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Financial Meltdown: The Case Against the Ratings Agencies

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In today's looming confrontation the ratings agencies are playing the political role of "enforcer" as the gatekeepers to credit, to put pressure on Iceland, Greece and even the United States to pursue creditor-oriented policies that lead inevitably to financial crises. These crises in turn force debtor governments to sell off their assets under distress conditions. In pursuing this guard-dog service to the world's bankers, the ratings agencies are escalating a political strategy they have long been refined over a generation in the corrupt arena of local U.S. politics.

Why ratings agencies public selloffs rather than sound tax policy: The Kucinich Case Study

In 1936, as part of the New Deal's reform of America's financial markets, regulators forbid banks and institutional money managers to buy securities deemed "speculative" by "recognized rating manuals." Insurance companies, pension funds and mutual funds subject to public regulation are required to "take into account" the views of the credit ratings agencies, provided them with a government-sanctioned monopoly. These agencies make their money by offering their "opinions" (for which they have never been legally liable) as to the payment prospects of various grades of security, from AAA (as secure government debt, the top rating because governments always can print the money to pay) down to various depths of junk.

Moody's, Standard and Poor's and Fitch focus mainly on stocks and on corporate, state and local bond issues. They make money twice off the same transaction when cities and states balance their budgets by spinning off public enterprises into new corporate entities issuing new bonds and stocks. This business incentive gives the ratings agencies an antipathy to governments that finance themselves on a pay-as-you-go basis (as Adam Smith endorsed) by raising taxes on real estate and other property, income or sales taxes instead of borrowing to cover their spending. The effect of this inherent bias is not to give an opinion about what is economically best for a locality, but rather what makes the most profit for themselves.

Localities are pressured when their rising debt levels lead to a financial stringency. Banks pull back their credit lines, and urge cities and states to pay down their debts by selling off their most viable public enterprises. Offering opinions on this practice has become a big business for the ratings agencies. So it is understandable why their business model opposes policies – and political candidates – that support the idea of basing public financing on taxation rather than by borrowing. This self-interest colors their "opinions."

If this seems too cynical an explanation for today's ratings agencies self-serving views, there are sufficient examples going back over thirty years to illustrate their unethical behavior. The first and most notorious case occurred in Cleveland, Ohio, after Dennis Kucinich was elected mayor in 1977. The ratings agencies had been giving the city good marks despite the fact that it had been using bond funds improperly for general operating purposes to covered its budget shortfalls by borrowing, leaving Cleveland with $14.5 million owed to the banks on open short-term credit lines.

Cleveland had a potential cash cow in Municipal Light, which its Progressive Era mayor Tom Johnson had created in 1907 as one of America's first publicly owned power utilities. It provided the electricity to light Cleveland's streets and other public uses, as well as providing power to private users. Meanwhile, banks and their leading local clients were heavily invested in Muni Light's privately owned competitor, the Cleveland Electric Illuminating Company. Members of the Cleveland Trust sat on CEI's board and wielded a strong influence on the city council to try and take it over. In a series of moves that city officials, the U.S. Senate and regulatory agencies found to be improper (popular usage would say criminal),1 CEI caused a series of disruptions in service and worked with the banks and ratings agencies to try and force the city to sell it the utility. Banks for their part had their eye on financing a public buyout – and hoped to pressure the city into selling, threatening to pull the plug on its credit lines if it did not surrender Muni Light.

It was to block this privatization that Mr. Kucinich ran for mayor. To free the city from being liable to financial pressure from its vested interests – above all from the banks and private utilities – he sought to put the city's finances on a sound footing by raising taxes. This threatened to slow borrowing from the banks (thereby shrinking the business of ratings agencies as well), while freeing Cleveland from the pressures that have risen across the United States for cities to start selling off their public enterprises, especially since the 1980s as tax-cutting politicians have left them deeper in debt.

The banks and ratings agencies told Mayor Kucinich that they would back his political career and even hinted financing a run for the governorship if he played ball with them and agreed to sell the electric utility. When he balked, the banks said that they could not renew credit lines to a city that was so reluctant to balance its books by privatizing its most profitable enterprises. This threat was like a credit-card company suddenly demanding payment of the full balance from a customer, saying that if it were not paid, the sheriff would come in and seize property to sell off (usually on credit extended to customers of the bankers).

The ratings agencies chimed in and threatened to downgrade Cleveland's credit rating if the city did not privatize its utility. The financial tactic was to offer the carrot of corrupting the mayor politically, while using the threat of forcing the city into financial crisis and raising its interest rates. If the economy did not pay higher utility charges as a result of privatization, it would have to pay higher interest.

