STAFF REPORT
ON

TRANSACTIONS IN SECURITIES OF THE CITY OF NEW YORK

THE ROLE OF THE RATING AGENCIES

August 26, 1977

S E C U R I T I E S   A N D   E X C H A N G E   C O M M I S S I O N

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Chapter Five

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I. INTRODUCTION

This section of the Report examines certain activities of the rating agencies up to and including that period of time covered by the Commission's investigation into the transactions in securities of the City of New York. This section shows the impact of municipal securities ratings on investors, municipalities and underwriters, among others, and that the ratings may assume a significance disproportionate to what they actually are.

Rating agencies annually rate thousands of municipal issues involving billions of dollars of securities which enter the capital markets throughout the world. The ratings are relied upon by investors in making investment decisions and by underwriters in determining whether to underwrite a particular issue. They are an important factor in determining the interest rate a municipality will pay and investors will receive. They determine whether institutions, such as savings banks, may purchase a particular debt security or are required to divest themselves of obligations they already hold. And, they are virtually indispensible to the municipality's access to the capital markets.

During the period covered by the investigation, as shown below, billions of dollars of New York City's securities were sold and traded predicated upon ratings that were based largely upon unverified data and information furnished by the City to the two rating agencies involved. Indeed, the agencies expressly disclaimed any responsibility for the accuracy of the information upon which they acted. Nor did they apparently recognize a responsibility to make diligent inquiry even in the face of adverse facts which came to their attention. Based upon the facts disclosed by this investigation, it can reasonably be concluded that the agencies failed to make timely adjustments to their assigned ratings of the City's securities, to the detriment of many and widespread public investors not intimately familiar with the City's affairs.

II. BACKGROUND

Three rating agencies rate securities issued by U.S. municipalities: Moody's Investors Services, Inc. ("Moody's"); Standard & Poor's Corporation ("S&P"); and Fitch Investor Services, Inc. ("Fitch"). 1/ In addition, several brokerage houses and banks rate municipal securities and these ratings are available to their customers. This phase of the staff's investigation focused on Moody's and S&P because these two nationally recognized rating agencies are responsible for rating the vast majority of the municipal issues that come to market each year. 2/ However, for certain purposes, this Report discusses particular actions taken by Fitch during the period under investigation.

1/ Ross, "Higher Stakes in the Bond-Rating Game," Fortune Magazine, April 1976, pages 133-134 [hereinafter referred to as "Ross"].

2/ Id.

Moody's and S&P are located in New York City. Moody's, a subsidiary of Dun & Bradstreet Companies, Inc., has been rating municipal issues since 1919. 1/ Moody's rates approximately 3,000 municipal issues a year. 2/ Moody's has been registered with the SEC as an investment adviser pursuant to Section 203 of the Investment Advisers Act of 1940 ("Investment Advisers Act") since 1940. 3/ In addition to its ratings, Moody's provides various services for investors and underwriters including publications concerning bonds and notes of governments, municipalities, corporations, utilities, transportation companies and others. 4/

S&P, a wholly-owned subsidiary of McGraw Hill, Inc., has been registered with the Commission as an investment adviser pursuant

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1/ The Twentieth Century Fund, The Rating Game (Report of the Twentieth Century Fund Task Force on Municipal Bond Credit Ratings), 1974, 51 [hereinafter referred to as "The Rating Game"].

2/ Ross at 134; Testimony of Jackson Phillips, Executive Vice-President of Moody's [hereinafter referred to as "Phillips"] at 19 (Feb. 26, 1976).

3/ SEC File No. 801-2887 (Aug. 31, 1976).

Section 202(a)(11) of the Investment Advisers Act defines an investment adviser as any person who, for compensation, engages in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing or selling securities or who issues analyses or reports concerning securities. We are aware of no applicable exemptions for agencies that rate municipal obligations.

4/ Testimony of Jackson Phillips before the Subcommittee on Consumer Protection and Finance of the Committee on Interstate and Foreign Commerce, June 24, 1976 (Prepared Statement) [hereinafter referred to as Phillips Consumer Protection Subcommittee testimony].

to Section 203 of the Investment Advisers Act since 1940. 1/ S&P and its predecessor companies have been in business for over 115 years. 2/ The agency rates an average of 900 municipal issues each year. 3/ However, unlike Moody's, which rates bonds and notes, S&P's ratings are confined mostly to bonds. 4/ Its municipal bond ratings are published in its weekly "Bond Outlook" supplemented by a monthly "Bond Guide." 5/

III. MUNICIPAL RATING FUNCTION OF MOODY'S AND S&P

At the request of an issuing municipality or its lead underwriter, Moody's and S&P undertake to examine, for a fee, economic and financial data relating to the issuer and supply the issuer with a credit rating. 6/ This rating is made to the issuer and its underwriters and then used by the underwriter in the sale of the issuer's securities. 7/ In connection

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1/ SEC File No. 801-3891 (June 20, 1977).

