Cezary Podkul writes: Credit rating agencies' letter grades signal their judgment as to which debts are safe to buy and which ones carry a higher risk of nonpayment, or default – akin to credit scores banks look at before they decide to make home loans.

Depending on the size of the issue, a local government issuing bonds with an "AAA" rating, the highest in the scale run by S&P and Fitch, could wind up paying millions of dollars less in annual interest to bond buyers than an entity selling an issue with a rating below "BBB-", the lowest grade for safe, investment-grade bonds.

Thus, issuers and their bankers have a natural incentive to push the credit-rating agencies to assign favorable ratings. Their leverage is that the raters' compensation comes from money raised from the debt they rate. S&P, for example, earned $266,000 for rating a March tobacco deal in New Jersey.

Executives of S&P, Fitch and Moody's, the three biggest firms in the business, have long maintained that their ratings are independent judgments of the creditworthiness of a bond. They have said there is no incentive to succumb to pressure because that would taint the reputation as honest brokers that their business model demands.

But as the SEC acknowledged in its recent rules, the potential conflict of interest faced by rating agencies is "more acute" in the area of structured finance. That term refers to the practice of turning streams of money – like mortgage or credit-card payments – into debt backed by those payments.

That is exactly what happened to money from the 1998 settlement.

For bankers and politicians, it was an irresistible opportunity for structured finance deals. The accord with cigarette manufacturers promised to send more than $200 billion over its first 25 years to state governments to reimburse smoking-related health care costs – and more money beyond. Even before the first payments began flowing in 1999, bankers were asking rating agencies to develop criteria for how they would grade the creditworthiness of the debt, the documents show.

From the beginning, that was going to be part art, part science.

The tobacco settlement payments are linked to inflation as well as cigarette sales, with room for adjustments based on legal disputes. That left a whole host of uncertainties, from the rate of the likely decline in cigarette sales to the potential bankruptcy of tobacco firms.

Starting in 1999, the rating agencies published their basic expectations, along with various so-called stress scenarios, for attaining various letter grades on their credit scales. They made clear that these criteria were subject to change at their discretion.

To protect investors, these criteria are supposed to be a non-negotiable element of the rating process: They are the independent recipe rating agencies use to fairly measure deals brought to them by bankers.

“Rating criteria should not be changed simply to enable securities to achieve the rating level the banker desires," said Thomas McGuire, former executive vice president of Moody’s, who worked at the rating agency from 1977 to 1995.

Going shopping

Beginning in 2002, documents show, the bankers took aim at that recipe. They sought to pack more debt into tobacco deals while preserving the highest possible grades.

“UBS’s tobacco securitization team turned the sector on its head in mid–2002 when the rest of the industry was passively accepting ratings criteria, and blindly structuring securitizations to meet the most constrictive criteria of the three rating agencies (the lowest common denominator approach),” UBS bankers boasted to Michigan officials when they were wooing the state’s business in 2006.

“UBS analyzed, challenged and fundamentally changed the underpinning criteria for mainstream ratings," they added in bold italic text.

A 2002 pitch to New York State recounted how the UBS bankers said they did it. After being hired by Rhode Island on a tobacco deal, the bankers said they spent an “intensive 10 days redefining the statistical ranges employed in Moody’s tobacco stress tests” using cash-flow projections they’d developed for the deal.

UBS said Moody’s agreed to alter its stress tests, allowing Rhode Island to get more proceeds out of the deal, which Moody’s rated “A1”– the highest rating it assigned in the sector.

“This was the first time that any issuer had been successful in achieving a favorable change in a rating agency’s tobacco rating criteria," UBS said in a 2005 deal resume submitted to California. “As a result, Moody’s decided to permanently ease its stress tests,” UBS claimed in a later California document.

The Rhode Island transaction was only the beginning. UBS said that over the following years, it “pioneered” the concept of “shopping” ratings to max out the amount of cash it could raise for its clients by pitting rating agencies against each other. Competitors followed its lead, UBS said.

