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Study Finds Flawed Practices at Ratings Firms

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The analyst at the credit ratings agency was blunt: “Let’s hope we are all wealthy and retired by the time this house of cards falters.”

That candid assessment, sent by e-mail to a colleague in December 2006, referred to the market for certain investments linked to subprime mortgages — investments that were assigned top AAA ratings from major agencies, only to later plummet in value.

That e-mail message and dozens like it were disclosed Tuesday in a blistering **37-page report** [*click on the link to read the report*] issued by the Securities and Exchange Commission, which confirmed what many on Wall Street had long suspected: the major ratings firms, including Fitch, Moody’s and Standard & Poor’s, flouted conflict of interest guidelines and considered their own profits when rating securities, among other suspect practices.

The report represented a definitive dent in the aura of objectivity that has been cultivated for decades by ratings firms, considered the ivory towers of Wall Street. Investors, public and private alike, often gamble billions of dollars on securities the agencies deem reliable. The assumption was that the firms’ analysts — ostensibly disinterested types who assess the financial health of everything from states and cities to complex mortgages — offered a bias-free view of potential investments.

Instead, the S.E.C. found that the agencies had become overwhelmed by an increase in the volume and sophistication of the securities they were asked to review. Analysts, faced with less time to perform the due diligence expected of them, began to cut corners.

“It could be structured by cows and we would rate it,” an analyst wrote in April 2007, noting that she had only been able to measure “half” of a deal’s risk before providing a rating.

The agencies continued to issue ratings despite frequent complaints from managers that they had neither the time nor manpower to measure the safety of investments sufficiently. “We do not have the resources to support what we are doing now,” a managing analyst wrote in an e-mail message in February 2007.

The trust in the ratings firms plays a vital role in the modern financial system. To ensure their bonds are rated AAA, many states and cities buy specialized insurance policies that are themselves dependent on premium ratings.

The agencies appear to be taking steps to address the problems; Moody's has ousted two high-ranking executives in the last two months.

The report was the result of a 10-month investigation into practices at Fitch, Moody's and S.& P. None of the e-mail messages or findings were attributed to an individual firm, according to standard commission practice, a spokesman said.

The report also turned up evidence that ratings firms had run afoul of basic guidelines intended to avoid conflicts of interest. It is common practice for investment banks and other financial outfits to pay agencies to rate assets they will later sell. Agency regulations often require analysts — the people actually rating the securities — to remain unaware of any business interests involved with the products whose safety they are gauging.

The S.E.C. found that this was not always the case. "There does not appear to be any internal effort to shield analysts from e-mails and other communications that discuss fees and revenue from individual issuers," the report said.

For example, in an e-mail message from November 2004, an analyst wrote that he was unsure of providing a particular rating because it could hurt revenue.

"I am trying to ascertain whether we can determine at this point if we will suffer any loss of business because of our decision and if so, how much?" the analyst wrote. He added that some employees disagreed with a recommended rating "because they believed it would negatively impact business."

The agencies also considered changing their ratings criteria to better compete with their rivals. "We are meeting with your group this week to discuss adjusting criteria for rating C.D.O.'s of real estate assets this week because of the ongoing threat of losing deals," a business manager wrote in an August 2004 e-mail message, referring to collateralized debt obligations.

The S.E.C. also found that the agencies did not sufficiently disclose or document changes to their ratings criteria.

"Each credit rating agency examined has agreed to take remedial measures to address the issues we've identified," the S.E.C. chairman, Christopher Cox, said Tuesday at a news conference.

All three ratings agencies issued statements on Tuesday that0Aexpressed a commitment to reforming their ratings practices. None commented directly on the e-mail messages or the report's conclusions. Each firm said it welcomed regulatory suggestions from the S.E.C.

It was unclear whether the findings would lead to criminal charges against the agencies. The ratings firms first came under S.E.C. regulation in September 2007, and the commission has few regulations that specifically relate to ratings firms. The findings from Tuesday's report would have to be referred to the enforcement arm of the S.E.C. before any charges can be filed, a spokesman said.

Some states have already opened investigations into the agencies' conduct. Last week, Moody's acknowledged that some employees had gone astray of internal conduct codes. Shares of the Moody's Corporation, which is publicly traded, rose 1.15 percent on Tuesday to $33.45 a share. It is off 47 percent over the last year. Shares of McGraw-Hill, the parent company of Standard & Poor's, rose 1.5 percent to $38.53 a share, and are down 43 percent in the last year.