2/ Statement of Brenton W. Harries (President, S&P) before the House Subcommittee on Consumer Protection and Finance (June 23, 1976) [hereinafter referred to as Harries' Statement].

3/ Ross at 134.

4/ As used herein, the term "notes" refers to short-term obligations; the term "bonds" refers to obligations with long-term maturities. S&P did not rate the City's notes during the period covered by the investigation. Testimony of Hyman Grossman, Vice-President of S&P [hereinafter referred to as "H. Grossman"] at 24-25 (Feb. 6, 1976).

5/ The Rating Game at 77.

6/ Phillips at 21-22 (Feb. 26, 1976); H. Grossman at 22, 33-34 (Feb. 6, 1976).

7/ The Rating Game at 2-3.

with their respective ratings, Moody's and S&P also prepare written analyses of the municipality and securities rated. These credit ratings "enjoy universal use in the municipal bond market. They assist in the marketing of the many, and otherwise highly diverse, types of securities by compressing them into a few, relatively homogeneous groupings." 1/ It is uncommon for an issue of municipal securities to be sold without a rating from Moody's or S&P. 2/

The judgment of the rating agencies is regarded as a major factor in determining the interest rate a municipality must pay to market its securities since underwriters and ultimate purchasers obviously demand a greater rate of return on securities which are deemed to involve higher degrees of risk. 3/

Moody's and S&P use alphabetical symbols to show the relative creditworthiness of municipal securities. Moody's uses Aaa to C; S&P uses AAA to D. These ratings and the associated quality characteristics are as follows:

1/ The Rating Game at 73.

2/ Phillips at 19 (Feb. 26, 1976). In this connection, it should be noted that research reports and recommendations disseminated to the investing public by underwriters and brokers relating to securities issued by the City during the period under investigation often cited the ratings of the rating services to buttress their recommendations. See, e.g., Merrill Lynch, Pierce, Fenner & Smith, "A Fresh Look at New York City" (Release dated Jan. 15, 1973); Marine Midland Municipals Release, Jan. 6, 1975.

3/ See generally The Rating Game at 43-48; Testimony of Robert Margolies, Associate Manager, Municipal Bond Department, S&P [hereinafter referred to as "Margolies"] at 13 (Feb. 9, 1976).

QUALITY CHARACTERIZATION 1/	MOODY'S	S&P
Prime	Aaa	AAA
Excellent	Aa	AA
Upper Medium	A, A-1	A
Lower Medium	Baa, Baa-1	BBB
Marginally Speculative	Ba	BB
Very Speculative	B, Caa	B
Default	Ca, C	D

1/ The Rating Game at 40.

Both Moody's and S&P provide fuller descriptions of the meanings of the various ratings employed. The Moody's A and Baa and the comparable S&P A and BBB ratings are described as follows:

(1) Moody's: A

Bonds which are rated A possess many favorable investment attributes and are to be considered as upper medium grade obligations. Factors giving security to principal and interest are considered adequate, but elements may be present which suggest a susceptibility to impairment sometime in the future.

Baa

Bonds which are rated Baa are considered as medium grade obligations; i.e., they are neither highly protected nor poorly secured. Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and in fact have speculative characteristics as well.

[From Moody's Investors Service, Inc., "Analytical Factors in Municipal Bond Ratings."]

(2) S&P: A - Good Grade

Principal and interest payments on bonds in this category are regarded as safe. This rating describes the third strongest capacity for payment of debt service. It differs from the two higher ratings [AAA and AA] because:

The Moody's rating for notes begins at MIG-1, the best quality short-term security, and continues down to MIG-4, the lowest quality investment grade rating. 1/ MIG is an acronym for "Moody's Investment Grade."

The ratings in the top four bond categories for both Moody's and S&P are known as investment grade ratings. All four of Moody's MIG ratings are investment grades because, if Moody's decides a note is not investment grade, it declines to give any rating. 2/ Any investment grade rating, even the lowest given by either

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[Continued]

General Obligation Bonds--There is some weakness, either in the local economic base, in debt burden, in the balance between revenues and expenditures, or in quality of management. Under certain adverse circumstances, any one such weakness might impair the ability of the issuer to meet debt obligations at some future date.

* * *

BBB - Medium Grade

This is the lowest investment grade security rating.

General Obligation Bonds--Under certain adverse conditions, several of the above factors could contribute to a lesser capacity for payment of debt service. The difference between "A" and "BBB" ratings is that the latter shows more than one fundamental weakness, or one very substantial fundamental weakness, whereas the former shows only one deficiency among the factors considered.

[From Standard & Poor's Municipal Bond Ratings, "Rating Criteria," at 6-7 (hereinafter cited as "Rating Criteria")]

1/ Phillips at 14 (Feb. 26, 1976).

