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Reviewing the ratings: Standard & Poor's ordered to explain ratings modelling and methodology in multiple Australian class actions

KEY POINTS

- Several class actions have been commenced in the Federal Court in relation to losses suffered by investors in synthetic collateralised debt obligations (CDOs), constant proportion portfolio insurances (CPPIs) and commercial mortgage backed securities (CMBS) (financial products), some of which were distributed or sold by Lehman Brothers Australia Ltd (in liquidation) (LBA) and by certain major Australian banks, and were assigned credit ratings by Standard & Poor's (S&P).
- An earlier decision of the Federal Court (approved on appeal) was the first time that S&P had ever been sued in relation to its credit ratings and established that as a matter of Australian common law, a credit ratings agency could owe a duty of care to investors in respect of its rating of a financial product. The case, *ABN Amro v Bathurst Regional Council* [2012] FCA 1200 (*'Bathurst* decision') concerned a constant proportion debt obligation (CPDO) (a similar product to a CDO) that was rated by S&P.
- The *Bathurst* decision established that the credit rating agency must exercise reasonable care and skill in the assignment of the credit rating on the basis that it knew that potential investors in a structured credit product would rely on its opinion as to the credit worthiness of the notes in making their decision to invest.
- In the latest class actions, the Federal Court has ordered S&P, by its chief executive officer (CEO), to identify by affidavit the real issues relating to the ratings methodology used in rating various CDOs. The credit ratings assigned to those CDOs by S&P are the subject of seven separate representative proceedings currently before the Federal Court.

BACKGROUND

Several class actions have been commenced in the Federal Court which arose out of the purchase by the class action applicants and group members in 2005 to 2011 of synthetic collateralised debt obligations (CDOs), constant proportion portfolio insurances (CPPIs) and commercial mortgage backed securities (CMBS) (financial products), that were variously rated 'AAA' or 'AA' or 'AA-' by Standard & Poor's (S&P). The applicants allege that S&P was negligent and engaged in misleading and deceptive conduct by assigning those ratings to those financial products. S&P has denied the allegations. The group members include institutional investors, private high-net-worth individuals, councils across Australia, significant charitable organisations and churches that bought the financial products. The financial products were distributed or sold by Lehman Brothers Australia Ltd (in liquidation) (LBA), and by some major Australian banks, and financial advisers, and were assigned credit ratings by S&P.

In 2011, a claim was brought in the Federal Court by investors against LBA as the distributor of 39 CDOs. Some of those CDOs are now the subject of the further class actions against S&P. In *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (In Liq)* (2012) 301 ALR 1 ('*Wingecarribee* Proceedings'), the Federal Court found that LBA engaged in misleading and deceptive conduct when it promoted the CDOs as suitable investments to the applicant councils, that it was liable for breach of contract and negligence, and that it breached its fiduciary duty as a financial adviser to the applicant councils.

In another decision of the Federal Court, *ABN Amro v Bathurst Regional Council* ('*Bathurst* decision') [2012] FCA 1200, S&P was sued for the first time in relation to its credit ratings of a constant proportion debt obligation (CPDO). The *Bathurst* decision established that the credit rating agency must exercise reasonable care and skill in the assignment of the credit rating on the basis that it knew that potential investors in a structured credit product would rely on its opinion as to the credit worthiness of the notes in making their decision to invest.

The Federal Court of Australia has recently approved the settlement of a class action brought by the Applicants, City of Swan (WA), Moree Plains Shire Council (NSW) and Baron-Hay Investments Pty Limited (WA) on their own behalves and on behalf of approximately 90 group members against S&P ('Swan Proceedings'). The Federal Court has also approved the terms of a settlement distribution scheme. Squire Patton Boggs acted for the applicants and group members in the Swan Proceedings and was appointed by the court to administer the scheme.

There are several class actions that are still to be determined by the Federal Court in respect of S&P's conduct in assigning the credit ratings that it did to the claim financial products.

