Rolling Stone

The Last Mystery of the Financial Crisis

It's long been suspected that ratings agencies like Moody's and Standard & Poor's helped trigger the meltdown. A new trove of embarrassing documents shows how they did it

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What about the ratings agencies?

That's what "they" always say about the financial crisis and the teeming rat's nest of corruption it left behind. Everybody else got plenty of blame: the greed-fattened banks, the sleeping regulators, the unscrupulous mortgage hucksters like spray-tanned Countrywide ex-CEO Angelo Mozilo.

But what about the ratings agencies? Isn't it true that almost none of the fraud that's swallowed Wall Street in the past decade could have taken place without companies like Moody's and Standard & Poor's rubber-stamping it? Aren't they guilty, too?

Man, are they ever. And a lot more than even the least generous of us suspected.

Everything Is Rigged: The Biggest Price-Fixing Scandal Ever

Thanks to a mountain of evidence gathered for a pair of major lawsuits by the San Diego-based law firm Robbins Geller Rudman & Dowd, documents that for the most part have never been seen by the general public, we now know that the nation's two top ratings companies, Moody's and S&P, have for many years been shameless tools for the banks, willing to give just about anything a high rating in exchange for cash.

In incriminating e-mail after incriminating e-mail, executives and analysts from these companies are caught admitting their entire business model is crooked.

"Lord help our fucking scam . . . this has to be the stupidest place I have worked at," writes one Standard & Poor's executive. "As you know, I had difficulties explaining 'HOW' we got to those numbers since there is no science behind it," confesses a high-ranking S&P analyst. "If we are just going to make it up in order to rate deals, then quants [quantitative analysts] are of precious little value," complains another senior S&P man. "Let's hope we are all wealthy and retired by the time this house of card[s] falters," ruminates one more.

Ratings agencies are the glue that ostensibly holds the entire financial industry together. These gigantic companies – also known as Nationally Recognized Statistical Rating Organizations, or NRSROs – have teams of examiners who analyze companies, cities, towns, countries, mortgage borrowers, anybody or anything that takes on debt or creates an investment vehicle.

Their primary function is to help define what's safe to buy, and what isn't. A triple-A rating is to the financial world what the USDA seal of approval is to a meat-eater, or virginity is to a Catholic. It's supposed to be sacrosanct, inviolable: According to Moody's own reports, AAA investments "should survive the equivalent of the U.S. Great Depression."

The Scam Wall Street Learned From the Mafia

It's not a stretch to say the whole financial industry revolves around the compass point of the absolutely safe AAA rating. But the financial crisis happened because AAA ratings stopped being something that had to be earned and turned into something that could be paid for.

That this happened is even more amazing because these companies naturally have powerful leverage over their clients, as they are part of a quasi-protected industry that enjoys massive de facto state subsidies. Largely that's because government agencies like the Securities and Exchange Commission often force private companies to fulfill regulatory requirements by retaining or keeping in reserve certain fixed quantities of assets – bonds, securities, whatever – that have been rated highly by a "Nationally Recognized" ratings agency, like the "Big Three" of Moody's, S&P and Fitch. So while they're not quite part of the official regulatory infrastructure, they might as well be.

It's not like the iniquity of the ratings agencies had gone completely unnoticed before. The Financial Crisis Inquiry Commission published a case study in 2011 of Moody's in particular and discovered that between 2000 and 2007, the agency gave nearly 45,000 mortgage-backed securities AAA ratings. One year Moody's doled out AAA ratings to 30 mortgage-backed securities every day, 83 percent of which were ultimately downgraded. "This crisis could not have happened without the rating agencies," the commission concluded.

Thanks to these documents, we now know how that happened. And showing as they do the back-and-forth between the country's top ratings agencies and one of America's biggest investment banks (Morgan Stanley) in advance of two major subprime deals, they also lay out in detail the evolution of the industrywide fraud that led to implosion of the world economy – how banks, hedge funds, mortgage lenders and ratings agencies, working at an extraordinary level of cooperation, teamed up to disguise and then sell near-worthless loans as AAA securities. It's the black box in the American financial airplane.