2/ *Id.* at 14-15.

agency, means that the rating agency foresees timely payment of both principal and interest by the issuer. 1/ Although rating agencies occasionally differ in their credit ratings of a particular issue, the criteria considered and the information received by the agencies, discussed below, is fairly uniform. 2/

IV. INFORMATION REQUIREMENTS

Both agencies require that certain data be supplied to them prior to the issuance of a rating 3/ including annual financial reports, budget figures, tax collection statements (including the tax levy and the taxes actually collected), long term investment plans, debt statements including maturities, assessed valuation of realty and personalty, information dealing with specific economic and legal conditions (e.g., population estimates and trends, school enrollments, building activity, etc.) as well as reports from academic sources or private research organizations with respect to the municipality. 4/ In addition to the information that is requested at the time of the initial rating, both agencies request updated information in order to ensure that their credit ratings reflect any subsequent change in the condition of the issuer. 5/ Both

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1/ *Id.*

2/ The Rating Game at 76.

3/ *Id.*

4/ *Id.*; Phillips at 22, 25 (Feb. 26, 1976); H. Grossman at 34-36 (Feb. 6, 1976).

5/ Phillips at 20-21 (Feb. 26, 1976); Harries' Statement at 4-5.

agencies maintain that they rely on the entity submitting the data for its accuracy and do not attempt to verify the information received. 1/

New York City was obligated to prepare and publish certain information in connection with each offering. State law required that the City prepare, file, advertise and record certain documents and authorizations prior to the issuance of either bonds or notes. 2/

The City also publishes a "Notice of Sale" for both bonds and notes which recites the amount and type of the proposed offering, information with respect to the submission of bids and the form required in connection with the submission. 3/ The "Notice of Sale" for bonds is accompanied by a "Supplemental Report of Essential Facts," which contains figures reflecting the City's outstanding debt as of a recent date, its debt-incurring power as of the same date, its estimated budgetary receipts for the fiscal year in progress, and its real estate tax collections for the most recent five year period. 4/ The "Supplemental Report" also includes a listing

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1/ Phillips at 124-26 (Feb. 26, 1976); Rating Criteria at 3.

2/ Local Finance Law Sections 57.00 and 60.00, and Regulations 25.1 through 25.6, 27.1 through 27.3 thereunder; General Municipal Law Section 9, and Regulations 26.0 and 26.1 thereunder.

3/ See e.g., Notice of Sale dated Feb. 15, 1975, of $141,440,000 Serial Bonds ("Bond Notice") and Notice of Sale, dated Sept. 9 1974, of $600,000,000 Revenue Anticipation Notes ("Note Notice").

4/ Bond Notice at 4-7.

of the principal amount of bonds maturing within the next several years, local non-property tax revenue items, bonded debt items excluded in accordance with the local finance law and funds applicable to the reduction of debt as of a recent date. 1/ The "Notice of Sale" for notes merely recites that a "Report of Essential Facts" is available upon request. 2/

V. RATING PROCESS

The procedures used by Moody's and S&P in analyzing the data and arriving at a rating appear to be similar. When a rating request is received by either agency, an analyst employed by the agency is assigned to analyze relevant data, reach a conclusion as to a rating and prepare a preliminary report for superiors. 3/

In reaching a decision on a rating, the rating analyst examines the issue and issuer with several broad areas of concern in mind, including debt factors, administrative and legal factors and a financial account analysis, *i.e*, an examination of balance sheet data. 4/ The adequacy

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1/ *Id*.

2/ Note Notice at 2. Although Dr. Phillips testified that Moody's sometimes received the Report of Essential Facts in connection with note offerings, it appears that the City prepared no such reports prior to March 13, 1975. Phillips at 142-43 (Feb. 26, 1976); Report on the Role of the Underwriters at 36.

3/ Phillips at 27-28 (Feb. 26, 1976); Margolies at 11-12; The Rating Game at 76.

4/ Rating Criteria at 4-5; The Rating Game at 78-80; Phillips at 32-37 (Feb. 26, 1976).

of revenues to meet all of the obligations of the issuer, present and prospective, is examined as well. 1/

A key tool used by the rating analyst in this work is the development of various debt ratio analyses. These ratios include debt per capita, the ratio of tax-supported debt to the assessed and/or full value of taxable real property, and the computation of annual debt service as a percentage of the total current revenue budget expenditures. In addition to the above, other ratios used in the analysis of general obligation securities include the percentage of outstanding debt repaid during the prior year, the percentage of capital outlays funded by current revenue, tax collection as a percentage of assessments, overall tax rates on property by all overlapping local units and current deficits and short-term indebtedness. 2/ In short, the rating agencies consider relevant all factors that bear on the timely payment of principal and interest.

When the rating analyst completes this work, the analyst then presents a proposed rating to a rating committee. 3/ Both Moody's and S&P use the committee rating system though the number of members on the committee varies from three members at Moody's to five at

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1/ Rating Criteria at 4; Testimony of Freda Ackerman, Vice-President of Moody's [hereinafter referred to as "Ackerman"] at 97.

2/ The Rating Game at 78-79.

3/ Id. at 76; Margolies at 11-12; Phillips at 28-29 (Feb. 26, 1976).