Biog box
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CEO TO PROVIDE AFFIDAVIT IN DEFENCE OF RATINGS

On 20 May 2016, the Federal Court of Australia published its reasons for judgment in *Mitsub Pty Ltd v McGraw-Hill Financial Inc* [2016] FCA 559 in which it has ordered S&P, by its CEO, to identify by affidavit the real issues relating to the ratings methodology used in rating the various financial products. The credit ratings assigned to those financial products by S&P are the subject of seven separate representative proceedings currently before the Federal Court ('S&P Proceedings'). Squire Patton Boggs acts for the applicants and certain group members in six of the seven S&P Proceedings.

The order requires the CEO to confirm by affidavit, at a very early stage of each of the S&P Proceedings, whether the Federal Court's judgment in the *Bathurst* decision (and the decision on appeal), that concerned S&P's rating of a CPDO and which concerned the inappropriateness of the use of the Gaussian copula, apply to S&P's ratings of the CDOs in the S&P Proceedings.

In addition, the court ordered the CEO to confirm by affidavit, whether the court's findings in the *Wingecarribee* Proceedings, in relation to reports by the Bank for International Settlements (in *The role of ratings in structured finance: issues and implications*, CGFS publication No 23) and Banque de France (in *The CDO Market: Functioning and Implications in Terms of Financial Stability, Financial Stability Review*, No 6 June 2005), concerning the inappropriateness of ratings agencies' methodologies to address systemic events, do or do not apply to the respondents' ratings methodologies used for each CDO in the S&P Proceedings.

If the CEO believes that those findings do not so apply, then the CEO must explain why they do not apply in the affidavit, and why the court will need to deal with the issue of reliability of the respondents' ratings that are impugned at a final hearing.

In its Reasons for Judgment, the court referred to the Honourable Justice Jagot's judgment in the *Bathurst* decision that in relation to modelling defaults:

> '… the expert evidence discloses that S&P would or ought to have known what was common knowledge in the industry, that *modelling defaults using the Gaussian copula would seriously underestimate the potential for joint severe events because it "severely underestimates the correlation out in the tail of distribution"*. The expert evidence also discloses that S&P must have known that its model modelled default risk separately from spreads which is not how markets actually work…' (emphasis added)

The Honourable Justice Rares also referred to His Honour's earlier decision in the *Wingecarribee* Proceedings about the 2005 reports by the Bank for International Settlements and Banque de France that:

> 'A feature of the claim structured CDOs as structured products, was their particular susceptibility to extreme events that could lead to significant loss. As the 2005 working group observed:
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> 'The Working Group believes that *risks associated with structured products may not have been fully grasped by some investors*. Similarly, with consensus on "best practice" regarding the modelling of portfolio credit risk still lacking, *"model risk" in instruments such as collateralised debt obligations (CDOs) is an issue for even the most sophisticated market participants. Use of structured finance instruments, together with the occurrence of worst case scenarios relating to mispriced or mismanaged exposures, might thus lead to situations in which extreme market events could have unanticipated systemic consequences*. Given these issues and the fact that structured finance markets are still largely untested, continued growth in structured finance activity warrants ongoing central bank awareness.' (emphasis in original)

The court considered that it was appropriate to require S&P to explain whether or to what extent the findings in earlier judgments about its ratings methodology are relevant to issues in the S&P Proceedings.

S&P'S SUBMISSIONS

S&P argued that the court had no power to make such an order and that, even if there were, it should not be made because, *inter alia*:

> 'The Federal Court of Australia… has ordered S&P, by its CEO, to identify by affidavit the real issues relating to the ratings methodology used in rating the various financial products'

- The CEO would need to rely on hearsay, the affidavit would thus be of no probative weight and would not narrow the issues.
- The earlier findings about the Gaussian copula and ratings methodology did not directly relate to the CDOs and did not decide that use of the Gaussian copula in rating those products was inappropriate or resulted in the assigned ratings being erroneous.
- The proposed order was 'more akin to a punitive sanction', where there was nothing in S&P's conduct that warranted censure. Moreover, in some of the S&P Proceedings, the pleadings have not yet even closed.
- The making of the order would give rise to real and legitimate concerns as to whether His Honour had prejudged the issues in the S&P Proceedings, including what will be a live issue as to the use of the Gaussian copula.