It was all viewed as business as usual: “In the structured finance arena, each rating agency is accustomed to and comfortable with the ‘shopping’ dynamic,” UBS told Virginia in a 2007 pitch.

By 2005, rivals Bear Stearns and Citigroup were making similar claims about their persuasive prowess. Citigroup took credit for negotiating new stress tests with Moody’s,

and in one pitch, it provided a "timeline of events" outlining its negotiations – and favorable results – with all three rating agencies.

Not to be outdone, UBS said it helped Moody's spruce up its criteria in late 2005 after the firm didn't get hired on a spate of deals: "Though others viewed Moody's as obsolete, UBS brought them back to the sector and worked with them to modernize their criteria."

Weill, the Moody's executive, declined to discuss any specific remarks by bankers.

However, an internal Moody's document, disclosed in one of several lawsuits brought against the firm in the wake of the financial crisis, indicates that something happened in late 2005 that allowed the rater to recapture market share in rating tobacco bonds.

"Moody's position is this market was regained in late 2005 but could be lost again," an executive wrote to senior management in a November 2006 discussion of "competitive issues."

'Cherry-Picking'

As the market for tobacco debt continued to heat up in 2005, bankers added one particularly toxic security into their sales pitch: a capital appreciation bond, or CAB.

Unlike traditional bonds, CABs do not pay interest to bondholders every year, instead letting it add up into huge amounts at maturity. The CABs were often dated to mature in 40 years or later, so that regular interest-paying tobacco bonds would be paid first. CAB investors were last in line.

Some issuers, such as Puerto Rico, had already maxed out on the amount of interest-paying tobacco bonds they could sell. So the CABs helped keep the tobacco market humming. But CABs were a riskier proposition to investors, since their longer maturities meant forecasts of cigarette sales would have to hold up over many decades for the debt to repay.

To attract buyers, and get better prices, bankers needed the rating agencies to weigh in. But Moody's didn't rate CABs. Neither had S&P.

Fitch stepped in to fill the void.

Starting with its first CAB sale in 2005, the rating agency got hired again and again to assess CABs.

With Fitch in the game, bankers pushed for more favorable treatment of CABs in areas like the stress tests used to rate the bonds. Changing the tests could allow bankers to squeeze out more money from CAB deals Fitch rated. In pitches they submitted to Michigan on Feb. 17, 2006, Citigroup and Bear Stearns each took credit for lobbying Fitch to ease up on CABs.

Just a few days later, Fitch announced that "with the advent of new bond structures," it would update its criteria with a stress test that would make it easier for bonds 40 years or longer – the typical maturity for CABs – to get rated.

UBS bankers immediately ran the numbers and decided the change wasn't favorable enough.

"UBS shared its findings with Fitch within 24 hours of their press release. Fitch confirmed our analysis and worked with our tobacco securitization bankers to devise a new stress test methodology," UBS told California in bold letters in a 2006 deal document.

Fitch did not respond to written questions from ProPublica about UBS' claims.

Days later, in a Feb. 28, 2006, presentation to Michigan, UBS bankers bragged about getting Fitch to agree to what they called a "revision to revision" on its CAB criteria. Thanks to the rater's more "lenient" rules for CABs, they also recommended that Michigan use Fitch on its deal, which UBS ultimately didn't win.

By then, one of Fitch's competitors, S&P, had decided to jump into rating CABs, too.

During the months that followed, bankers continued to press agencies to relax their criteria, pouncing on any advantage they could find. Bear Stearns claimed to have the most success negotiating favorable changes. Led by Arnone, the top banker in the sector, the firm handled enough deals to have leverage in challenging rating agencies' criteria and picking the ones that agreed to the best terms.

"Cherry-picking" is how Arnone and her team described the ratings process in a January 2007 document submitted to Virginia. Often, the team would get "negotiations" with the agencies started before pitching a deal so they could brief governments on various criteria changes they could expect if they hired Bear Stearns. These were noted on a running list of "major inroads" with the rating agencies.