In April, Moody's and Standard & Poor's settled the lawsuits for a reported $225 million. Brought by a diverse group of institutional plaintiffs with King County, Washington, and the Abu Dhabi Commercial Bank taking the lead, the suits accused the ratings agencies of conspiring in the mid-to-late 2000s with Morgan Stanley to fraudulently induce heavy investment into a pair of doomed-to-implode subprime-laden deals, called Cheyne and Rhinebridge.

Stock prices for both companies soared at the settlement, with markets believing the firms would be spared the hell of reams of embarrassing evidence thrust into public view at trial. But in a quirk, an earlier judge's ruling had already made most of the documents in the case public. Although a few news outlets, including *The New York Times*, took note at the time, the vast majority of the material was never reported, and some was never seen by reporters at all.

The cases revolved around a highly exotic and complex financial instrument called a SIV, or structured investment vehicle.

The SIV is a not-so-distant cousin of the special purpose entity, or SPE, which was the main weapon of destruction in the Enron scandal. The corporate scam du jour in those days was mass accounting fraud, in which a company would create an ostensibly independent corporate structure that would actually be controlled by its own executives, who would then move their company's liabilities off their own books and onto the remote-controlled SPE, hiding the firm's losses.

The SIV is a similar concept. They first started showing up in the late Eighties after banks discovered a loophole in international banking standards that allowed them to create SPE-like repositories full of assets like mortgage-backed securities and keep them off their own books.

These behemoths operated on the same basic concept as an ordinary bank, which borrows short-term cash from depositors and then lends money long-term in the form of things like mortgages, business loans, etc. The SIV did the same thing, borrowing short-term from investors and then investing long-term on things like student loans, car loans, subprime mortgages. Like banks, a SIV made money on the spread between its short-term debt and long-term investments. If a SIV borrowed on the commercial paper market at 3 percent but earned 6.5 percent on subprime mortgages, that was an easy 3.5 percent profit.

The big difference is a bank has regulatory capital requirements. A SIV doesn't, and being technically independent, its potential liabilities don't show up on the books of the megabank that created it. So the SIV structure allowed investment banks to create and take advantage of, without risk, billions of dollars of things like subprime loans, which became the centerpiece of the new trendy corporate scam – creating and then selling masses of risky mortgage-backed securities as AAA investments to institutional suckers.

Ratings agencies helped this game along in two ways. First, banks needed them to sign off on the bogus math of the subprime era – the math that allowed banks to turn pools of home loans belonging to people so broke they couldn't even afford down payments into securities with higher credit ratings than corporations with billions of dollars in assets. But banks also needed the ratings agencies to sign off on the safety and reliability of these off-balance-sheet SIV structures.

The first of the two SIVs in question was dreamed up by a London-based hedge fund called Cheyne Capital Management (pronounced like Dick "Cheney"), run by an ex-Morgan Stanley banker duo who hired their old firm to build and stock this vast floating Death Star of subprime loans.

Morgan Stanley had multiple motives for putting together the Cheyne deal. For one thing, it earned what the bank's lead structurer affectionately called "big fat upfront fees," which bank executives estimated would eventually add up to $25 million or $30 million. It was a lucrative business, and the top dogs wanted the deal badly. "I am very focused on . . . getting this deal done to get NY to stop freaking out" and "to make our money," said Robert Rooney, the senior Morgan Stanley executive on the deal. A spokesman for Morgan Stanley, however, told *Rolling Stone*, "Our sole economic interest was in the ongoing success of the SIV."

But that wasn't Morgan Stanley's only motive. Not only could the bank make the "big fat upfront fees" for structuring the deal, they could also turn around and sell scads of their own mortgage-backed securities to the SIV, which in turn would be marketed to investors like Abu Dhabi and King County. In Cheyne, 25 percent of the original assets in the deal came from Morgan Stanley – over time, $2 billion of the SIV's $9 billion to $10 billion portfolio of assets came from the bank as well.

Internal Morgan Stanley memorandums show that the bank knowingly stuffed mortgages in the SIV whose borrowers were, to say the least, highly suspect. "The real issue is that the loan requests do not make sense," complained a Morgan Stanley employee back in 2005. He noted loans had been made to a "tarot reading house" operator who claimed to make $12,000 a month, and a "knock off gold club distributor" who claimed to make $16,000 a month. "Compound these issues," he groaned, "with the fact that we are seeing what I would call a lot of this type of profile."

