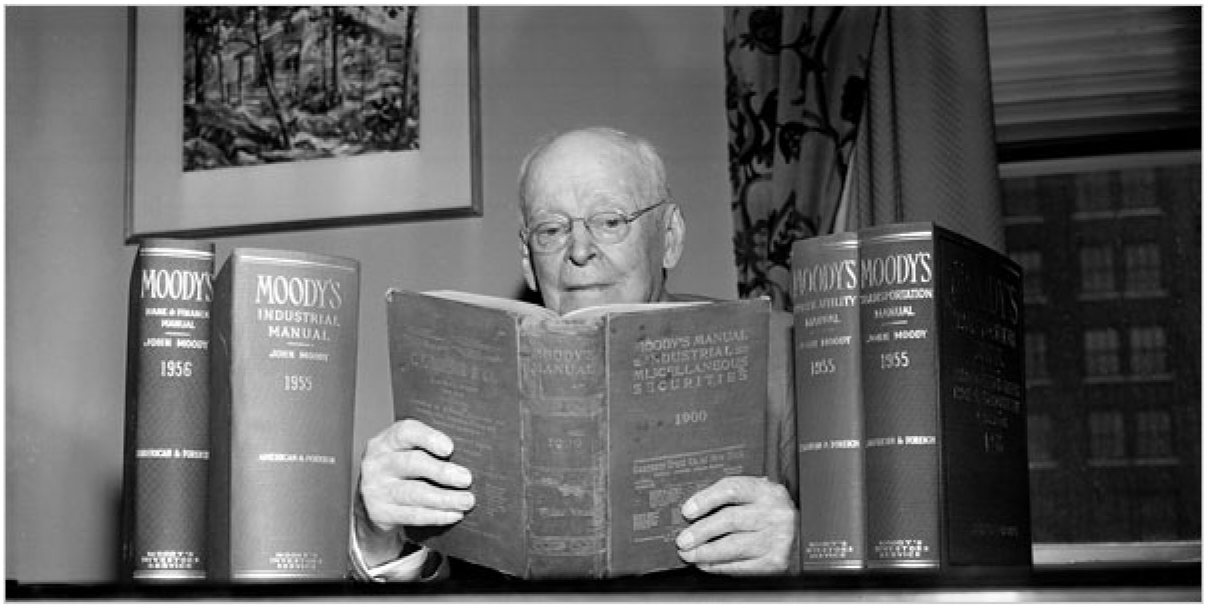
The Reckoning

Debt Watchdogs: Tamed or Caught Napping?



The New York Times

John Moody in 1956. He made his name by publishing opinions on risks facing investors.

By GRETCHEN MORGENSON
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“These errors make us look either incompetent at credit analysis or like we sold our soul to the devil for revenue, or a little bit of both.”

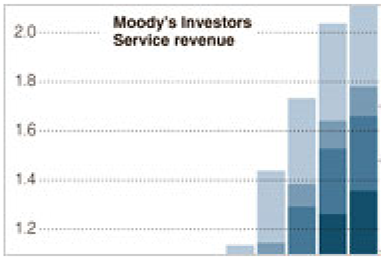
The Reckoning

Grade Inflation

Articles in this series are exploring the causes of the financial crisis.

Previous Articles in the Series »

Multimedia



Graphic

Benefiting From the Housing Boom

Enlarge This Image


Joshua Roberts/Bloomberg News

SCIENCE OF RISK Stephen Joynt of Fitch Ratings, left, Raymond McDaniel of Moody's and Deven Sharma of S.& P. at a hearing.


Alex Wong/Getty Images

Jerome Fons, formerly of Moody's, said investors "relied heavily on the rating agencies when purchasing subprime-related assets."

Enlarge This Image

Hiroko Masuike for The New York Times

Sylvain Raynes left Moody's to start a consultancy.

— A Moody's managing director responding anonymously to an internal management survey, September 2007.

The housing mania was in full swing in 2005 when analysts at Moody's Investors Service, the nation's oldest and most prestigious credit-rating agency, were pressured to go back to the drawing board.

Moody's, which judges the quality of debt that corporations and banks issue to raise money, had just graded a pool of securities underwritten by Countrywide Financial, the nation's largest mortgage lender. But Countrywide complained that the assessment was too tough.

The next day, Moody's changed its rating, even though no new and significant information had come to light, according to two people briefed on the change who requested anonymity to preserve their professional relationships.