S&P. 1/ The committee system has several benefits in that it prevents individual bias and lessens the possibility of undue influence. 2/

Once a rating is established for a municipal bond or note issue, the agencies continue to monitor their ratings by examining updated data. With respect to New York City securities, both agencies annually review the Comptroller's Annual Report for the City of New York in order to ascertain if a rating change in either direction is warranted. 3/

The determination of a rating precedes the sale of the issuer's obligations. 4/ If a municipality receives a rating that it believes to be inaccurate or unfair, the issuer or the issuer's underwriter is provided the opportunity to present additional information, if any, and to request the rating committee to reconsider the rating. 5/

VI. THE RATING AGENCIES AND NEW YORK CITY

A. Background

In July 1965, Moody's lowered its rating of City bonds from A to Baa. 6/ According to Moody's, the action was based on a number of factors: (1) the City had recently proposed the issuance of a new form of debt instrument which would have required constitutional amendment by New York

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1/ Phillips at 29 (Feb. 26, 1976); H. Grossman at 45 (Feb. 6, 1976).

2/ Ross at 135-36.

3/ Margolies at 16-25; Phillips at 81 (Feb. 26, 1976).

4/ The Rating Game at 76-77.

5/ Address by Brenton W. Harries before the Pacific Coast Association of Port Authorities, Sept. 25, 1976; The Rating Game at 76-77.

6/ The Rating Game at 127.

State; (2) the City was borrowing long-term to fund current operations; (3) market access had weakened; (4) few if any corrective budgetary measures were being taken; (5) pension and retirement fund obligations were determined by criteria which did not sufficiently reflect the financial costs of these systems; (6) a revenue deficiency existed and appeared to be widening; (7) there were problems in refinancing maturing City obligations; (8) City services were not self-sustaining; (9) the City did not have home rule; (10) there was a limit on the tax rate the City could impose; and (11) welfare and education costs were rising. 1/

In 1966, S&P also determined to reduce the City's bond rating from A to BBB, a rating comparable to Moody's existing Baa rating. 2/ According to S&P, the reduction was precipitated by rising municipal expenditures and a deteriorating economic situation. 3/

Although Moody's upgraded its rating slightly, from Baa to Baa-1, in 1968, the two agencies' ratings of City bonds remained unchanged until the latter part of 1972. 4/

B. The 1972-73 Ratings Increases

On December 18, 1972, Moody's raised its rating of City bonds from Baa-1 to A. 5/ According to Dr. Jackson Phillips, Executive Vice-President

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1/ Phillips at 44-66 (Feb. 26, 1976); Phillips Exh. 2.

2/ The Rating Game at 146.

3/ H. Grossman at 154-55 (Mar. 1, 1976).

4/ Ross at 134.

5/ Moody's Municipal Credit Report, Dec. 18, 1972.

of Moody's, several significant factors prompted the revision. First, in 1972, the market value of taxable real estate had increased in proportion to outstanding debt. Second, there was an improvement in the relationship of current receivables to the current deficit, resulting in an improvement in the City's short-term borrowing situation. 1/ Finally, Dr. Phillips cited the importance of the so-called "first lien" on municipal revenues in favor of holders of City debt. 2/

Notwithstanding the foregoing, during that period, the City's financial condition does not appear to have improved in certain significant respects. For example, during the early 1970's, the City had negotiated a number of contracts with municipal workers which represented major increases in wage and pension benefits; 3/ the City was financing current operating expenses out of the capital budget, resulting in deferral of maintenance on City properties; 4/ and, according to Congressional testimony of City Comptroller Harrison Goldin in 1976, the City's tax base was eroding in 1972 and the City had not been successful in closing major budget gaps. 5/

1/ Phillips at 66-68 (Feb. 26, 1976).

2/ Id. at 41-42.

3/ Id. at 62-63.

4/ Id. at 57-58.

5/ Statement by H. Goldin before the House Subcommittee on Consumer Protection and Finance, June 24, 1976, at 6.

Moody's rating increase occurred one day prior to the opening of hearings before the State Senate Select Committee to Investigate the Rating of Tax Exempt Bonds. Dr. Phillips of Moody's testified at the opening day's hearings. See Phillips Exh. 1. (Statement by Jackson Phillips before the Select Senate Committee to Investigate the Rating of Tax Exempt Bonds, Dec. 19, 1972). In addition, earlier that year, two U.S. Representatives from New York scheduled hearings in connection with a bill which would provide for federal regulation of municipal bond rating agencies. The Rating Game at p. 129.

In December 1973, approximately 12 months after Moody's raised its City bond rating, S&P raised its rating as well. 1/ The new S&P "A" rating, which was the equivalent of the existing Moody's "A" rating, was apparently prompted by a number of factors. In September 1973, City Budget Director David Grossman, accompanied by Sol Lewis, Chief Accountant for the City, and John Fava of the Finance Administration, met with members of S&P and delivered a written report outlining various improvements in the City's financial, socio-economic and accounting areas. 2/ At the meeting, the discussion and documents concerned, among other things, the reduction in the growth rate of City expenditures from 15 percent to between 5 percent and 10 percent, 3/ the fact that the City had no need to go the state for special taxing authority, 4/ that the City had recently raised the water rates and could raise them again if additional revenues were required 5/ and that school enrollments were showing little growth. 6/ When asked about the City's increasing debt, the City officials attributed the increased financing to accelerated contract letting and bidding procedures on capital projects, representing that

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1/ S&P Fixed Income Investor at 361-64 (Dec. 15, 1973).

