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S.&P. Bond Deals Are on the Rise Since It Relaxed Rating Criteria

By NATHANIEL POPPER

During a meeting at Standard & Poor's New York offices in the summer of 2012, analysts responsible for rating bonds tied to home loans were informed that their unit had sustained big losses in the previous quarter.

In a way, the news was not surprising. In the wake of the financial crisis, S.& P. was hesitant to rate most of the new bonds tied to residential mortgages, and for good reason. The agency and its rivals had been accused of helping to set off the crisis by giving their highest ratings to bonds backed by subprime mortgages that ended up suffering huge losses.

But as banks began reviving the market for the bonds in 2012, S.& P.'s tough stance was hurting the bottom line.

An employee at the summer meeting, who spoke on the condition of anonymity out of fear of retribution from the company, said that the analysts were not told explicitly to relax their standards to win back business. But he said that the numbers made it clear that if the division wanted to stay afloat, the analysts would have to make changes.

A few months later, they did exactly that, introducing modified standards that made it easier to give bonds higher ratings.

The changes seemed to work. More banks began choosing S.& P. to rate the new bonds backed by residential mortgages. S.& P., in turn, faced criticism from industry participants who worried that the changes were allowing lower-quality bonds to make it into the market.

"It kind of blindsided all of us," said one banker involved in the deals at the time, who was not authorized to speak publicly. "It turns out you could water these down and have them rated by S.& P."

An S.& P. spokesman, Ed Sweeney, said the changes were not made in response to "commercial considerations" but instead put in place a "method that had already been applied by S.& P. elsewhere."

Mr. Sweeney said that the unit rating residential mortgage bonds was still losing money this year but that "S.& P. remains committed to serving this market."

The changes, in November 2012, came just two months after analysts in a related part of S.& P. modified their standards for bonds backed by commercial real estate mortgages after that unit had also struggled to win business. An earlier analysis by The New York Times found that those changes allowed S.& P. to give higher ratings than its competitors and to capture more business.

The market for bonds backed by residential mortgages has been slower to bounce back than the one tied to commercial ones. But an analysis of industry data shows that S.& P. has followed a similar course in its efforts to win business in the residential bond market. Since S.& P. eased its standards last year, its market share has risen to 69 percent from the 18 percent it had in the first years after the crisis.

On nearly every deal since it changed its standards, S.& P. has been willing to make more optimistic predictions about the bonds it was rating than the other agencies rating the deals, according to analysis of data from company reports. Bankers want more optimistic predictions because they make the bonds easier to sell to investors.

Matt Birkbeck, who follows the industry for the publication Asset Backed Alert, said S.& P.'s increase in market share was "largely a function" of its "revised rating approach," which allows banks, in the bonds they issue, to include smaller cushions to protect investors.

The changes that S.& P. has made to its standards for both commercial and residential real estate surprised industry participants because the agency was already under fire for its practices before the financial crisis. The government sued S.& P. in February, accusing it of inflating its ratings to get jobs grading subprime mortgage bonds in the run-up to the crisis.

Many critics of the system say that the problems were caused in part by conflicts of interest built into the ratings industry. The banks decide which agencies rate their bonds. Because the banks want higher ratings to make the bonds look more attractive to investors, the credit agencies have an incentive to comply.

S.& P. has said in its response to the government lawsuit that its ratings are "objective, independent, uninfluenced by any conflicts of interest." It recently began an advertising campaign declaring that it "used the lessons learned from the financial crisis to improve the methodologies, procedures and rigor underlying our ratings."

The company, though, has faced an unusual amount of criticism from competitors for its work on residential mortgage bonds since the crisis.

Fitch, the market leader in rating new mortgage bonds, has issued three reports since 2011 criticizing bonds that it believed were rated too kindly. All three of the deals had been rated by S.& P., the most recent in July.

Jim Nadler, president of the relatively new Kroll Bond Rating Agency, said that S.& P. had been more aggressive than the other big agencies in changing its standards to win business rating bonds backed by mortgages.

"They've been more singly focused on the wrong thing, and that is making sure they are getting deals," Mr. Nadler said. "That's really the only conclusion you can come to when you look at where they were on earlier deals and where they are today."

Immediately after the crisis started, all of the agencies tightened their standards. S.& P. quickly gained a reputation for being particularly tough. In the first deal containing new mortgages after the crisis, in 2010, the banks did not choose S.& P. The company wrote an unusual public report criticizing Moody's for rating the deal AAA.

After failing to get in on the next three deals, however, S.& P. replaced the head of its mortgage bond unit in February 2012.

S.& P. employees in the unit said they felt pressure to change their standards to win business, including in meetings where analysts were given information about revenues and profits of their division that was not publicly available.

Many ratings agency experts said that analysts are supposed to be walled off from commercial concerns, making it unusual for them to be told about the financial results of their units. Mr. Sweeney said that the company had a "longstanding practice of sharing business updates, including high-level information about the company's past financial performance, with our staff on a quarterly basis."

In the months after the mortgage bond unit leadership change, the company won the contract to rate two bonds. But industry participants say the real change came later in the year, when S.& P. officially altered its standards in a way that reduced the penalty for bonds that had a high concentration of mortgages from the same region. That was significant at a time when many of the mortgages going into new bonds came from California.

In one of the first deals after it modified its standards, S.& P. predicted much lower losses than it had on similar deals in the past, a signal that it was willing to give the AAA rating to a larger proportion of the underlying tranches of the deal. The deal also attracted criticism because S.& P. agreed to rate the bond even though it included a provision that shielded the bank from future lawsuits if the mortgages ended up going sour.

Fitch published a note criticizing the deal, and Moody's later wrote a report saying it would not give AAA ratings to deals that gave the banks such protections. Competitors have also complained that S.& P.'s forecasts for the losses on bonds suddenly became more optimistic.

Mr. Sweeney said that S.& P. had been willing to give high ratings because the underlying mortgages were of such high quality and because of the "level of due diligence conducted on the loans."

The new bonds generally contain only high-quality mortgages that are too large to be put into bonds by Freddie Mae and Fannie Mac. Many analysts have said they do not think these bonds are likely to sustain losses, making the ratings less important. But several investors said that the standards now being set could be a problem if mortgage credit quality declines.

“Once these historical precedents are there, they’re there to stay,” said Laurie Goodman, a mortgage bond analyst at Amherst Securities.

This post has been revised to reflect the following correction:

Correction: September 21, 2013

An article on Wednesday about changes in the criteria of Standard & Poor’s for rating bonds backed by residential mortgages referred incorrectly to changes in standards related to the geographic concentration of loans. S.& P. reduced the penalty for bonds that had a high concentration of mortgages from the same region, but it did not remove it entirely.