But standing on principle, the mayor refused to sell the utility, and voters elected to keep Muni light public by a 2-to-1 margin in a referendum. They proceeded to pay down the city's debt by raising its income-tax rate in order to avoid paying higher rates for privatized electricity. Their choice was thoroughly in line with Book V of Adam Smith's Wealth of Nations provides a perspective on how borrowing ends up with a proliferation of taxes to pay the interest. This makes the private sector pay higher prices for its basic needs that Cleveland Mayor Tom Johnson and other Progressive Era leaders a century ago sought to socialize in order to lower the cost of living and doing business in the United States.

The bankers' alliance with the Cleveland's wealthy would-be power monopoly led it to be the first U.S. city to default since the Great Depression as the state of Ohio forced it into fiscal receivership in 1979. The banks used the crisis to make an easy gain in buying up bond anticipation notes that were sold under distress conditions exacerbated by the ratings agencies. The banks helped fund Mayor Kucinich's opponent in the 1979 mayoral race.

But in saving Muni Light he had saved voters hundreds of millions of dollars that the privatizers would have built into their electric rates to cover higher interest charges and financial fees, dividends to stockholders, and exorbitant salaries and stock options. In due course voters came to recognize Mr. Kucinich's achievement have sent him to Congress since 1997. As for Mini Light's privately owned rival, the Cleveland Electric Illuminating Company, it achieved notoriety for being primarily responsible for the northeastern United States power blackout in 2003 that left 50 million people without electricity.

The moral is that the ratings agencies' criterion was simply what was best for the banks, not for the debtor economy issuing the bonds. They were eager to upgrade Cleveland's credit ratings for doing something injurious – first, borrowing from the banks rather than covering their budget by raising property and income taxes; and second, raising the cost of doing business by selling Muni Light. They threatened to downgrade the city for acting to protect its economic interest and trying to keep its cost of living and doing business low.

The tactics by banks and credit rating agencies have been successful most easily in cities and states that have fallen deeply into debt dependency. The aim is to carve up national assets, by doing to Washington what they sought to do in Cleveland and other cities over the past generation. Similar pressure is being exerted on the international level on Greece and other countries. Ratings agencies act as political "enforcers" to knee-cap economies that refrain from privatization sell-offs to solve debt problems recognized by the markets before the ratings agencies acknowledge the bad financial mode that they endorse for self-serving business reasons.

Why ratings agencies oppose public checks against financial fraud

The danger posed by ratings agencies in pressing the global economy to a race into debt and privatization recently became even more blatant in their drive to give more leeway to abusive financial behavior by banks and underwriters. Former Congressional staffer Matt Stoller cites an example provided by Josh Rosner and Gretchen Morgenson in *Reckless Endangerment* regarding their support of creditor rights to engage in predatory lending and outright fraud.2 On January 12, 2003, the state of Georgia passed strong anti-fraud laws drafted by consumer advocates. Four days later, Standard & Poor announced that if Georgia passed anti-fraud penalties for corrupt mortgage brokers and lenders, packaging including such debts could not be given AAA ratings.

> Because of the state's new Fair Lending Act, S&P said that it would no longer allow mortgage loans originated in Georgia to be placed in mortgage securities that it rated. Moody's and Fitch soon followed with similar warnings.
>
> It was a critical blow. S&P's move meant Georgia lenders would have no access to the securitization money machine; they would either have to keep the loans they made on their own books, or sell them one by one to other institutions. In turn, they made it clear to the public that there would be fewer mortgages funded, dashing "the dream" of homeownership.

The message was that only bank loans free of legal threat against dishonest behavior were deemed legally risk-free for buyers of securities backed by predatory or fraudulent mortgages. The risk in question was that state agencies would reduce or even nullify payments being extracted by crooked real estate brokers, appraisers and bankers. As Rosner and Morgenson summarize:

> Standard & Poor's said it was taking action because the new law created liability for any institution that participated in a securitization containing a loan that might be considered predatory. If a Wall Street firm purchased loans that ran afoul of the law and placed them in a mortgage pool, the firm could be liable under the law. Ditto for investors who bought into the pools. "Transaction parties in securitizations, including depositors, issuers and servicers, might all be subject to penalties for violations under the Georgia Fair Lending Act," S&P's press release explained.3

The ratings agencies' logic is that bondholders will not be able to collect if public entities prosecute financial fraud involved in packaging deceptive mortgage packages and bonds. It is a basic principle of law that receivers or other buyers of stolen property must forfeit it, and the asset returned to the victim. So prosecuting fraud is a threat to the buyer – much as an art collector who bought a stolen painting must give it back, regardless of how much money has been paid to the fence or intermediate art dealer. The ratings agencies do not want this principle to be followed in the financial markets.