2/ H. Grossman at 60-61, 65-66 (Feb. 6, 1976).

3/ H. Grossman at 26 (March 1, 1976).

4/ H. Grossman at 62 (Feb. 6, 1976).

5/ Id. at 63.

6/ Id.

this was a short-term development. 1/ At the conclusion of the meeting, S&P's analysts decided to wait until they had an opportunity to review the City's Annual Report for the prior fiscal year, which would be available in November 1973, before making a rating determination. 2/

The City's Annual Report for the period ending June 30, 1973 was received and reviewed by S&P in November 1973. 3/ The S&P analysts concluded that the information in the report indicated a steady improvement in the City's financial picture during the period 1971-73 based upon, among other things, the improvement in the City's ratio of current assets (other than cash equivalents) to current liabilities, 4/ which had increased from .83 in 1971 to .97 in 1972 to 1.00 in 1973. 5/ S&P analysts were aware at the time that the data supplied by the City was, to some extent, a product of fiscal "gimmickry," including overestimation of revenues, deferral of expenditures and acceleration of revenues from one year to the next

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1/ *Id.* at 54-55.

2/ *Id.* at 89.

3/ Margolies at 34.

4/ This ratio reflects the amount of money that the City was owed as of the end of a given fiscal year as a fraction of the unpaid obligations not covered by cash and cash equivalents resulting from the prior year's activities. Margolies Exh. 3.

5/ Margolies at 66-67 (Feb. 9, 1976).

and maintaining properties on the tax rolls that were not paying taxes. 1/ However, S&P was "assured" by City officials that these abuses were being corrected, 2/ and, based on its belief in the economic strength of the City and the City's improved financial operations over the preceding two years, S&P determined that, under all of the circumstances, an increase in the City's rating was warranted. 3/

C. Events Subsequent to the 1972-73 Rating Increases

Within a short period of time following the S&P rating increases in December, a number of events occurred which raised doubts about the City's financial strength in general and about the validity of earlier optimistic assessments by the City in particular.

On December 17, 1973, the day following S&P's rating increase, The New York Times reported that advisers of Mayor Beame were projecting a budget deficit for the 1973-74 fiscal year of $1.3 billion, the largest ever projected for the City's operating budget. 4/ On December 18, 1973, City Budget Director Grossman called John Pfeiffer of S&P to

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1/ Other examples of "gimmickry" known to S&P included: (1) the inclusion of operating expenses in the capital budget; (2) budgeting for 100% property tax collections knowing that this level would not be reached; (3) initially borrowing against these taxes, then continually rolling over notes against property tax receivables that were not collectible; and (4) borrowing against state and federal aid which was not 100% collectible and including the uncollectible aid on the balance sheet. S&P Internal Memorandum, Dec. 5, 1975.

2/ Id.

3/ H. Grossman at 69, 98 (Feb. 6, 1976).

4/ The New York Times, Dec. 17, 1973, at 41-42.

thank S&P for raising its rating. Grossman told Pfeiffer not to "worry" about the announced deficit of $1.3 billion and that the real figure would more likely be $300 million. It appears that Pfeiffer made no further inquiry during the conversation into the reasons for the discrepancy or the basis for Grossman's conclusion. 1/

During the fiscal year 1973-74, the City was compelled to increase substantially its reliance on short-term debt. This increased reliance by the City was known to S&P and Moody's and, indeed, was the subject of comment in their respective publications. 2/

In early 1974, the City determined that it would be advisable to convert to long-term some $520 million of short-term debt that had been maturing on a recurring basis. At this time, however, the City was approaching its constitutional debt limit and its ability to fund a substantial amount of long-term debt was in doubt. The state legislature authorized the formation of the Stabilization Reserve Corporation, an entity which could incur long-term debt outside the constitutional

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1/ H. Grossman Exh. 8.

2/ See e.g., Moody's Municipal Credit Reports, May 13, 1974, May 31, 1974 and Dec. 31, 1974; S&P Fixed Income Investor, Dec. 21, 1974.

limitation for purposes of balancing the City budget, without endangering the City's ability to borrow further. 1/ Although Moody's did not approve of this practice, it nevertheless determined to maintain its rating on the City's bonds. 2/

On July 24, 1974, Fitch released an analysis detailing recent developments relating to the City's finances. The report cited a number of adverse factors including: (1) heavy use of capital budget funds to finance recurring expense items, thus jeopardizing necessary maintenance of existing properties; (2) increased tax delinquency, reducing the City's borrowing capacity; and (3) possible further erosion of the tax base through the continued exodus of upper middle income residents and business and manufacturing establishments to the suburbs. In addition, the report cited a projected $1.5 billion budgetary gap in fiscal 1974-75, an amount five times higher than the City's projections for fiscal 1973-74. 3/

The most tangible evidence of the City's weakening financial condition in 1974 was revealed when, in November, the City issued its Annual Report for the fiscal year ending June 30, 1974. 4/ Among other things, the Report indicated the following:

1/ Ackerman at 10-12; Phillips Exhs. 3, 4.

