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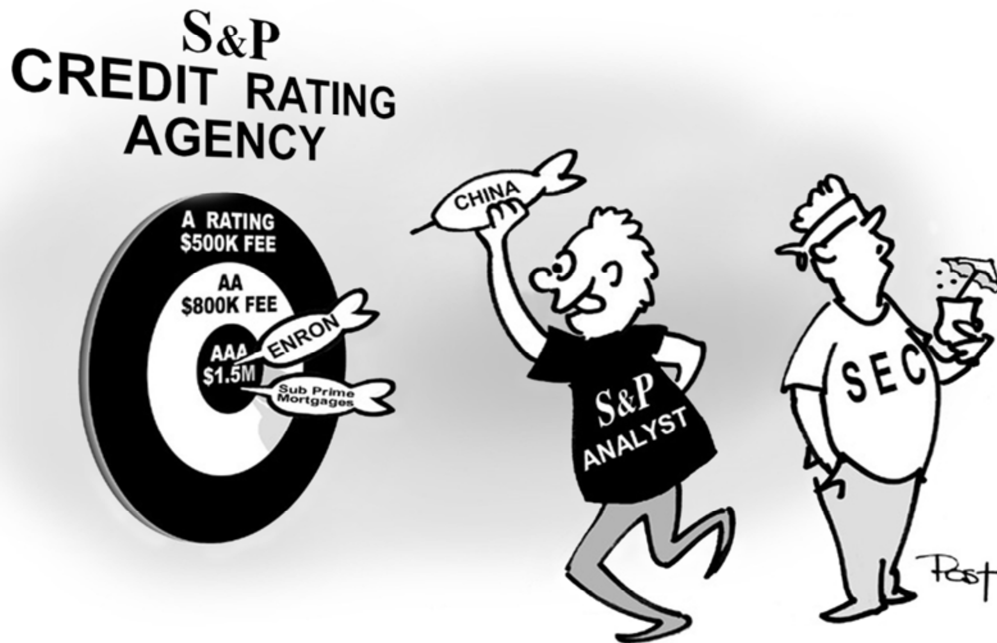
The Great Global Credit Meltdown of 2007 – Brought to You Courtesy of the SEC

How Complacency, Failure to Regulate Credit Rating Firms Led to Subprime Credit Rout - SEC Ignored 2005 Warning / China's Double Standard



Credit rating firms score big profits as SEC looks other way

TUCSON, Ariz., September 18 /PRNewswire/ -- Commentary by Sovereign Advisers -- In the wake of multi-billion dollar losses, shaken investor confidence and increased calls for regulation of global credit markets following the sale of falsely-rated mortgage bonds in the U.S., Europe and Asia, it is noteworthy that this most recent credit implosion could have been avoided, had the SEC acted on a request in 2005 by the Chairman of the Joint Economic Committee of the U.S. Congress for an investigation into the unregulated business practices of the international credit rating agencies (http://www.globalsecuritieswatch.org/investigation.pdf). According to a recent article published by the Wall Street Journal, (*Credit and Blame: How Rating Firms' Calls Fueled Subprime Mess*, August 15, 2007), the subprime meltdown appears to have resulted primarily from the sale and subsequent default of "investment-grade" mortgage bonds carrying artificial triple-A ratings. These bonds were marketed to financial institutions including hedge funds in the

United States, Europe and Asia, which were apparently induced into purchasing the bonds on the pretext of artificially high credit ratings assigned by Standard & Poor's, Moody's Investors Service and Fitch Ratings. The ratings assigned to the bonds, which concealed the true credit risk, were intended to make them more appealing (and thus more easily marketed) to institutional and retail investors. Far from representing a deception perpetrated on an unprecedented scale, this latest debacle represents only the most recent instance in a long and unenviable history of questionable practices by the credit rating firms, the true nature of which are only now becoming exposed.