We have fallen into quite a muddle when ratings agencies take the position that packaged mortgages can receive AAA ratings only from states that do not protect consumers and debtors against mortgage fraud and predatory finance. The logic is that giving courts the right to prosecute fraud threatens the viability of creditor claims endorses a race to the bottom. If honesty and viable credit were the objective of ratings agencies, they would give AAA ratings only to states whose courts deterred lenders from engaging in the kind of fraud that has ended up destroying the securitized mortgage binge since September 2008. But protecting the interests of savers or bank customers – and hence even the viability of securitized mortgage packages – is not the task with which ratings agencies are charged.

Masquerading as objective think tanks and research organizations, the ratings agencies act as lobbyists for banks and underwriters by endorsing a race to the bottom – into debt, privatization sell-offs and an erosion of consumer rights and control over fraud. "S&P was aggressively killing mortgage servicing regulation and rules to prevent fraudulent or predatory mortgage lending," Stoller concludes. "Naomi Klein wrote about S&P and Moody's being used by Canadian bankers in the early 1990s to threaten a downgrade of that country unless unemployment insurance and health care were slashed."

The basic conundrum is that anything that interferes with the arbitrary creditor power to make money by trickery, exploitation and outright fraud threatens the collectability of claims. The banks and ratings agencies have wielded this power with such intransigence that they have corrupted the financial system into junk mortgage lending, junk bonds to finance corporate raiders, and computerized gambles in "casino capitalism." What then is the logic in giving these agencies a public monopoly to impose their "opinions" on behalf of their paying clients, blackballing policies that the financial sector opposes – rulings that institutional investors are legally obliged to obey?

Threats to downgrade the U.S. and other national economies to force pro-

financial policies

At the point where claims for payment prove self-destructive, creditors move to their fallback position. Plan B is to foreclose, taking possession of the property of debtors. In the case of public debt, governments are told to privatize the public domain – with banks creating the credit for their customers to buy these assets, typically under fire-sale distress conditions that leave room for capital gains and other financial rake-offs. In cases where foreclosure and forced sell-offs are not able to make creditors whole (as when the economy breaks down), Plan C is for governments simply to bail out the banks, taking bad bank debts and other obligations onto the public balance sheet for taxpayers to make good on.

Standard and Poor's threat to downgrade of U.S. Treasury bonds from AAA to AA+ would exacerbate the problem if it actually discouraged purchasers from buying these bonds. But on the Monday on August 8, following their Friday evening downgrade, Treasury borrowing rates fell, with short-term T-bills actually in negative territory. That meant that investors had to lose a small margin simply to keep their money safe. So S&P's opinions are as ineffectual as being a useful guide to markets as they are as a guide to promote good economic policy.

But S&P's intent was not really to affect the marketability of Treasury bonds. It was a political stunt to promote the idea that the solution to today's budget deficit is to pursue economic austerity. The message is that President Obama should roll back Social Security and Medicare entitlements so as to free more money for more subsidies, bailouts and tax cuts for the top of the steepening wealth pyramid. Neoliberal Harvard economics professor Robert Barro made this point explicitly in a Wall Street Journal op-ed. Calling the S&P downgrade a "wake-up call" to deal with the budget deficit, he outlined the financial sector's preferred solution: a vicious class war against labor to reduce living standards and further polarize the U.S. economy between creditors and debtors by shifting taxes off financial speculation and property onto employees and consumers.

First, make structural reforms to the main entitlement programs, starting with increases in ages of eligibility and a shift to an economically appropriate indexing formula. Second, lower the structure of marginal tax rates in the individual income tax. Third, in the spirit of Reagan's 1986 tax reform, pay for the rate cuts by gradually phasing out the main tax-expenditure items, including preferences for home-mortgage interest, state and local income taxes, and employee fringe benefits—not to mention eliminating ethanol subsidies. Fourth, permanently eliminate corporate and estate taxes, levies that are inefficient and raise little money. Fifth, introduce a broad-based expenditure tax, such as a value-added tax (VAT), with a rate around 10%.

Bank lobbyist Anders Aslund of the Peterson Institute of International Finance jumped onto the bandwagon by applauding Latvia's economic disaster (a 20 percent plunge in GDP, 30 percent reduction of public-sector salaries and accelerating emigration as a success story for other European countries to follow. As they say, one can't make this up.

