted: April 22, 2008, 7:28 PM by Jeff White
Anthony S. Fell, subprime crisis
By Anthony S. Fell
We are now in the midst of global financial crisis, brought on by a U.S. housing bubble. How did this happen? The first factor I call Wall Street failure — the inability, once again, of some of the world's largest banks and dealers to control risk in their own businesses. It's almost as if no one had learned from, or studied, past crises.

Citigroup, Merrill Lynch, Wachovia,the Union Bank of Switzerland, Bear Stearns — this credit debacle is a huge embarrassment for the global banking business, especially in the United States. Some of the largest banks and dealers, their boards, the risk-management committees of the boards and top managements, either were not aware of the risks being taken three or four levels down or, quite possibly, just didn't understand them.

It is indeed a sad commentary and a stinging indictment of the financial industry. It was greed run amok and it will take years or perhaps a decade or longer for the financial industry to regain its credibility.

Second: We have regulatory failure, and not for the first time. The Federal Reserve has the power to regulate the residential mortgage industry in the United States but elected, for whatever reason, to not use its authority. The decline in residential mortgage underwriting standards from 2001 to 2006 was dramatic. From 2001 to 2006, the loan to value ratio of mortgage lending went from 79% to 89%. The percentage of 100% financings went from 3% to 33%.

Third, we have the incredibly low interest rates that prevailed from 2002 through 2006. Following the breaking of the telecom and Internet bubble in 2001, to ward off recession or possible deflation, the Federal Reserve lowered interest rates too far and kept them low too long.

Fourth, the bubble in residential housing was aided and abetted by a dramatic change in how banks and investment banks do business. Banks went from an "originate and hold model" to an "originate and sell" model in financial products.

The new model was that banks and dealers generate these loans, but rather than keep them on their own books, which requires capital, they packaged them up into structured products and sold them into the marketplace. Unfortunately, the new model — securitization — was flawed.

Securitization of assets can be good for the bank and good for investors, but the products quickly became far too complex. Also, if a bank originates a loan or a mortgage for its own balance sheet, it will make sure it's a good loan or mortgage because it retains the risk on its own books. If you're just originating a loan or mortgage to sell it as quickly as possible, who cares about the quality of the loan.

There was a lot of money in the originate and sell model, while it lasted, and this is where greed took over. Brokers, agents, appraisal agents, banks and dealers, the rating agencies — all would get big fees. Everyone was a winner — except the unsuspecting buyer.

Fifth: The U.S. governments went way too far in encouraging home ownership for low-income Americans through a variety of its agencies, such as Fannie Mae, Freddie Mac and the Federal Home Loan banks. It was a case of a well-intentioned public policy carried way too far, with disastrous results.

Sixth: The credit rating agencies — Moody's, Standard & Poor's, Fitch and DBRS — once again failed to protect investors. The rating agencies have now lost all credibility. Over time, investors have become far too reliant and too trusting of rating agencies, to the point where rating agencies are dangerous. They provide investors with a false sense of security. In 1970, Pennsylvania Railroad Co., a giant at the time, went into receivership with a triple A credit rating. In 1982, Venezuela defaulted with a triple A rating. The agencies were slow in pinpointing deteriorating credit before the real estate

crisis in 1991. They were also slow in identifying problems at Enron and WorldCom. Just think about it for a minute. Over the past several years, many incredibly complex structured products were rated triple A, the same credit rating as the U.S. Treasury or the government of Canada. It doesn't stand the test of common sense. The only securities that should be rated triple A are those obligations of an issuer that has taxing power and the ability to print money — which means a credible sovereign government.

Finally, a central cause of this credit crisis is the complexity of the new financial instruments that were developed. Financial innovation and engineering was way ahead of regulatory oversight or investor understanding. Those structuring these new products did not know what they were making. The raters did not know what they were rating. Sellers did not know what they were selling. Purchasers then did not know what they were buying.

I believe we have reached the end of a multi-decade credit super-cycle and can now look forward to a lengthy period of de-leveraging, with banks and dealers gradually repairing their balance sheets and restoring their capital ratios by curtailing lending and raising equity. A super-cycle credit bubble like this, which has been more than 25 years in the making, will not be unwound in six months or a year. This is going to be a longer process.

Financial Post

Adapted from The David Dodge Lecture, at Humber College, Toronto, April 15, by Anthony S. Fell. Mr. Fell is a former chairman of RBC Capital Markets.

Photo: Foreclosure signs are cropping up all over the U.S. due to a mortgage crisis (Getty Images)

The Daily Star
Leading Lebanese banker slams international rating agencies

Daily Star staff

Wednesday, April 23, 2008

BEIRUT: A leading Lebanese banker called for an independent assessment of the performance of international rating agencies, saying they had given an unfair credit rating to the Lebanese banking sector. Speaking in Beirut at a workshop on the effects of the Basel II accord, Saad Andary, the deputy general manager of Bank of Beirut and the Arab Countries (BBAC), proposed new international laws and regulations for these rating agencies, adding that the US laws have proven to be insufficient.

"There is a need for an independent assessment of the rating agencies. One of the independent bodies that can conduct such as assessment is the Bank of International Settlement," he said in his paper delivered at the workshop, which was organized by First Protocol Company.

He questioned why a rating agency like Standard & Poor's would punish the Lebanese market after the subprime real estate crisis in the United States.

"The wise policies of the central bank have immunized the Lebanese markets from the subprime crisis in other countries. But nevertheless, S&P downgraded Lebanon to CCC+ which could have damaged the Lebanese banks if Moody's and Fitch had followed suit," he said.