Judging from reports in the media, it appears that not only did the credit raters intentionally hide the true risk of the mortgage bonds they rated in order to make them more marketable to investors around the globe, but this practice is habitually engaged in by these firms in order to boost the fees they charge to companies and governments seeking a rating in order to sell bonds. Such practices routinely leave investors holding the bag after sustaining huge losses from falsely-rated securities, as occurred in the Penn Central bankruptcy (1970), New York City financial crisis (1975), Washington State Public Power default (1983), Orange County debt crisis (1994), Asian financial meltdown (1997), Enron collapse (2001), and Worldcom bankruptcy (2002), to name a few such instances. Following this latest scandal, legislators in the U.S. as well as the European Commission have belatedly cast an unwelcome spotlight upon the business practices of the international credit rating firms with a view toward crafting a much needed regulatory framework with which to finally end such abusive practices.

Enforcement Failure: SEC Rejected 2005 Request by Congress to Investigate Allegations of Fraud by Rating Firms - Policy of "Zero Accountability" Encouraged Market Abuses, Empowered Credit Ratings with Force of Law Free from Regulatory Oversight

Despite the pervasive and influential power wielded by S&P, Moody's and Fitch to shape markets and capital flows (granted by virtue of their exclusive oligopoly franchise which enables the three firms to control 94% of the industry) these firms have historically been able to escape regulation and oversight, including any degree of accountability for their ratings when such ratings are revealed as false, as has frequently proven to be the case, albeit "after the fact". Concerned that the stage was being set for yet another contagion, our firm alerted the SEC Division of Market Regulation in early 2005 to the latent danger of the rating agencies' practices including inflated ratings, and cited the "investment grade" sovereign credit rating assigned to China as an obvious example of a contrived, artificial credit rating designed to open the door to global bond sales by Chinese corporations, thereby creating windfall profits for the rating firms (which receive large fees for rating companies' credit risk) at the expense of defaulted American creditors of the government of China (PRC) whom are owed some $260 billion by the PRC, and whom found their claims ignored by the Chinese government since it enjoys a pretextual credit rating which conceals its defaulted sovereign debt and so no longer has any incentive to honor repayment (http://www.globalsecuritieswatch.org/SEC.pdf).

In a concerted attempt to prevent the creation and spread of another credit contagion, numerous Members of Congress including the then-Chairman of the Joint Economic Committee wrote the SEC requesting an investigation into the matter. Although forewarned of the application of a reckless standard of care, and despite the written request for an investigation into the questionable practices employed by the credit rating agencies by Members of Congress including the JEC Chairman, the warning was soundly ignored by SEC Chairman Christopher Cox in a nod to the Administration's 'Goldman Sachs' China policy (i.e., empowering China and granting special privileges such as exemption from debt repayment at the expense of individual American citizens living on main street while benefiting Wall Street institutions engaged in the highly profitable

sale of Chinese stocks and bonds). As a glaring example of this policy, we observe that Goldman Sachs knew of China's defaulted sovereign debt, the repayment obligation of which is that of the People's Republic of China, yet acted as credit rating adviser to the PRC in 2003 in order to establish an artificially high credit rating which conceals the repayment obligation of the PRC for the defaulted debt in order to help market the PRC's sovereign bonds. Such credit upgrades are frequently timed to bond sales in order to artificially stimulate demand. This practice is revealed by the subtitle of a recent Reuters article, "International ratings agency Moody's Investors Service upgraded its debt ratings on China and Hong Kong in a move that will further tempt investors to snap up China's upcoming $1 billion bond." (*Moody's upgrades HK and China,* October 16, 2003).

