The Conclusion of the Department of Justice's Investigation into Moody's: Financial Penalties but No Deterrent

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The U.S. Department of Justice recently concluded its investigation into the role that the credit rating agency, Moody's, had played in contributing to the Financial Crisis of 2007/08. The size of the financial-based penalty was to be expected because, as mentioned in a previous article, the extent of evidence that could have been gathered against Moody's, as opposed to the evidence gathered against Standard & Poor's in a similar investigation in 2015, was going to be smaller due to the record-keeping policies of Moody's. Yet, what is of interest is the remarkable statement of facts that Moody's have acknowledged, and the compliance provisions that the Department of Justice are promoting as being a victory for investors and the public at large. In this article we will see that the result of these investigations is that the top two agencies have emerged relatively unscathed, and that they are primed to take advantage of their position again when regulatory amnesia takes hold.

Introduction

In a previous article, I had discussed the investigation of the Department of Justice (DoJ) into Standard & Poor's conduct regarding the Financial Crisis of 2007/08 and had suggested that, given that S&P were fined a record $1.375 billion, it would set an awful precedent if

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Moody's was to escape the same fate[1]. The divergence regarding possible differences in punishment existed because of the record-keeping policies of Moody's in comparison to S&P. However, whilst the DoJ have punished Moody's, and also in an expected fashion i.e. a smaller financial penalty, the *content* of the conclusion of the investigation is remarkable and is the focus of this article. After analysing the report itself, it will be suggested that the agencies are in a much different position now than they were before S&P settled with the DoJ two years ago – unfortunately, that position is a favourable one for them and a particularly perilous one for the public.

The Settlement

The DoJ was always expected to settle with Moody's, and settle for an amount much smaller than the one agreed with S&P in its first post-Crisis investigation into the conduct of the Ratings Industry[2]. Announcing on January 13th 2017, the DoJ declared that it had secured nearly $864 million on behalf of itself and a number of U.S. states[3], which represents over half of what was agreed with S&P two years earlier. However, the content of the settlement is telling. The Principal Deputy Associate Attorney General Bill Baer proclaimed that:

[1] Daniel Cash 'Why the U.S. Department of Justice Must Act Against Moody's Corp' [2016] 37 Business Law Review 6.
[2] Ben McLannahan 'Moody's faces US civil complaint over ratings' [2016] Financial Times (Oct 21) https://www.ft.com/content/31a28d4c-97aa-11e6-a1dc-bdf38d484582.
[3] Department of Justice 'Justice Department and State Partners Secure Nearly $864 Million Settlement with Moody's Arising from Conduct in the Lead Up to the Financial Crisis' [2017] Office of Public Affairs. https://www.justice.gov/opa/pr/justice-department-and-state-partners-secure-nearly-864-million-settlement-moody-s-arising.

> 'Today's settlement contains not only a significant penalty and factual admission of its conduct, but also a commitment by Moody's to new and continued compliance measures designed to ensure the integrity of credit ratings going forward'[4].

There are two elements which stand out. Firstly, getting the rating agencies to admit to any wrongdoing is an extraordinary achievement in itself[5]. Secondly, the commitment to a 'new' standard of compliance has all the 'buzzwords' one would want, but actually reading what those standards are cultivate a very different feeling. With regards to the Statement of Facts that Moody's agrees to, there are persistent themes which deserve attention.

Within the Statement of Facts included in the DoJ's announcement, Moody's admitted that it had published a 'Code of Professional Conduct' which included how it would manage any conflicts of interest. This document alone, published and available to all, is designed to demonstrate to investors (and the public moreover) why the agency can be trusted. As part of this mission, Moody's is keen to promote the ideal that the profit-concerned and rating-concerned elements of the business are effectively separated, ultimately suggesting that the ratings produced by analysts are independent of the success of the agency. However, here Moody's admits that rather than this 'firewall' being in place, the practice was actually to ask Managing Directors to resolve the 'dilemma' between maintaining ratings quality and winning business from the issuers who selected them – the result of this delegation of

[4] ibid.

[5] The agencies have a long and successful history of using a variety of techniques to avoid admitting guilt. For an historical analysis see Marc Flandreau and Gabriel G Mesevage 'The Untold History of Transparency: Mercantile Agencies, the Law, and the Lawyers (1851-1916)' [2014] Enterprise and Society. For recent accounts see Lynn Bai 'On Regulating Conflicts of Interests in the Credit Rating Industry' [2010] 13 New York University Journal of Legislation and Public Policy 253; Paulo Fulghieri, Gunter Strobl and Han Xia 'The Economics of Solicited and Unsolicited Credit Ratings' [2014] 27 The Review of Financial Studies 2.

responsibility needs no further analysis; asking people whose future depends upon the success of the firm to act ethically, rather than instilling a *culture* of ethical practice, is an *extraordinary* departure from responsibility by the leading figures of the Agency.

