S&P charged with fraud in mortgage ratings

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The US Department of Justice on Monday filed a civil suit in Los Angeles charging Standard & Poor's Ratings Services, the world's biggest credit rating agency, with defrauding investors and the public by inflating the credit ratings it gave to subprime mortgage-backed securities in the run-up to the 2008 financial crisis.

The suit was announced Tuesday at a Washington press conference presided over by Attorney General Eric Holder. He indicated that the government would seek damages of at least $5 billion from S&P, a subsidiary of McGraw-Hill. Sixteen states and the District of Columbia have joined the federal suit.

Coming nearly four-and-a-half years after the Wall Street crash, the suit is the first federal action against a credit rating firm. S&P and its main competitor, Moody's Investors Service, played a critical role in the vast edifice of financial speculation and fraud that came crashing down following the bursting of the housing bubble in 2007.

S&P, Moody's and Fitch Ratings are all private, for-profit companies. As previous US government investigations have documented, S&P and Moody's made huge profits between 2004 and 2008 by landing contracts from Wall Street banks to rate residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs), which were assembled by the banks from home loans and sold to other financial institutions and investors around the world.

Wall Street drove mortgage lenders to sell high-risk, high-interest subprime home loans to people who could not afford them, bought up the loans from the mortgage companies, bundled them into RMBS and CDOs, and sold off these toxic investments, making massive profits in the process. The entire US and global financial system was infected as a result by what was, in essence, a vast Ponzi scheme.

While US bank regulators looked the other way, the credit rating firms facilitated the fraud by giving triple-A ratings to RMBS and CDOs backed by mortgages they knew were headed for default.

The credit rating firms had a financial interest in inflating the ratings on RMBS and CDOs, since they were paid by the banks whose securities they were rating. Under the inherently corrupt, deregulated system for rating securities—a system that serves the interests, in the first instance, of Wall Street—banks shop around for the credit rating firm most likely to give their products the highest rating. Consequently, the credit rating firms compete for a share in the lucrative financial derivatives market, which includes mortgage-backed securities, by proving to their bank paymasters that they will deliver the top ratings the banks need to maximize their profits.

At the Justice Department press conference, Holder and other officials painted a picture of pervasive and deliberate fraud, costing investors and taxpayers hundreds of billions of dollars. Between 2004 and 2007, Holder said, "S&P executives made false representations to investors and financial institutions, and took other steps to manipulate ratings criteria and credit models to increase revenue and market share."

"Put simply," he declared, "this alleged conduct is egregious—and it goes to the very heart of the recent financial crisis."

Acting Associate Attorney General Tony West described how the major banks, beginning in 2007, worked furiously to package their failing subprime home loans into CDOs and offload the CDOs to investors, in order to get the bad loans off of their books. "And we have evidence," he said, "that S&P not only knew this is what the banks were doing; S&P helped them to do it.

"As our complaint explains, through the spring and summer of 2007, S&P moved at a record pace, rating hundreds of billions of dollars worth of CDOs packed with subprime mortgage bonds… S&P gave triple-A ratings to nearly all of the CDOs it rated during this time—and they did this despite their own internal reports which showed that the ratings on the mortgage bonds on which the financial quality of these CDOs depended would not hold.”

Despite this narrative of outright criminality, amply documented in the 119-page complaint filed by the Justice Department in the US District Court, the government does not name a single individual in its legal brief, nor has it pressed criminal charges. The Obama administration is thus maintaining its record of refusing to criminally prosecute a single leading figure on Wall Street for illegal actions that brought the US and world economy to the brink of collapse and triggered the deepest slump and highest unemployment since the Great Depression.

The government spent four months in talks with S&P in an attempt to reach a settlement and avoid going to court, as it has done in dozens of previous financial fraud cases. Talks reportedly broke down in the last two weeks when S&P rejected any deal requiring it to admit wrongdoing and objected to a cash payment above $100 million.

The Justice Department’s legal complaint cites internal emails, messages and reports demonstrating that the company was well aware it was violating its own standards and giving securities inflated ratings. The legal brief focuses on 40 CDOs S&P rated between March and October of 2007.

The document cites one S&P analyst who wrote in 2006 that the company had loosened its criteria for CDOs to create “a loophole big enough to drive a Mack truck through.” In December of 2006, an S&P employee wrote in an internal email: “Rating agencies continue to create an even bigger monster—the CDO market. Let’s hope we are all wealthy and retired by the time this house of cards falters.”

In April 2007, one S&P analyst told another, “We rate every deal. It could be structured by cows and we would rate it.”

In a July 2007 exchange between an S&P analyst and an investment banking colleague, the banker wrote: “I mean, come on, we pay you to rate our deals, and the better the rating the more money we make?!?! What’s up with that? How are you possibly supposed to be impartial????”

The complicity of the credit rating agencies was previously documented in extensive government reports on the financial crisis. “The Financial Crisis Inquiry Report,” issued in January of 2011 by a commission established by Congress in 2009, wrote: “The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval.”

The Senate Permanent Subcommittee on Investigations devoted 75 pages of its 639-page report on the Wall Street crash, released in April of 2011, to the role of S&P and Moody’s in facilitating the subprime mortgage swindle. It wrote: “It was not in the short-term economic interest of either Moody’s or S&P, however, to provide accurate credit ratings for high-risk RMBS and CDO securities, because doing so would have hurt their own revenues.”

The Senate report found that more than 90 percent of triple-A ratings given to mortgage-backed securities in 2006 and 2007 were eventually downgraded to junk status.

Whatever the outcome of the suit filed on Monday, the Obama administration has systematically worked, and will continue to work, to shield the banks and their accomplices from any accountability for their crimes, and create conditions for Wall Street to make more money than ever.

The same credit rating system—unregulated and dominated by the banks—remains in place today. The same credit rating companies continue to make millions by giving top ratings to high-risk bonds and derivatives and helping conceal violations of securities laws by the banks, creating the conditions for another, even more catastrophic financial crisis.