As a result of the SEC's inaction, such practices were allowed to continue unabated. In its response to the Committee and instead of launching a probe as requested by Congress, the SEC prepared an internal memorandum, subsequently obtained by our firm, in which the Commission disclaimed any regulatory jurisdiction over the activities of the rating agencies, declined to enforce the federal securities laws prohibiting half-truths and omissions of fact, and demurred to launch an investigation into the artificial "investment grade" credit ratings which conceal true credit risks including, in the instance of China, the Chinese government's practice of discriminatory payments to selected creditors and its policy of selective default whereby it steadfastly refuses to honor any repayment of its defaulted national debt to Americans (http://www.globalsecuritieswatch.org/memorandum.pdf). In its response to Congress, the SEC also conveniently ignored the fact that it is responsible for determining which firms qualify as "nationally recognized statistical rating organizations" (i.e., recognized credit rating firms) as well as the fact that the three major international credit rating firms, Standard & Poor's, Moody's Investors Service and Fitch Ratings are each registered with the SEC as Investment Advisers and as such, are prohibited from "engaging in unethical business practices including engaging in any act, practice, or course of business which is fraudulent, deceptive or manipulative." Accordingly, the three primary rating firms are restrained from applying a reckless standard of care in developing their rating classifications. The rating definitions, as published by the credit raters themselves, state that such ratings are an evaluation of the rated entity's ***willingness*** and ability to pay financial obligations. As evidenced by the factual record in the instance of China, the prevailing "investment grade" rating classifications assigned to the Chinese government by the three primary credit rating firms do not truthfully reveal the actions of the PRC and thus do not conform to their published definitions, indicative of both foreknowledge of falsity and the application of a reckless standard of care by the rating agencies (http://www.globalsecuritieswatch.org/definitions.pdf).

It is also an indictment against the lax enforcement policy adopted by the SEC that the Commission failed to undertake an investigation even though the Advisers Act explicitly requires the SEC to investigate allegations of wrongdoing and to impose penalties upon registrants whose wrongful actions "directly or indirectly result in substantial losses or create a significant risk of substantial losses to other persons." The failure to rein in the rating agencies two years ago thus set the stage for the latest in a long string of credit "events" in which the rating agencies have once again demonstrated how they have utterly failed in their gatekeeper role. The refusal by the SEC to regulate the rating agencies also established a dangerous precedent in light of the extensive incorporation of credit rating classifications into investment policies by both the public and private sectors (e.g., private pension plan administrative standards, municipal retirement systems policies, and federal banking regulations governing permissible activities of insured depository institutions).

Dangerous Focus on Creating Marketable Products for Investor Consumption –
Example: China's False Credit Rating Conceals Selective Default, Discriminatory Payments and Establishes an Artificial Sovereign Benchmark for Sales of Corporate Bonds

As evidenced by the facts, the root cause of ratings inflation and the recurring cyclical credit contagions is the predilection of the agencies for creating marketable investment products which are highly saleable by the prime brokerage community, targeting institutional and retail investors to the enormous profitable benefit of the rating agencies. Such penchant is evocative of the often articulated industry maxim, "brokers are selling machines when backed by agency ratings." According to the same Wall Street Journal article previously cited, "Underwriters don't just assemble a security out of home loans and ship it off to the credit raters to see what grade it gets. Instead, they work with rating companies while designing a mortgage bond or other security, *making sure it gets high-enough ratings to be marketable."*

Judging from recent events, the three primary credit rating firms continue to actively pursue a policy of rating debt securities in a manner intended to generate ever larger fees from sales of new bonds, including development of customers located in foreign markets. An international sovereign credit rating is absolutely essential for any government seeking to borrow internationally, or more significantly, to establish an international sovereign benchmark against which the country's corporations may raise capital in the world financial markets in order to compete internationally. The international sovereign credit rating assigned to a specific government acts to set a "sovereign ceiling" which constrains the ratings of the corporate issuers located within that nation. If the ceiling is artificially high, then the creditworthiness of the corporations within that nation enjoy a higher rating and a commensurately lower cost of capital, which translates into a major competitive advantage globally. It also means that more companies will be able to issue bonds, which will need to be rated by the agencies, thereby enabling the credit raters to develop new markets for their services (http://globalsecuritieswatch.org/Moody's-Promotion.pdf). The most extreme example of obvious ratings inflation is the instance of China's contrived "investment grade" ratings assigned by S&P, Moody's and Fitch, unprecedented for a government in default on its national debt and which conceal the existence of the Chinese government's defaulted sovereign debt and fail to conform to their published definitions.