2/ Phillips at 91 (Feb. 26, 1976).

3/ Fitch Investor Service Analysis, July 24, 1974.

4/ Annual Report of the Comptroller of the City of New York for the Fiscal Year 1973-74.

(1) As of June 30, 1974, the City had outstanding some $2 billion in tax and revenue anticipation notes ("TANS" and "RANS"), almost twice the amount outstanding on the same date a year earlier; 1/

(2) Cash in the City's "rainy day" fund dropped from $46.5 million on June 30, 1973 to $1.5 million on June 30, 1974, virtually depleting the fund; 2/

(3) The delinquency rate on property tax collections rose from 4.94 percent in 1972-73 to 5.59 percent in 1973-74--the highest figure for the period of time covered by the staff's investigation; 3/ and

(4) Finally, and perhaps most significantly, the year-end cash deficit calculated by Moody's was covered only 0.82 times by covering assets — a drop from the 1.00 ratio calculated in the prior year and the lowest ratio in any year since at least 1970. 4/

Fitch issued an update of its July 24, 1974 analysis in which update it reported that, on October 10, 1974, it had downgraded the City's bond rating from A to BBB (medium grade) on all bonds

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1/ Id. at 482.

2/ Id. at 142.

3/ See Moody's Municipal Credit Report, Dec. 31, 1974, at 19.

4/ Id. at 14. S&P calculated a similar ratio of 0.69, a figure which was lower than any other ratio calculated by S&P since at least 1967. Margolies Exh. 3.

maturing prior to January 1, 1980, and to BB (fair grade) on all bonds maturing thereafter. The report cited a "further deterioration in the City's financial operations" with specific references to (1) a 22 percent increase in real estate tax delinquencies in fiscal 1974 over 1973; (2) an increase in short-term indebtedness and associated borrowing costs; (3) the virtual elimination of cash balances in the "rainy day" fund; (4) a large increase in the annual current deficit; and (5) the possibility that the City's practice of deferred maintenance might necessitate complete reconstruction, at some future time, of many of the City's properties. 1/

Despite the adverse disclosures in the City's Annual Report and the action taken by Fitch, after separate meetings in November with Comptroller Goldin, Moody's and S&P determined to take no immediate action to reduce their respective ratings of City securities. 2/ Rather, both Moody's and S&P determined to wait to see whether steps would be taken to remedy the situation. 3/

1/ Fitch Investors Service, Update of July 24, 1974 Report.

2/ Phillips at 101-102 (Feb. 26, 1976); H. Grossman at 108-10 (Feb. 6, 1976).

3/ Id.

According to notes prepared in early November by an unidentified employee of Bankers Trust Co., pressure was also being exerted on the rating agencies during this period not to lower their ratings, in that reduced ratings would require the City's savings banks to sell their City-issued obligations. Banker's Trust Internal Memorandum, Nov. 8, 1974.

During the month of December 1974, Moody's and S&P issued rating reports on City bonds, both of which affirmed the A rating which each of the agencies then maintained. 1/ In its report, S&P informed its subscribers of specific adverse developments in the City's financial situation which had occurred since that agency had raised its rating in December 1973. This information included the facts that the ratio of current assets to current liabilities had dropped to .69 2/ from 1.00, that the City had substantially increased its short-term debt burden, and that the ability of the City to successfully market further debt issues would be dependent upon its ability to retain investor confidence by maintaining a truly balanced budget. 3/

Moody's issued a 20-page report accompanying its A rating. Significantly, in a number of respects, financial data cited in the report was substantially worse than the data cited in its earlier year-end reports. For example, from 1970 (when the City bonds were rated Baa-1) to 1974 (when the bonds were rated A), the City's current

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1/ Moody's Municipal Credit Report, Dec. 31, 1974; S&P Fixed Income Investor, Dec. 21, 1974, at 190-91.

2/ As noted above, the comparable figure calculated by Moody's was 0.82. Despite the discrepancy, both figures indicated a significant reversal of the trend noted by both agencies in prior years.