DECISION

The court, in rejecting S&P's submissions, noted that the purpose for which the affidavit from the CEO was sought was to assist in the case management of the S&P Proceedings.

Feature

Biog box

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The Honourable Justice Rares referred to the court's case management powers, contained in the Federal Court of Australia Act 1976, that are intended to facilitate the just resolution of disputes according to law and as quickly, inexpensively and efficiently as possible. The court can give directions about the practice and procedure to be followed in relation to the whole or any part of a proceeding, including requiring things to be done. The *Court's Practice Note CM1, Case Management and the Individual Docket System*, also explains that parties and their lawyers can expect the court to have regard to the desirability of, first, identifying and narrowing the issues in dispute as early as possible and, secondly, ascertaining the degree of difficulty or complexity of the issues really in dispute.

His Honour noted that:

> 'Provisions such as Pt VB have the purpose of ensuring that the conduct of civil proceedings, as French CJ, Kiefel, Bell, Gageler and Keane JJ said in *Expense Reduction Analysts Group Pty Ltd v Armstrong Strategic Management and Marketing Pty Ltd* (2013) 250 CLR 303 at 323 [56], "is firmly in the hands of the court".'

Having regard to the above matters, the court wished to be assured that the CEO of S&P, as the person ultimately responsible for the decision to litigate the S&P Proceedings, had actually turned his or her mind to those issues and explained, at a high level, why the court, having already spent considerable time and resources on different, but apparently related issues, should revisit those generated in the S&P Proceedings involving the use of the Gaussian copula.

The court further noted that the order was not punitive or any other kind of sanction, nor based on any prejudgment about any of the complex and, as yet, protean matters potentially in issue. But, for the purpose of case management the court can require a party, by its proper officer, to explain the reason why it needs to litigate particular issues in the proceedings and thus to require the court and the other parties to devote resources to deal with those issues.

APPEAL

S&P did apply for, and was granted, leave to appeal the decision. The appeal was heard on 6 July 2016 before the Honourable Justices Foster, Gilmour, and Gleeson of the Full Federal Court. Their Honours have reserved their decision.

IMPLICATIONS

The outcome of this case has highlighted that organisations such as S&P require transparency and accountability in the formulation of the credit ratings that they assign to financial products such as CDOs. In these proceedings, the applicants and group members based their purchase decisions on the fact that the credit ratings assigned by the ratings agency were objective, independent and uninfluenced by conflicts of interest that might compromise S&P's analytical judgment, and that it reflected its true current opinion of the credit risks that the financial products posed to investors.

The decision is significant in its timing, requiring S&P's CEO to provide affidavit evidence very early in the S&P Proceedings, when pleadings have not yet closed. It is also significant in confirming the Federal Court's broad case management powers, which include the power to give directions and make orders to facilitate the just resolution of disputes as quickly, inexpensively and efficiently as possible. Where required, the court is prepared to take a robust and proactive approach to case management by placing the conduct of proceedings firmly in its own hands. In the S&P Proceedings, these powers have extended to an order for the ultimate decision maker of the respondents (the CEO of S&P) to explain effectively S&P's defence of the credit ratings that it assigned to the CDOs. ■

Further reading

- Good securitisation, bad securitisation and the quest for sustainable EU capital markets (2015) 4 JIBFL 221
- The credit ratings agencies and stakeholder relations: issues for regulators (2009) 1 JIBFL 11
- The role of rating agencies and their potential exposure in the ongoing credit crisis (2008) 7 JIBFL 349