In one case, Arnone's team told California officials in November 2006 they were seeking an adjustment to the estimated market share of cigarette manufacturers participating in the settlement. Even a tiny increase in the assumed market share, from the current 94 percent to 94.3 percent, would mean $26 million more in upfront cash to the state – if a committee of S&P rating analysts agreed to the change.

"We are highly confident that this criteria change will be approved by the rating committee," Arnone's team said in its pitch. Six months later, S&P did publish new criteria for tobacco bonds, establishing the market share for participating firms at 94.3 percent.

Arnone, now a managing director at Barclays Capital, declined to comment or to answer written questions about the documents through a spokesman for her current bank.

S&P said in a statement that its May 2007 criteria changes were actually more conservative, since they included "more severe" stress tests for cigarette consumption declines underpinning the bonds.

At the time, however, bankers disagreed. In a June 2007 document dissecting the new criteria, Bear Stearns said that, overall, S&P's new criteria were more favorable since they allowed them to raise more cash.

Sometimes the bankers took advantage of the apparent absence of a constraint to spark negotiations.

Citigroup noticed that S&P's new 2007 criteria chose to "remain silent" on the maximum length of the CABs it would rate. With Fitch rating CABs longer than 40 years, Citigroup had been pushing S&P to do the same. And so, "immediately after the release of the criteria," Citigroup's bankers made a case for rating CABs with a 45-year term instead of 40. Goldman Sachs also sought the change.

A few weeks later, Citigroup closed an all-CAB deal in Rhode Island in which S&P for the first time rated CABs with a 45-year maturity. In general, the longer the term of an investment, the more risky it becomes because predictions are less dependable.

Just a few years into their 45-year terms, those risks been realized: The highest-rated CABs in the deal have been downgraded from a relatively safe "BBB" rating to well below investment grade. Earlier this year, Rhode Island sought to bail out the debt.

Citigroup declined to comment.

Biggest Deal of All

In the summer of 2007, Ohio officials decided to come to market with a $5.5 billion bond sale linked to their share of the tobacco settlement. It was to be the biggest such offering yet, and the stage was set for a historic showdown among bankers eager for a piece.

JPMorgan beefed up its tobacco team by hiring two key bankers from UBS. The firm said it now had a "leading tobacco bond resume."

However, by now the landscape was changing, the bank warned. Storm clouds of the financial crisis were gathering as Congress began to scrutinize the rating agencies for their faulty grades on subprime-mortgage securities.

"What was formerly a very negotiated, fluid ratings process at Moody's is now poised to become clinical and public. Moody's criteria will be published and rigidly adhered to for the first time," JPMorgan's bankers lamented to Ohio in their August 2007 pitch.

The rating firms continued to insist that their work wasn't subject to meddling from bankers. "We offer reasoned independent forward looking opinions about relative credit

risk," Michael Kanef, an executive in Moody's structured finance division, testified to a Congressional committee just a few weeks after JPMorgan pitched Ohio.

JPMorgan declined to comment.

Bear Stearns, meanwhile, had been readying the ground by negotiating a list of favorable rating criteria changes that would help Ohio get more cash. Among them, Bear said, were a more optimistic assumption Moody's had agreed to about what would happen in case a cigarette manufacturer went bankrupt, and more favorable cigarette consumption declines agreed to by Fitch.

Fitch was also reviewing its ratings of the tobacco companies themselves. Bear told Ohio that an upgrade for the industry might help boost the ratings available for the bonds, including CABs, since Fitch links its ratings on the bonds to its assessment of cigarette manufacturers.