Moody's had assigned high grades to many securities containing Countrywide mortgages. Those securities and mortgages, issued during the lending spree of recent years, later soured — leaving investors with large losses and homeowners and communities struggling with foreclosures.

That was not the only time Moody's softened its stance on Countrywide securities. It elevated ratings several times after Countrywide complained, the people briefed on the matter say.

Since the subprime mortgage troubles exploded into a full-blown financial crisis last year, the three top credit-rating agencies — Moody's, Standard & Poor's and Fitch Ratings — have faced a firestorm of criticism about whether their rosy ratings of mortgage securities generated billions of dollars in losses to investors who relied on them.

The agencies are supposed to help investors evaluate the risk of what they are buying. But some former employees and many investors say the agencies, which were paid far more to rate complicated mortgage-related securities than to assess more traditional debt, either underestimated the risk of mortgage debt or simply overlooked its danger so they could rake in large profits during the housing boom.

A Moody's spokesman, Anthony Mirenda, said the company would not change ratings without substantive reasons. "As a matter of policy, Moody's is obligated to reconvene a rating committee if there is new information put forth by an issuer that could have a material impact on a security's creditworthiness," he said, "and our policies prohibit changes to ratings for anything other than credit considerations."

He added that "Moody's knows of no instances in which a reconvened rating committee resulted in improper changes to ratings on Countrywide securities."

Bank of America, which took over Countrywide earlier this year, said it could not verify details of prior management's interactions with Moody's.

Members of Congress have grilled the agencies, asking their executives to answer accusations of incompetence and to say whether they assigned glowing ratings to keep clients happy and expand their business.

State and federal officials are also making inquiries. Moody's recently disclosed in its regulatory filings that it had received subpoenas from state attorneys general and other authorities pertaining to its role in the credit crisis.

Moody's said it was cooperating with the investigations.

"Moody's credit ratings play an important but limited role in the financial markets — to offer reasoned, independent, forward-looking opinions about relative credit risk, based on rigorous analysis and published methodologies," Mr. Mirenda said. The company denies that it went easy on ratings to generate income.

That the credit-rating agencies missed immense problems in the mortgage-related securities they blessed is undeniable. Moody's declined to say how many classes of the securities it has downgraded. But the number is in the thousands and the original value in the hundreds of billions of dollars.

When Moody's began lowering the ratings of a wave of debt in July 2007, many investors were incredulous.

"If you can't figure out the loss ahead of the fact, what's the use of using your ratings?" asked an executive with Fortis Investments, a money management firm, in a July 2007 e-mail message to Moody's. "You have legitimized these things, leading people into dangerous risk."

Whether such risks were truly undetectable, or were ignored by Moody's and the other agencies, is at the core of what regulators, legislators, investigators and investors are trying to determine.

Moody's current woes, former executives say, were set in motion a decade or so ago when top management started pushing the company to be more profit-oriented and friendly to issuers of debt. Along the way, the firm, whose objectivity once derived from the fact that its revenue came from investors who bought Moody's research and analysis, ended up working closely with the companies it rated, and being paid by them.

And in 2000, when Moody's issued stock to the public for the first time, executives hungry to churn out quarterly profit growth had another incentive to redirect the firm's focus from low-margin ratings of relatively simple bonds to highly lucrative assessments of much more complex debt securities.

As it rode the mortgage wave, Moody's came to enjoy profit margins that were higher than those of the mightiest of Fortune 500 companies, including Exxon and Microsoft.

"Moody's was like a good watchdog that had regarded the financial markets as its turf and barked and growled when anybody it didn't know came near it," said Thomas J. McGuire, a former director of corporate development at the company who left in 1996. "But in the '90s, that watchdog got muzzled and gelded. It was told to turn into a lapdog."

A Lucrative Niche

A key reason for the soaring housing market was a process known as securitization. The machinery, devised by Wall Street, packaged individual mortgages into ever larger and more complex bundles. This allowed banks to sell their loans to investors, thereby reducing the banks' risk and allowing them to lend more to aspiring homeowners.

Wall Street made handsome profits bundling and selling the loans, and investors stepped up to buy the packaged debt, often because rating agencies like Moody's had graded it as safe enough for the investors' portfolios.

The agencies divided the securities into slices known as tranches and analyzed each based on its risk. The securities deemed safest received the rating Moody's called Aaa.