As the main advocate and ultimate beneficiary of privatization, the financial sector directs debtor economies to sell off their public property and cut social services – while increasing taxes on employees. Populations living in such economies call them hell and seek to emigrate to find work or simply to flee their debts. What else should someone call surging poverty, death rates and alcoholism while a few grow rich? The ratings agencies today are like the IMF in the 1970s and '80s. Countries that do not agree sell off their public domain (and give tax deductibility to the interest payments of buyers-on-credit, providing multinationals with income-tax exemption on their takings from the monopolies being privatized) are treated as outlaws and isolated Cuba- or Iran-style.

Such austerity plans are a failed economic model, but the financial sector has managed to gain even as economies are carved up. Their “Plan B” is foreclosure, extending to the national scale. By the 1980s, creditor-planned economies in Third World debtor countries had reached the limit of their credit-worthiness. Under World Bank coordination, a vast market in national infrastructure spending for creditor-nation bank debt, bonds and exports. The projects being financed on credit were mainly to facilitate exports and provide electric power for foreign investments. After Mexico announced its insolvency in 1982 when it no longer could afford to service foreign-currency debt, where were creditors to turn?

Their solution was to use the debt crisis as a lever to start financing these same infrastructure projects all over again, now that most were largely paid for. This time, what was being financed was not new construction, but private-sector buyouts of property that had been financed by the World Bank and its allied consortia of international bankers. There is talk of the U.S. Government selling off its national parks and other real estate, national highways and infrastructure, perhaps the oil reserve, postal service and so forth.

S&P’s “opinion” was treated seriously enough by John Kerry, the 2004 Democratic Presidential nominee, as a warning that America should “get its house in order.” Despite the fact that on page 4 of its 8-page explanation of why it downgraded Treasury bonds, S&P’s stated: “We have changed our assumption on this because the majority of Republicans in Congress continue to resist any measure that would raise revenues, a position we believe Congress reinforced by passing the act,” was one of the three senators appointed to the commission under the debt-ceiling agreement. He chimed in to endorse the S&P action as a helpful nudge for the country to deal with its “entitlements” program – as if Social Security and FICA withholding were a kind of welfare, not actual savings put in by labor, to be wiped out as the government empties its coffers to bail out Wall Street’s high rollers.

No less a financial publication than the Wall Street Journal has come to the conclusion that “in a perfect world, S&P wouldn’t exist. And neither would its rivals Moody’s Investors Service and Fitch Ratings Ltd. At least not in their current roles as global judges and juries of corporate and government bonds.” As its financial editor Francesco Guerrera wrote quite eloquently in the aftermath of S&P’s bold threat to downgrade the U.S. Treasury’s credit rating: “The historic decision taken by S&P on Aug. 5 is the culmination of 75 years of policy mistakes that ended up delegating a key regulatory function to three for-profit entities.”4

The behavior of leading banks and ratings agencies Cleveland and other similar cases – of promising to give good ratings to states, counties and cities that agree to pay off short-term bank debt by selling off their crown jewels – is not ostensibly criminal under the law (except when their hit men actually succeed in assassination). But the ratings agencies have made an compact with crooks to endorse only public borrowers that agree to pursue such policies and not to prosecute financial fraud.

To acquiescence in such economically destructive financial behavior is the opposite of fiscal responsibility. Cutting federal taxes and Social Security payments to obtain a more positive S&P “opinion” would give banks an ability to “pull the plug” and force privatization and anti-labor austerity plans by refraining from rolling over the U.S. debt – and cutting taxes Tea-Party style rather than funding spending by taxation on a pay-as-you-go-basis.

The present meltdown of the euro provides an object lesson for why policy-making never should be left to central bankers, because their mentality is pro-creditor. Otherwise they would not have the political reliability demanded by the financial sector that has captured the central bank, Treasury and regulatory agencies to gain veto power over who is appointed. Given their preference for debt deflation of the "real" economy – while trying to inflate asset prices by promoting the banks' product (debt creation) – central bank and Treasury solutions tend to aggravate economic downturns. This is self-destructive because today's major problem blocking recovery is over-indebtedness.

Notes

1 http://en.wikipedia.org/wiki/Dennis_Kucinich. The financial ploy included hiring a Mafia hit man to shoot Mr. Kucinich at a parade – which he fortunately did not attend. For Mr. Kucinich's own narrative of these events, see "Kucinich and Muny Light – Battle with the Banks," truthdig.com, December 15, 2008, also available at http://www.dailypaul.com/76343/kucinich-and-muny-light-battle-with-the-banks.

2 Matt Stoller, "Standard & Poor's Predatory Policy Agenda," *Naked Capitalism*, August 7, 2011.

3 Robert Barro, "How to Get That AAA Rating Back," *Wall Street Journal*, August 8, 2011.

4 Francesco Guerrera, "Here's How to Rejigger the U.S. Credit-Rating System," *Wall Street Journal*, August 16, 2011.

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