A few weeks later, on Aug. 29, 2007, Fitch made the upgrade. By then, Ohio's bond issue was under way, with Arnone's Bear Stearns team at the helm alongside Citigroup. Bear Stearns immediately helped Ohio cash in, selling two tranches of CABs that netted the state $319 million but promised to repay $6.6 billion by 2052. Fitch rated the CABs "BBB+" and "BBB," ratings that comfortably landed them within the investment-grade categories sought by the state.

The upgrade might well have been the result of Fitch's independent analysis of the tobacco sector. But bankers at Bear Stearns also took credit.

When pitching another deal in Michigan a few months later, Bear Stearns bragged about "facilitating" Fitch's upgrade and getting a rating agency "for the first time in the history of the tobacco market" to give CABs a "BBB+" rating. More negotiations were "ongoing," Bear said.

Fitch disputed such claims in its statement to ProPublica: "Even if the bankers actually believed they had some sort of undue influence over us, that doesn't make it so – they had no such influence."

By 2008, the broader markets already were beginning to crumble under the weight of subprime mortgage debt. Bear's competitors wondered why tobacco bond criteria were being loosened.

"We view the current rating criteria relaxation for tobacco bonds as particularly interesting and unusual given current market conditions, where the rating agencies are 'under fire' for rating criteria for structured financings," bankers for DEPFA First Albany Securities wrote in a competing March 10, 2008, pitch to Michigan.

Four days later, on March 14, 2008, Bear Stearns collapsed and was sold off to rival JPMorgan in a fire sale brokered by the Federal Reserve Bank of New York. The financial crisis precipitated by the banks, with rating agencies' help, had arrived.

'Sold out'

After 2008, the market for tobacco bonds collapsed with the broader economy. Prices nosedived, too, especially for the long-dated CABs.

Downgrades ensued as cigarette sales slid more than expected. A big federal tax increase on cigarettes, announced in 2009, had dashed those expectations, and soon prompted the rating agencies to retool their criteria, too.

Fitch has downgraded Ohio's CABs five times since they were issued. They are now considered highly speculative. S&P has also lowered ratings on its CABs to junk territory. Moody's flirted with rating CABs, according to a Goldman Sachs pitch, but in the end didn't.

S&P told ProPublica that its ratings on tobacco bonds reflected its own views of cigarette consumption and, as those views changed in 2009, CABs got downgraded to speculative levels. Fitch said its downgrades were prompted by lower-than-expected cigarette sales after 2006, though about half of its portfolio of rated tobacco bonds remains within investment-grade ratings.

The implosion of mortgage-backed securities graded favorably by rating agencies prior to the financial crisis triggered lawsuits, including one in 2009 by Ohio's then-Attorney General Richard Cordray. As Ohio treasurer in 2007, he had overseen the state's tobacco bond sale. While the state had been issuing tobacco bonds with questionable ratings, its pension funds had been investing in mortgage debt securities whose ratings also turned out to be inflated. He sued the three big rating firms in November 2009 over $457 million of losses caused by what he called "false and misleading" ratings.

"The credit rating agencies sold out, and they sold us out," Cordray was quoted in news reports at the time. "They traded in their objectivity, and in exchange received massive profits." The lawsuit was tossed out in 2011 by a federal judge.

Congress addressed rating agencies in its 2010 Dodd-Frank financial system reform law. The Permanent Senate Subcommittee on Investigations and the Financial Crisis Inquiry Commission each concluded that the raters contributed to the 2008 disaster. In August, the SEC adopted rules requiring the firms to set up better internal controls so that business managers do not interfere with the analytical work.

More stringent policing of conflicts of interest is also required, as well as the opportunity to give everyone a chance to comment when the firms propose changes to rating criteria.

An SEC official said the rules would help avoid a repeat of the behavior that led to the financial crisis. But others who reviewed the rules and the documents collected by ProPublica demurred.

“One of the things that the documents illustrate is that it’s not just the rating agencies alone making bad decisions,’’ said Frank Partnoy, professor of law and finance at the University of San Diego and a former Wall Street trader. “It’s the banks manipulating the rating agencies into making bad decisions.”