3/ S&P Fixed Income Investor, Dec. 21, 1974, at 190-91.

account deficit had increased from $829 million to $2.5 billion; tax delinquencies had increased from 4.23 to 5.59 percent; and the ratio of current tax receivables to current debt had fallen from 1.16 to 0.82. The report did not discuss such comparisons in explaining the continued A rating. 1/

During the early part of 1975, evidence continued to mount relating to the City's difficult fiscal position. New short-term note offerings, which were beginning to experience difficulties in November-December 1974, 2/ continued to meet with market resistance. During this period, the City reduced the face amount of the instruments it issued to more effectively reach the general public. 3/ There was also a noticeable decline in the membership within the syndicates bidding on City securities. 4/

1/ Compare Moody's Municipal Credit Report, Dec. 31, 1974 with Dun & Bradstreet Municipal Credit Report, Dec. 1, 1970. (Moody's was acquired by Dun & Bradstreet in 1971.)

2/ An offering of RANS in December 1974 was accomplished at the highest rate ever paid by the City--9.5 percent. This was 250 basis points higher than similarly-rated securities then issued by other municipalities. Moody's Municipal Credit Report, April 8, 1975; News Release, Office of the Comptroller, December 2, 1974.

3/ During October, the City found it necessary to propose an issue of bonds in smaller denominations of $10,000 in order to supplant the lack of interest in City securities by institutional investors with smaller non-institutional investors. Minutes of Comptroller's Technical Debt Management Committee, Nov. 12, 1974; News Release, Office of the Comptroller, December 2, 1974.

4/ Minutes of Special Meeting of the Comptroller's Advisory Technical Debt Management Committee, Dec. 17, 1974 (4 pp.).

In January 1975, Moody's analysts met with Comptroller Goldin to inform him that they were considering dropping the rating on the City's BANS from MIG-1 to MIG-2. Comptroller Goldin immediately responded that a drop in the rating could be a "very nearly fatal blow" to the City, and asked Moody's to defer its decision pending preparation of a presentation by the City in support of maintaining the MIG-1 rating. 1/

In February, a lawsuit was instituted (the Wein action) alleging that the City had exceeded its constitutional debt incurring limit. Specifically, the suit claimed that the debt incurred by certain of the City's public benefit corporations, including the recently-created Stabilization Reserve Corporation, were includable in the City's total outstanding debt for purposes of determining whether the debt limit had been exceeded. The effect of the suit was significant. It caused the cancellation of the SRC's initial offering, 2/ giving rise to substantial doubt about the City's ability to raise nearly $383 million which would be necessary to fill a projected year-end budget gap. This figure represented over 10 percent of the total anticipated revenues of the City in fiscal 1974-75. The availability of these funds was one of the factors cited by Moody's in its December

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1/ Phillips at 103-06. (Feb. 26, 1976).

2/ New York Daily News, Mar. 14, 1975, p. 30.

1974 bond rating in connection with the City's ability to balance its year-end budget. 1/

On February 28, 1975, the City was forced to cancel the sale of $260 million of tax anticipation notes which had been scheduled to close that day. 2/ A bid had been made by the underwriting community on the TAN offering and accepted by the City. Moody's rated the offering MIG-2, a rating consistent with earlier ratings for these types of notes. 3/ On March 1, 1975, Comptroller Goldin was quoted in the press as stating that the cancellation came about because of "a sudden demand by the underwriters, unprecedented in the history of the city, for data that could not physically be compiled, checked and verified in the short time available." 4/ However, four days later, the press also quoted a spokesman for Bankers Trust as stating: "Counsel for all the banks and investment houses involved concurred that the City had failed to comply with the law which mandates that the tax receivables information be as of the last of the current month" and that "this was the sole reason for refusal to consummate the sale." 5/

1/ Moody's Municipal Credit Report, Dec. 31, 1974 at 13.

2/ The New York Times, March 1, 1975 at 29; New York Post, March 1, 1975 at 3, 10; New York Daily News, March 1, 1975 at 5.

3/ Phillips at 131 (Feb. 26, 1976).

4/ The New York Times, Mar. 1, 1975 at 29.

5/ Daily Bond Buyer, "Goldin Blames Cancellation of TANS on Banks Involved," Mar. 5, 1975.

Beginning at least as early as October 1974 and continuing throughout early 1975, news articles appeared on a continuing basis which discussed the financial problems of the City, including large discrepancies in the size of the projected year-end deficit. 1/ Although Moody's was aware of these articles, it took no steps to determine whether the information contained in the articles was accurate. 2/

Despite these events, during the first four months of 1975, Moody's and S&P did not revise their ratings downward. Indeed, following the cancellation of the TAN sale in late February 1975, Moody's and apparently S&P accepted the City's explanation for its action without further inquiry into the reasons for the allegedly "unprecedented request" for financial information by bond counsel or the City's inability to supply the information. 3/

1/ See e.g, Barrons, Jan. 13, 1975, p. 7; The New York Times, "Just How Did New York City's Finances Come to This," Feb. 12, 1975; The New York Times, "Fantasia", Feb. 18, 1975; New York Post, Mar. 21, 1975, 1, 62.

2/ Phillips at 125-26 (Feb. 26, 1976).

3/ Phillips at 134 (Feb. 26, 1976).