Consider a residential mortgage pool put together in summer 2006 by Goldman Sachs. Called GSAMP 2006-S5, it held $338 million of second mortgages to subprime, or riskier, borrowers.

The safest slice of the security held $165 million in loans. When it was issued on Aug. 17, 2006, Moody's and S.& P. rated it triple-A. Just eight months later, Moody's alerted investors that it might downgrade the top-rated tranche. Sure enough, it dropped the rating to Baa, the lowest investment-grade level, on Aug. 16, 2007.

Then, on Dec. 4, 2007, Moody's downgraded the tranche to a "junk" rating. On April 15 of this year, Moody's downgraded the tranche yet again; today, it no longer trades. The combination of downgrades and defaults hammered the securities.

Reversals like this have enraged investors. Internal e-mail messages disclosed by Congress in October, for example, recounted a July 2007 conversation Moody's had with an irate customer at Pimco, a major money management firm.

"He feels that Moody's has a powerful control over Wall Street but is frustrated that Moody's doesn't stand up to Wall Street," the e-mail stated. "They are disappointed that in this case Moody's has 'toed the line. Someone up there just wasn't on top of it,' he said." For decades after its founding in 1909, Moody's was an independent and respected arbiter of credit quality. Today, the company's 1,200 analysts rate debts of 100 nations, 12,000 corporate issuers, 29,000 public issuers like cities and 96,000 complex securities known as "structured finance." It is a franchise that generated revenue of $1.35 billion and earnings of $370 million in the first three quarters of this year alone.

Edmund Vogelius, a Moody's vice president, explained the company's business model in a 1957 article in The Christian Science Monitor.

"We obviously cannot ask payment for rating a bond," he wrote. "To do so would attach a price to the process, and we could not escape the charge, which would undoubtedly come, that our ratings are for sale."

In the early 1970s, Moody's and other rating agencies began charging issuers for opinions. The numbers of securities — and their complexity — had increased and the agencies could no longer finance their operations on revenue from investors who bought Moody's publications.

In 1975, the Securities and Exchange Commission secured the rating agencies' positions by allowing banks to base their capital requirements on the ratings of securities they held. The upside of this was that it theoretically created an elegant self-policing mechanism: any firm that ran afoul of the agencies also would run afoul of investors. The heavier hand of direct government regulation could be scaled back.

But for Mr. McGuire, the former director of corporate development at Moody's, there were also dangers in relying on ratings as a form of regulation because the agencies would be able to sell ratings even if they failed investors.

"Rating agencies are staffed by ordinary people with families to support and bills to meet and mortgages to pay," he said in a speech to the S.E.C. in 1995. "Government regulators are inadvertently subjecting those people to improper pressure, and share accountability for any scandals which may result."

Fortunes Tied to Issuers

As the agencies exerted growing sway, they became the arbiters that issuers loved to hate. Yet instead of viewing that ire as a reflection of their independence, Moody's executives decided that it signaled a need to become more friendly to issuers of debt, according to Jerome S. Fons, a former managing director for credit quality at Moody's.

“In my view, the focus of Moody’s shifted from protecting investors to being a marketing-driven organization,” he said in testimony before Congress last month. “Management’s focus increasingly turned to maximizing revenues. Stock options and other incentives raised the possibility of large payoffs.”

An early proponent of the profit push was John Rutherfurd Jr., who joined Moody’s in 1985. In 1998, he became chief executive; a news release that year praised him for helping the company’s bottom line.

According to people who worked with him at Moody’s, Mr. Rutherfurd was very focused on profit. They recall a conversation about 10 years ago in which he said he wanted every Moody’s analyst to produce at least $1 million in revenue each year. This encouraged Moody’s to generate as many ratings per analyst as possible.

In an interview, Mr. Rutherfurd said that he might have discussed such a goal but that he did not recall it specifically.

“Moody’s has to be all the time both a standards business and a service business,” he said. “I wasn’t in Moody’s in the old days, so to speak, but I think I always understood both elements of what we had to do.”

By the time Moody’s became a public company in 2000, structured finance had become its top source of revenue. Employees in this unit rated bundles of assets like credit card receivables, car loans and residential mortgages. Later they rated collateralized debt obligations, or C.D.O.’s, yet another combination of various bundles of debt.

Moody’s could receive between $200,000 and $250,000 to rate a $350 million mortgage pool, for example, while rating a municipal bond of a similar size might have generated just $50,000 in fees, according to people familiar with Moody’s fee structure.