Despite their claim that they rate a government's *willingness* to pay its sovereign obligations, the three primary credit rating firms continue to maintain an artificial "investment grade" credit rating classification for China and have actually upgraded China's rating six times since disclosure of the Chinese government's refusal to honor repayment of its defaulted sovereign debt was communicated to each of the primary rating agencies in 2002. The actions of the credit raters may be explained by the apparently irresistible temptation represented by the potential for enormous fees earned from rating the debt of Chinese corporations which are now empowered to issue debt globally due to the creation of an artificial sovereign benchmark rating while the central government enjoys an unimpeded ability to continue its predatory financial markets practices including selective default, evasion of debt repayment, and discriminatory debt payments to preferential creditors. The actions of the central government are the subject of a complaint (http://www.globalsecuritieswatch.org/disclosure.pdf) recently filed with the U.S. Securities & Exchange Commission alleging fraud (http://www.globalsecuritieswatch.org/Amended_SEC_Complaint.pdf) in connection with the offer and sale in the U.S. of its sovereign bonds.

Beyond actively assisting a government in default on its national debt in evading repayment, the actions of the rating agencies dangerously understate the true credit risk of both Chinese government bonds and corporate securities, exposing both U.S. and foreign pension funds to

hidden risks and greatly increasing the prospect for yet another credit contagion, not to mention the potential for further dislocation of entire industries. Such an effect would be far less likely to occur if the rating agencies had adhered to their published definitions and assigned the truthful rating classification of "Selective Default" to China, reflecting the existence of the Chinese government's attempts to evade repayment of its defaulted sovereign debt.

China's Double Standard: Unique Irony of Financial Losses Incurred by China

When tallying the financial losses incurred by foreign investors as a result of the sale of falsely-rated U.S. mortgage bonds, there is a special irony in the case of China, which recently complained publicly regarding the potential loss of billions of dollars attributable to the central bank's exposure to such securities which it purchased from U.S. investment banks, yet itself relies on a contrived sovereign credit rating in order to avoid repayment of its defaulted government debt. "This is like the pot calling the kettle black" according to Jonna Bianco, a Tennessee cattle farmer who serves as the president of the ABF, the organization representing U.S. creditors. The ABF is pressing Congress to enact legislation to restrict the sale of new Chinese securities in the U.S. until China fully honors repayment of its defaulted debt. Such legislation is similar to that enacted by the government of Great Britain in order to achieve repayment from the Chinese government in 1987 of British citizens' claims. "This is the only kind of response that China understands", said Ms. Bianco. "They don't adhere to the established international rules followed by other members of the international community. China should be held to the same standard of international conduct as other nations instead of granting unique privileges and exemptions, which only serves to encourage China to write its own rules of international conduct." According to the U.S. Foreign Bondholders Protective Council, in more than 40 settlements involving defaulted debt of foreign governments, the communist Chinese government represents the only instance of a government refusing to negotiate with American creditors.

Senate Expected to Join with House in Introducing Concurrent Legislation to Increase Transparency and Restore Integrity of U.S. Capital Markets

In acknowledgement of the enforcement failure by the SEC and the abandonment of an appropriate standard of care by the principal credit rating firms, and recognizing that the actions of the credit rating firms, in which the SEC was complicit by evading its regulatory responsibility, have now created the specter of a massive taxpayer-funded government bailout, Members of both Houses of Congress have realized the pressing need for immediate bipartisan action by the legislative branch to remedy the continuation of the abusive practices described herein, provide relief to defaulted creditors from the injurious actions of the credit rating agencies, and restore the transparency and integrity of the U.S. capital markets. Legislation has already been introduced in the United States House of Representatives (http://www.globalsecuritieswatch.org/h.con.res.160.pdf), while the Senate is presently drafting concurrent legislation (http://www.globalsecuritieswatch.org/brief.pdf) which primarily addresses the issues of inadequate disclosure and misleading credit ratings involving obligations of the government of China, and is expected to specifically address the issue of reclassification of the sovereign credit rating of the People's Republic of China into the proper classification of selective default (http://www.globalsecuritieswatch.org/senate.pdf).

Contact

Kevin O'Brien, President
Sovereign Advisers

Telephone: (520) 327-2482
Email: kevin.obrien@sov-advisers.com
Website: http://www.sov-advisers.com / http://www.globalsecuritieswatch.org
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