No matter – into the soup it went! Morgan sold mountains of this crap into Cheyne's SIV, where it was destined to be sold off to other suckers down the line. The only thing that could possibly get in the way of the scam was some pesky ratings agency.

Fortunately for the bank and the hedge fund, these subprime SIVs were a relatively new kind of investment product, so the ratings agencies had little to go on in the area of historical data to measure these products. One might think this would make the ratings agencies more conservative. In fact, caution in the face of the unknown was supposed to be a core value for these companies. As Moody's put it, "Triple-A structures should not be highly dependent on untestable assumptions."

But when it came to the Cheyne SIV, Moody's punted on caution. In an e-mail sent to executives from both Morgan Stanley and Cheyne in May 2005, David Rosa, a Moody's senior analyst, admitted that when it came to this SIV, he had nothing to go on.

"Please note that in relation to assumed spread [volatility] for the Aa and A there is no actual data backing up the current model assumptions," he wrote. In lieu of such data, he went on, "We will for now accept the proposal to use the same levels as [residential mortgage-backed securities] given that this assumption is supported by the analysis of the Aaa data . . . and Cheyne's comments on their views of this asset class."

Translation: We have no historical data, so we'll just accept your reasoning for the time being, even though you have every incentive in the world to lie about the quality of your product.

At one point, a Morgan Stanley analyst even claimed that the bank had written, in Moody's name, an entire 12-page "New Issue Report" for the Cheyne SIV – a kind of ratings summary in which Morgan Stanley appears to have given itself AAA ratings for large chunks of the deal. "I attach the Moody's NIR (that we ended up writing)," yawns Morgan Stanley fixed-income employee Rany Moubarak in a March 2006 e-mail. The attached document came proudly affixed with the "Moody's Investors Service" logo. (Both Moody's and Morgan Stanley deny that anyone other than Moody's wrote that report.)

Morgan Stanley ended up getting both Moody's and S&P to rate the deal, and that was not only common, it was basically industry practice. There were many reasons for this, but a big one was a concept called "notching," in which the agencies gave ratings penalties to any instrument that had not been rated by their own company. If a SIV contained a basket of mortgage-backed securities rated AA by Standard & Poor's, Moody's might "notch" those underlying securities down to A, or even lower. This incentivized the banks to hire as many ratings agencies as possible to rate every investment vehicle they created.

Again, despite the fact that the ratings agencies enjoyed broad quasi-official subsidies, and despite the powerful market leverage that techniques like "notching" gave them, they still routinely chose to roll over for banks. And the biggest companies were equally guilty. In the case of the Cheyne deal, Standard & Poor's was every bit as craven as Moody's.

In September 2004, an S&P analyst named Lapo Guadagnuolo sent an e-mail to Stephen McCabe, the agency's lead "quant" on the Cheyne deal, who apparently was on vacation. The e-mail chain was mostly a bunch of office gossip, where the two men e-whispered about an employee who was about to quit. But sandwiched in the office banter was an offhand line about the Cheyne deal and how full of shit it was. "Hi Steve!" Guadagnuolo wrote cheerily, adding, "How is Australia and how was Thailand????Back to [Cheyne] . . . As you know, I had difficulties explaining 'HOW' we got to those numbers since there is no science behind it . . .

"Thanks and regards . . . have you heard that [redacted] has resigned . . . and somebody else will follow suit today!!"

McCabe, blowing off the "no science behind it" comment, answered eagerly, "Who, Who, Who????" The quadruple question mark must be an S&P-ism.

A month later, McCabe seemed more concerned about the lack of science in the Cheyne deal. He complained in an e-mail to his boss, Kai Gilkes, who was the agency's senior quantitative analyst in Europe.

"From looking at the numbers it is quite obvious that we have just stuck our preverbal [sic] finger in the air!!" he fumed.

Gilkes was experiencing his own crisis of conscience by mid-2005, complaining in an oddly wistful e-mail to another S&P employee that the good old days of just giving things the ratings they deserved were disappearing. "Remember the dream of being able to defend the model with sound empirical research?" he wrote on June 17th, 2005. "If we are just going to make it up in order to rate deals, then quants are of precious little value."