A standard of profitability at many companies is its operating margin, which measures how much of its revenue is left over after it pays most expenses. While operating margins at Moody’s were always enviable — in 2000 they stood at 48 percent — they climbed even higher as revenue from structured finance rose. From 2000 to 2007, company documents show, operating margins averaged 53 percent.

Even thriving companies like Exxon and Microsoft had margins of 17 and 36 percent respectively in 2007. But Moody’s and its counterparts were not founded to be profit machines.

“The mistaken notion that Moody’s was a company like any other, that was very fundamental,” said Sylvain Raynes, a former Moody’s analyst who is co-founder of R&R Consulting, a firm that helps investors gauge debt risks. “It is not just a profit-maximization entity like Exxon or Microsoft. Moody’s has a duty to the American public. People trusted it.”

Moody’s soaring fortunes were tied to the housing boom. When the Federal Reserve Board cut interest rates to 1 percent in 2003, Moody’s structured-finance revenue stood at $474 million, more than twice the amount generated just three years earlier.

As low interest rates fed the housing surge, Moody’s structured-finance business continued to rack up impressive gains. In 2005, structured finance generated $715 million, or 41 percent, of Moody’s total revenue.

In both 2005 and 2006, almost all of the unit’s growth came from mortgage-related securities, the company said, rather than other forms of debt like credit card receivables or auto loans. By the first quarter of 2007, structured finance accounted for 53 percent of Moody’s revenue.

The man overseeing Moody’s structured-finance unit in the midst of the mania was Brian M. Clarkson, 52. He had joined Moody’s as an analyst in 1991 and rose through the organization until he became president in 2007. He resigned last May; he declined to comment for this article.

As mortgage securities grew more complex, investors leaned more heavily on the agencies’ ratings. There was little transparency around the composition and characteristics of the loans held in the pools, and the securitization process grew so complicated that it required sophisticated systems to assess the risks embedded in each bundle.

Even though the standards at many lenders declined precipitously during the boom, rating agencies did not take that into account. The agencies maintained that it was not their responsibility to assess the quality of each and every mortgage loan tossed into a pool.

Anger From Investors

By early 2007, it was becoming more and more obvious that the subprime mortgage boom was ending. Yet Moody’s did not start downgrading mortgage-related securities until that summer. In July and August, the firm cut the ratings on almost 1,000 securities valued at almost $25 billion.

“These loans are defaulting at a rate materially higher than original expectations,” Moody’s said. Investors sharply criticized Moody’s over the tardiness of the response, internal documents made public in Congressional hearings show.

Two e-mail messages in July 2007 recount conversations Moody’s had with executives at Vanguard, BlackRock and Fortis, three huge money management firms. While Fortis offered some of the harshest assessments, none of the firms were pleased.

The Vanguard executive, the messages show, was frustrated that Moody’s was willing to “allow issuers to get away with murder.” As a result, the Moody’s messages say, Vanguard “finds itself ‘less and less relying on the opinions of rating agencies.’ ” BlackRock, meanwhile, said that Moody’s “relied too much on manufactured data that is weak” when rating residential mortgage securities.

Two months later, Moody’s executives held a meeting for their managing directors to talk about the crisis. The tone of the meeting, according to a transcript released by Congress, was defiant.

Moody’s had become a “punching bag,” said one of its executives, an easy target for investors eager to deflect responsibility for escalating mortgage losses.

“One of the questions everybody asks is, ‘Why does everybody hate us so much?’ ” Mr. Clarkson said during the meeting. “The theory that I’ve come up with lately is the fact that it’s perfect. It’s perfect to be able to blame us for everything.”

During the meeting, Moody’s executives predicted that the current crisis of confidence would pass, just as investor outrage over the company’s failure to detect trouble at Enron and Worldcom had several years earlier.

Other employees at the meeting were not so sure. When asked by top management if the meeting addressed the topics of greatest concern, one managing director whose anonymous comments were part of the documents given to Congress said there had been “really no discussion of why the structured group refused to change their ratings in the face of overwhelming evidence they were wrong.”

And two months later, Christopher Mahoney, former vice chairman of Moody’s and the person who led its credit policy committee, wrote in an e-mail message to Raymond W. McDaniel, the firm’s chief executive, that although mistakes had been made in subprime mortgage loss estimates, “more importantly I think sector wide risk management rules should have done more to alert investors of problems.”

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