The Statement of Facts continues by showing the nascent development of a practice that would continue long after the Financial Crisis, and that is reporting rating methodology, and then *consciously* departing from that so that the issuer is aware of the departure but not the investors[6]. Going back as far as 2001, Moody's acknowledged that they promoted the idea that their ratings addressed the expected credit loss an investor may incur via the measurement of the 'probability of default' and the 'loss given default' on any rated securities. However, they then used an analytical tool that only applied those parameters to Residential Mortgage-Backed Securities rated Aaa, and not below. Instead, the tool meant that these parameters were 'replicated' to securities of a lower quality, thus inflating their creditworthiness – the investors were not aware of this, but issuers were. To talk plainly for one moment, we have here an absolutely scandalous revelation that Moody's were applying Aaa standards to lesser-quality issuances *whilst* informing the public that they were rating *all* securities in an independent manner. The Agency concludes its Statement of Facts by admitting that from 2004 onwards, it did not follow its publicised idealised expected loss standards but instead initiated a 'lenient' approach to the rating of all Aaa Collateralised Debt Obligations (a key component of the pre-Crisis structured finance market) – this is crucial

[6] This practice led to S&P being banned from rating a certain category of financial products for the period of 12 months in 2015, after five years of instituting this practice for the C/F CMBS class of product alone. See Securities and Exchange Commission *Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Section 8A of the Securities Act of 1933 and Sections 15E (d) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order* [2015] Release No. 9705; 74104, File No. 3-16348.

because many investors were bound by regulations to *only* invest in Aaa securities. The Agency finish by acknowledging that issuers knew of this leniency, but investors did not.

The Statement of Facts paints a remarkable picture. It shows, as admitted by the Agency themselves, that they *consciously* sided with issuers of structured finance products who. Lest we forget, *pay* the agencies for their services, *against* investors. Not only did they act against investors, but they *actively* acted against the interests of investors, by publishing information that they knew would be relied upon. A question will be raised at the end of this article but it is worth foreshadowing it here: it is arguably amazing that this Statement of Facts is not being used to initiate Criminal proceedings against the controllers of the Agency (irrespective of the conclusive nature of the settlement). Yet, these iniquities within the ratings industry are well known and should not shock or surprise. It is the so-called 'compliance commitments', however, which may leave one incredulous.

The announcement by the DoJ is very forthcoming in displaying the compliance agreement it has reached with Moody's. The announcement states that Moody's 'agrees to *maintain* a host of measures designed to ensure the integrity of its credit ratings' which include: the separation of its commercial and credit rating functions; independent review of its methodologies and alterations; 'changes to ensure that specified personnel are not compensated on the basis of the company's financial performance'; and increasing the timeliness of press releases, and their accuracy – there were a number of others besides as well. What can we take from this? Well, we can do one of two things. If we focus upon the sentiment of the announcement, we can conclude that Moody's has been reprimanded and is now seeking to address the issues that caused the transgressions because, as Deputy Assistant

Attorney General Jonathan Olin suggests, the DoJ is ‘committed to working with companies that are willing to admit to what they did and take steps to enhance compliance’. This is an accepting and forgiving narrative. Or, on the other hand, we can be enraged, disappointed, and emboldened in our belief that the law applies differently to large corporations. This announcement, as a whole, can be read in a number of ways, yet there is one reading that stands out. What we have here is an account which details that Moody’s *lied* to investors and actively *worked against* them, followed by the championing of an agreement that proclaims that Moody’s will now do *what they have said they have been doing for the past two decades*. Moody’s, along with S&P, are quick to advertise their ethical and compliant approaches, but admit that they do not follow them; the response from the U.S. Government has been to ‘agree’ with the agencies that they will try to follow them from now on. This settlement, which was supposed to champion the position of the Government as protector of the investor, and the public moreover, has had the opposite effect – it has highlighted their predisposition for supporting the corporation above the public.

Conclusion

The settlement between Moody’s and the DoJ has concluded the punishment of the Big Two rating agencies for their conduct in the lead-up to the Financial Crisis. Combined, the agencies have been fined just over $2.2 billion, which is a headline-grabbing figure. But, if we look at it critically, it is almost an irrelative sum. The rating agencies, as a result of their involvement in the sub-prime debacle, have posted year-on-year growth for the past 14 years (disregarding 2007 and 2008) according to their official reports, and have become even more engrained into the fabric of the interconnected global economy. As a punishment, the U.S.

Government has decided that a fine, which represents a fraction of their profits from the period, together with a pledge that the agencies will act as they have proclaimed for over two decades, represents a positive outcome. Well, it does not. It actually represents two things. Firstly, it represents the dynamic between the Government, the Private Sector, and the Public. The Government, in a similar modus operandi to that of the agencies, says one thing and does another – it is continuing to prove that it serves to facilitate private enterprise, rather than protect the public from the iniquities of the marketplace. Secondly, and perhaps most importantly, it highlights the hazardous situation we are in. Recently, newly-elected U.S. President Donald Trump has begun proceedings to repeal elements, or even perhaps all, of the Dodd-Frank Act of 2010, an Act which was designed to protect the public from Wall Street[7]. Now, when this is understood alongside the extraordinarily-lenient punishment of the top two rating agencies, only one thing can be deduced – the potential for a regulatory-inspired bubble is rapidly increasing. The rating agencies, bloated with profit from the last bubble, *will* be willing participants in any financial bubble, particularly now they know the punishment will never fit the crime. The question to be asked, however, is a pertinent and daunting one: there was over 70 years between the Great Depression and the Great Recession; is society capable of coping with another financially-based attack upon it so soon after 2007/08? This article suggests that it is not, and that the recent 'punishment' by the DoJ can go a long way to ensuring that that question gets answered.

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