Frank Parisi, Standard & Poor's chief credit officer for structured finance, was even more downtrodden, saying that the model that his company used to rate residential mortgage-backed securities in 2005 and 2006 was only marginally more accurate than "if you just simply flipped a coin."

Given all of this, why would top analysts from both Moody's and Standard & Poor's rate such a massive deal like Cheyne without any science to back it up? The answer was simple: money. In the old days, ratings agencies lived on subscriptions sold to investors, meaning they were compensated — indirectly, incidentally — by the people buying the financial products.

But over time, that model morphed into the current "issuer pays" model, in which a company like Moody's or Standard & Poor's is paid directly by the "issuer" — i.e., the company that is actually making the financial product.

For Cheyne, for instance, the agencies were paid in the area of $1 million to $1.5 million to rate the deal by Morgan Stanley, the very company with an interest in getting a high rating. It's the ultimate in negative incentives, and was and continues to be a major impediment to honest analysis on Wall Street. Michigan Sen. Carl Levin, one of the few lawmakers to focus on reforming the ratings agencies after the crash, put it this way: "It's like one of the parties in court paying the judge's salary."

Thanks to this model, ratings-agency business soared during the bubble era. A Senate report found that fees for the "Big Three" doubled between 2002 and 2007, from $3 billion to $6 billion. Fees for rating mortgage-backed securities at both Moody's and S&P nearly quadrupled.

So there were powerful incentives to whitewash deals like Cheyne. The eventual president of Moody's, Brian Clarkson, actually copped to this awful truth in writing, in a 2004 internal e-mail. "To put it bluntly," he wrote, "the issuer could take its business elsewhere unless the rating agency provides a higher rating."

Both Moody's and Standard & Poor's employees described complex/exotic new financial products like CDOs and SIVs as "cash cows," and behind closed doors, executives talked openly about the financial pressure to give scientifically unfounded analysis to products the banks wanted to sell.

The minutes from a 2007 conference of Standard & Poor's executives show that the raters knew they were in way over their heads. Admitting that it was virtually impossible to accurately rate, say, a synthetic derivative loan deal with underlying assets in China and Russia, one executive candidly admits, "We do not have the capacity nor the skills in house to rate something like this." Another counters, "Market pressures have significantly risen due to 'hot money.'" The first retorts that bankers are pushing boundaries, asking the raters to help them play the highly cynical hot-potato game, in which bad loans are originated en masse and then instantly passed off to suckers who will take on all the risk. "Bankers say why not originate bad loans, there is no penalty," the executive muses.

Hilariously – or tragically, depending on your point of view – an S&P executive at the conference even tossed off a quick visual sketch of their company's moral quandary. The picture is atrociously drawn (it looks like a junior high school student's rendering of a ganglion cell) and comes across like the Wall Street version of *Hamlet*, showing the industry traveling down a road and reaching a "Choice Point" crossroads, where the two options are "To Rate" and "Not Rate."

The former – basically taking the money and just rating whatever crap the banks toss their way – is crudely depicted as a wide, "well marked super highway." Meanwhile the honorable thing, not rating shitty investments, is shown to be a skinny little roadlet, marked "Dark and narrow path less traveled."

Obviously, the ratings agencies like S&P ultimately decided to take the road more traveled, choosing profits over scruples. Not that there wasn't some token resistance at first. For instance, some at S&P hesitated to allow the use of a questionable technique called "grandfathering," in which old and outdated rating models were used to rate newly issued investments.

In one damning e-mail chain in November 2005, a Morgan Stanley banker complains to an S&P executive named Elwyn Wong that S&P was preventing him from putting S&P ratings on Morgan Stanley deals that used this grandfathering technique. "My business is on 'pause' right now," the banker complains.

Wong took the news that S&P was holding up deals over the grandfathering issue badly. "Lord help our fucking scam," he said. "This has to be the stupidest place I have worked at." Wong, incidentally, was later hired by the U.S. Office of the Comptroller Currency, our top federal banking regulator.

