

December 2009 Issue

Ohio Attorney General Files Suit Against Credit Rating Agencies by Samuel D. Friedman

In a recently filed lawsuit, Ohio Attorney General Richard Cordray claims that the three major credit rating agencies inflated ratings for the purpose of maximizing profits at the expense of investors.

On Nov. 20, 2009, Attorney General Cordray filed suit in Federal District Court for the Southern District of Ohio against Standard & Poor's Financial Services LLC, the McGraw-Hill Companies Inc., Moody's Corp., Moody's Investors Service Inc., and Fitch Inc. on behalf of five Ohio public pension and retirement funds. According to the 73-page complaint, the pension funds purchased mortgage backed securities "in reliance on the false and misleading AAA (or equivalent) credit ratings that were negligently assigned to the securities by [the rating agencies]" resulting in losses of more than \$457 million.

Mortgage backed securities are financial investment products that are collateralized by an underlying pool of securitized mortgages. The interest and principal payments made by the borrowers on the underlying mortgages are passed through to the investors/security-holders. Typically, issuers of mortgage backed securities seek credit ratings from the rating agencies for pools of securitized mortgages. According to the complaint, the rating agencies were supposed to objectively apply an analytical model to each pool of mortgages and reach a final rating decision. The issuer could then decide to have the rating agency issue the rating.

The basis for the pension funds' lawsuit is that the rating agencies allegedly "provided unjustified and inflated ratings in exchange for the lucrative fees that the [securities] issuers paid...." The pension funds argue that the inflated ratings arose from the "issuer pay" model, under which the issuers of the securities, not the investors, paid the rating agencies, creating a systemic conflict of interest. An issuer, according to the complaint, only paid the rating agency if the issuer was satisfied with the outcome of the rating agency's analysis. This allowed issuers to "essentially shop around for a desired rating." The rating agencies maintained the latent conflict of interest did not compromise the objectivity of the ratings system. However, the pension funds allege that the rating agencies' desire for financial gain improperly influenced rating decisions.

Additionally, the lawsuit accuses the rating agencies of collaborating with the issuers to reach targeted ratings. In other words, an issuer would designate a desired rating, and the rating agency and issuer would work "backwards" and design an asset structure that yielded the rating. The security would only be issued, and the rating agency would only be paid, if the rating agency assigned the desired rating. The pension funds maintain that this resulted in the rating agencies rating their own work. The complaint also claims that the rating agencies used outdated rating models and failed to sufficiently monitor the assets.

The complaint argues that the inflated ratings were "crucial" to the pension funds' decisions to purchase mortgage backed securities, and when the housing market collapsed, the pension funds lost hundred of millions of dollars. Accordingly, Attorney General Cordray sued the rating agencies for negligent misrepresentation and violations of the Ohio Securities Act.

The Ohio district court is charged with the task of determining whether blame for the financial meltdown should, at least in part, be allocated to the rating agencies. There will be keen interest in the outcome of this case because if the pension funds win, there will almost certainly be a proliferation of similar lawsuits on behalf of state and private investors alike.