Andary added that if the other rating agencies had given similar marks to Lebanon then the cost of covering the risk for the capitals of Lebanese banks would have risen by 50 percent.

He said that Moody's maintained a B- rating for the Lebanon, adding that this spared the Lebanese banks extra and unjustified taxes.

He added that the rating agencies awarded high marks to some US companies that either collapsed or recorded huge losses. Andary cited the examples of Enron and WorldCom. Makram Sader, the secretary general of the Association of Banks in Lebanon, underlined the importance of Basel II accord. "Basel II train has taken off and no one can stop it," Sader said. ***- The Daily Star***

FT.com
FINANCIAL TIMES

Subprime crisis? Nothing to do with us, guv

By Jonathan Guthrie
Published: April 23 2008 20:18 | Last updated: April 23 2008 20:18

This spring is drear and Lowryesque for many business people. Credit shortages and weak sales numbers march across the landscape like wan mill workers. But the litigation lawyer, in contrast, is emerging into a Technicolor Disney wonderland. A bluebird alights on his finger and chirps a perky melody. Buck-toothed bunnies romp around his feet. There are any number of people he can sue because of the subprime crisis.

Some commentators deny that the lending fiasco will trigger much litigation. They doubt that business lawyers will turn on their pals, the bankers. For shame! Any litigator worthy of the name would sue his granny for the lollipop she promised in 1968 but never handed over. The incentives are there for a surge in litigation related to subprime. If just a small slice of the estimated $180bn (£91bn) in write-offs became claims, litigators would be busy for years.

Most of the fun has so far been in the US, where the freedom to sue practically anyone for anything is as closely woven into the fabric of society as the right to own an assault rifle. There, class actions by disgruntled investors have a history of extracting hefty settlements. Lawyers can take a cut of payouts, giving them an incentive to fight fiercely.

“The bulk of [subprime-related] actions have been about the diminution in the value of the shares,” says Thomas Dubbs, senior partner at Labaton Sucharow, retained by New York City and State to sue Countrywide, the mortgage lender in which their pension funds had invested.

There could be scope for European investors to bring lawsuits against European institutions in the US too, providing some of the alleged misdeeds happened there. British banks with dwindling share prices should be nervous. US attorneys with flash suits and flashier dentistry could be gunning for them in place of Bunterish British barristers.

So far, businesses involved in subprime securitisation have been slow to take legal action against each other. Here, squabbles between different classes of investor in collateralised debt obligations presage the bigger brawl ahead. This will only begin in earnest once each business has a clearer idea of its losses. The fisticuffs could drag on for decades.

Rating agencies must feel as vulnerable as a nude gymnast performing squat jumps in a porcupine farm. Their pivotal role in the subprime fiasco was to slap triple-A ratings on investments that have crumbled to dust in investors’ hands. When I requested a comment from one rating agency, its eventual response smacked of desperate men bickering in a room carpeted with balled-up papers. The statement read: “We have acknowledged that the assumptions underlying the rating analysis of US subprime securities have proven insufficient in light of [their] extraordinary performance.” Liable? Not us, guv.

Banks and their fund management arms have hung back from whacking each other with lawsuits over subprime losses. They have been motivated as much by the fear of mutually assured destruction as by*esprit de corps*. But according to Elizabeth Barrett, head of litigation at Slaughter and May in London, the economic imperative to obtain redress is compelling. “The sums involved are very large,” she says. “The upside of getting it right will therefore be high.”

One obstacle in the incestuous City of London is that the sharpest litigators are concentrated in big law firms that avoid acting against banks. But that ought only to delay cases rather than prevent them. The taboo creates an opportunity for smaller law firms to increase billings. They may be able to poach huffy litigators denied partnerships at “Magic Circle” practices. Scott Gibson, a director of the legal recruiters Hughes-Castell, says he is already finding jobs for candidates of this description. Law firms on both sides of the Atlantic are staffing up with litigators.

Subprime wrangles will be just one part of their workload. Business litigation is counter-cyclical, like bankruptcy proceedings and pawnbroking. Activity increases as
growth falters. Then, cash-strapped customers withhold payment from suppliers, who retaliate with writs. Joint ventures fail and partners who once swigged champagne together communicate via their solicitors with belligerent formality.

Business people could end up spending a lot of time with litigation lawyers. They are a different breed from transactional lawyers, the happy Hobbits who tie up new contracts and want everyone to be friends. Litigators are vengeful Orcs, who bash up clients' enemies when deals go sour. "The transactional people believe in win-win," one litigator told me dryly. "But we believe in win-lose. We win. You lose."

It is appropriate punishment that such toughies are on the tail of institutions whose involvement in subprime makes them partly responsible for the current economic woes. Other purported culprits face little serious legal scrutiny. Alan Greenspan, former chairman of the US Federal Reserve, is in the clear, if alibis published recently in this newspaper hold water. Mervyn King, governor of the Bank of England, got off the hook this week by slinging banks a £50bn-plus credit lifeline. That leaves us business journalists still under suspicion. "How come you're talking us into recession?" asks every business person I meet these days. "We're closet revolutionaries," I josh, "working to overthrow capitalism from within." They laugh. Bitterly. I hope they do not sue.

jonathan.guthrie@ft.com

Copyright The Financial Times Limited 2008

"FT" and "Financial Times" are trademarks of the Financial Times. Privacy policy | Terms

© Copyright The Financial Times Ltd 2008.