The purists, however, couldn't hold out for long. In the Cheyne case, when one of the "quants" tried to hold the line, Morgan Stanley went over their heads to someone on the business side at the company to get the rating it wanted.

In July 2004, for instance, analyst Lapo Guadagnuolo sent an e-mail to Morgan Stanley's point man on the Cheyne deal, Gregg Drennan, and told him that the best he could do for the "mezzanine capital notes" or "MCN" piece of the SIV – a piece that Drennan wanted at least an A rating for – was BBB-plus. Drennan responded in an e-mail that CC'd Guadagnuolo's boss, Perry Inglis, telling him that Morgan Stanley "believe[s] the position the committee is taking is very inappropriate."

Ultimately, the analyst committee agreed to give the dubious Mezzanine Notes an A rating, marking the first time these middle-tier investments in a SIV ever received a public A rating. For Wall Street, this was occasion to par-tay. In the summer of 2005, one of the Cheyne hedge-funders sent out a celebratory e-mail to Morgan Stanley execs, bragging about getting the ratings companies to cave. "It is an amazing set of feats to move the rating agencies so far," the hedgie wrote. "We all do all this for one thing and I hope promotions are a given. Let's hope big bonuses are to follow."

Later on, S&P caved even further, agreeing to allow Morgan Stanley to lower the "capital buffer" in the deal protecting investors without suffering a ratings penalty. As late as February 1st, 2006, Guadagnuolo was defiantly telling Morgan Stanley that the one-percent buffer was a "pillar of our analysis." But by the next day, Morgan Stanley executive Moubarak had chopped Guadagnuolo's knees out. He cheerfully announced in a group e-mail that the bank had managed to remove this "pillar" and get the buffer knocked down to .75 percent.

Tina Sprinz, who worked for the Cheyne hedge fund, sent an e-mail that very day to Moubarak, thanking him for straightening out the pesky analysts. "Thanks for negotiating that," she says. The ratings process shouldn't be a "negotiation," yet this word appears throughout these documents.

In the Cheyne deal, just the plaintiffs in the lawsuit invested a total of $980 million in "rated notes," and those who invested in these "MCNs" were completely wiped out. Analysts from both agencies would express regret and/or trepidation about their roles in unleashing the monster deals and their failure to stop the business-side suits running the companies from selling them out. Gilkes, the S&P analyst who worried about shunning real science in favor of just making things up, later testified that the subprime assets in such SIVs were "not appropriate."

"They should not have been rated," he said.

If the significance of Cheyne is that it showed how the ratings agencies sold out in an effort to get business, the significance of the next deal, Rhinebridge, is that it showed how low they were willing to stoop to keep that business.

Rhinebridge was a subprime-packed SIV structured very much like Cheyne, only both the quality of the underlying crap in the SIV and the timing of the SIV's launch were significantly more horrible than even Cheyne's.

Not only did Morgan Stanley insist that the ratings agencies allow the bank to pack Rhinebridge full of a much higher quantity of subprime than in the Cheyne deal, they were also pushing this massive blob of toxic mortgages at a time when the subprime market was already approaching full collapse.

In fact, the Rhinebridge deal would launch with high ratings from both agencies on June 27th, 2007, less than two weeks before both Moody's and S&P would downgrade hundreds of subprime mortgage-backed securities. In other words, both Moody's and S&P were almost certainly in the process of downgrading the underlying assets in the Rhinebridge SIV even as they were preparing to launch Rhinebridge with AAA-rated notes.

"It was the briefest AAA rating in history," says the plaintiffs' lawyer Dan Drosman. "Rhinebridge went from AAA to junk in a matter of months."

There is an enormous documentary record in both agencies showing that analysts and executives knew a bust was coming long before they sent Rhinebridge out into the world with a AAA label. As early as 2005, S&P was talking in internal memorandums about a "bubble" in the real-estate markets, and in 2006 it knew that there had been "rampant appraisal and underwriting fraud for quite some time," causing "rising delinquencies" and "nightmare mortgages."

In June 2007, the same month Rhinebridge was launched, S&P's Board of Directors Report talked about a total collapse of the market. "The meltdown of the subprime-mortgage market will increase both foreclosures and the overhang of homes for sale."

It was no better at Moody's, where in June 2007, executives were internally discussing "increased amounts of lying on income" and "increased amounts of occupancy misstatements" in mortgage applications. Clarkson, who would become president two months later, was told the week before Rhinebridge launched that "most players in the market" believed subprime would "perform extremely poorly," and that the problems were "quite serious."

Yet the two ratings agencies not only kept those concerns private, they both took outlandish steps to declare just the opposite.

In a pair of matching public papers, both Moody's and S&P proclaimed that summer that while subprime might be going to hell, subprime-packed investments like SIVs might be just fine. The Moody's report on July 18th read "SIVs: An Oasis of Calm in the Sub-prime Maelstrom," while an S&P report on August 14th, 2007, was titled "Report Says SIV Ratings Are Weathering Current Market Disruptions."

The S&P report was so brazen that it even shocked a Morgan Stanley banker involved in the SIV deals. "I cannot believe these morons would reaffirm in this market," chortled the banker in an e-mail the day after the paper was released.

Rhinebridge, cheyne and a hell of a lot of other subprime investments ultimately blew to smithereens, taking with them vast amounts of cash – 40 percent of the world's wealth was wiped out in the aftermath of the mortgage bubble, according to some estimates. 2008 was to the American economy what 9/11 was to national security. Yet while 9/11 prompted the U.S. government to tear up half the Constitution in the name of public safety, after 2008, authorities went in the other direction. If you can imagine a post-9/11 scenario where there were no metal detectors at airports and people could walk on carrying chain saws and meat cleavers, you get a rough idea of what was done to reform the ratings process.

Specifically, very little was done to change the way AAA ratings are created – the "issuer pays" model still exists, and the "Big Three" retain roughly the same market share. An effort by Minnesota Sen. Al Franken to change the compensation model through a new approach under which agencies would be assigned to rate new issues through a government agency passed overwhelmingly in the Senate, but in the House it was relegated to a study by the SEC – which released its findings last year, calling for . . . more study. "The conflict of interest still exists in the exact same way," says a frustrated Franken.

The companies by now are all the way back in black. In 2012, for instance, Moody's profits soared 22 percent, to $1.18 billion. McGraw-Hill, the parent company of Standard & Poor's, scored $437 million in profits last year, with the rating business accounting for 70 percent of the company's profits.

In February, the Obama Justice Department, in an action that seems belated, filed a $5 billion civil suit against Standard & Poor's, drawing upon some of the same data and documents that were part of the Cheyne and Rhinebridge suits. As part of that action, high-ranking officials at S&P were interviewed by government investigators and admitted that they had shaded their ratings methodologies to protect market share. In this deposition of Richard Gugliada, head of S&P's CDO operations, the government asks why the company was slow to implement updates to its model for evaluating CDOs:

Q: Is it fair to say that Standard & Poor's goal of preserving an increasing market share and profits from ratings fees influence the development of the updates to the CDO evaluator?

A: In part, correct.

Q: The main reason to avoid a reduction in the noninvestment grade ratings business was to preserve S&P's market share in that category, correct?

A: Correct.

Years after the crash, it's a little insulting to see industry analysts blithely copping under oath to having traded science for market share, especially since the companies continue to protest to the contrary in public. Contacted for this story, Moody's and S&P insisted many of the documents in this case were simply taken out of context, and that their analysis throughout has been rigorous, objective and independent.

It's a thin defense, but it's holding – for now. McGraw-Hill stock plunged nearly 14 percent when news of the Justice Department suit leaked, and dropped nearly 19 percent for February, but has since regained much of its value – its stock rose nearly 16 percent in March and April, as markets reacted favorably to, among other things, its recent settlement of the Cheyne and Rhinebridge suits. The markets clearly think the ratings agencies will survive.

What's amazing about this is that even without a mass of ugly documentary evidence proving their incompetence and corruption, these firms ought to be out of business. Even if they just accidentally sucked this badly, that should be enough to persuade the markets to look to a different model, different companies, different ratings methodologies.

But we know now that it was no accident. What happened to the ratings agencies during the financial crisis, and what is likely still happening within their walls, is a phenomenon as old as business itself. Given a choice between money and integrity, they took the money. Which wouldn't be quite so bad if they weren't in the integrity business.

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