During this period, the continuation of the A rating by both agencies was cited by brokers and City officials. In January 1975, Marine Midland Municipals, a large municipal bond broker, issued a strong "buy" and "hold" recommendation with respect to City bonds. Although Marine acknowledged the recent well-publicized problems of the City, it placed heavy emphasis on the recent affirmation by both S&P and Moody's of their respective A ratings. Marine Midland Release dated Jan. 6, 1975. During this

(Footnote continued)

On March 20, 1975, two S&P analysts visited Albany to discuss the State's financial situation with the State Comptroller's Office. During the course of the meeting, the analysts were advised that, based on the existing situation, the State could not render financial assistance to the City in the event it was unable to meet principal and interest payments on its outstanding obligations. 1/ This information was in turn conveyed to senior S&P personnel. 2/ Prompted by this news, on April 2, 1975, S&P contacted the Office of the Comptroller and inquired whether the City could meet its debt service requirements without borrowing. Sol Lewis, Chief Accountant, responded negatively. Lewis also stated that, absent the ability to borrow, the City could go bankrupt. 3/

(Continued footnote)

period as well, the City, in public releases, sought to reassure public investors concerning City securities through references to the continuation of the A ratings by Moody's and S&P. Press Release, City Comptroller's Office, Dec. 30, 1974 (No. 74-143); Press Release, Office of the Mayor, No. 618-74, Dec. 23, 1974. See also Press Release, City Comptroller's Office, April 3, 1975 (No. 75-38); Press Release, Office of the Mayor, No. 124-75, April 3, 1975.

1/ H. Grossman at 141-44 (March 1, 1976).

2/ Margolies at 53.

3/ Interoffice Memorandum from H. Grossman to B.W. Harries dated April 3, 1975.

On April 2, 1975, S&P suspended its rating for New York City bonds. 1/ The April 5, 1975 issue of S&P's Fixed Income Investor cited the following reasons, among others, for the action: the City's inability to control expenses, the diminution in the market for City bonds and the inability to obtain financing through the Stabilization Reserve Corporation. The report concluded:

> [T]he absence of a stream of current revenues to meet all financial requirements, possibly including debt service, has presented us with a unique and unprecedented problem, giving us no choice but to take this position until remedial action is more evident. 2/

Following the S&P suspension of the City bond rating, Moody's announced on April 8, 1975 that it was reaffirming its ratings for both New York City bonds and notes. Among other things, the Moody's report characterized the assumption that the City could meet its short-term debt repayment only by borrowing as "unwarranted" and stated that one of the steps available to the City included timely assistance from the State. 3/

Throughout the summer of 1975, the City's short-term liquidity situation continued to deteriorate. In June 1975, the Municipal Assistance Corporation ("MAC") was formed for the purpose of issuing

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1/ Dow Jones Wire Service Release dated April 2, 1975.

2/ Standard & Poor's Fixed Income Investor, April 5, 1975, at 756-57.

3/ Moody's Municipal Credit Report, April 8, 1975.

long-term debt, the proceeds of which would be used by the City. Moody's rated the MAC offering A. 1/ The initial $1 billion MAC offering in July, however, sold with difficulty, thereby, according to Moody's, raising doubt about MAC's ability to incur further debt. 2/

On July 1, 1975, the State made public its "Report on New York City's Budgetary and Accounting System" (the "Levitt Report"). 3/ The report detailed significant irregularities in the City's accounts, including the facts that there were substantial amounts in the City's accounts receivable which were uncollectable and that the City had been borrowing against revenues which would not be realized. 4/ Among other things, the Report concluded:

> The City's accounting is inadequate and the system of internal controls is ineffective for ensuring the accuracy of its estimated supplementary revenues receivable. As a result, the data in the City's central fiscal and accounting records cannot be relied on for reporting to the Public and for management decisions as to budgetary status, accounts receivable, and borrowings against these receivables. 5/

1/ Moody's Municipal Credit Report, May 26, 1976.

2/ Moody's Municipal Credit Report, July 25, 1975 (1 p.)

3/ Report on New York City's Central Budgetary and Accounting System, Prior Year Accounts Receivable (Managerial Summary) (Report No. NYC-3-76) at 3.

4/ Id. at 3-4.

5/ Id. at 28.

On July 25, 1975, Moody's withdrew its City note ratings, citing the City's failure to take the necessary steps to restore investor confidence and doubts concerning the ability of MAC to raise funds necessary to retire maturing short-term notes. 1/ Moody's did not, however, reduce the existing A rating on City bonds. 2/

It was not until October 2, 1975 that Moody's revised its New York City bond rating from A (upper medium) to B (marginally speculative). 3/ On October 29, the rating was lowered to Caa (very speculative) 4/ as City officials acknowledged publicly that the City would default without federal aid and the federal government, through the President, stated it was opposed to such aid. As of this date, the Moody's rating remains at Caa.

VII. CONCLUSION

Moody's and S&P are the principal agencies that rate municipal obligations. Their ratings are relied upon by every segment of the investment community. These ratings have enormous impact upon the investment decisions of individual and institutional investors and the availability of access by municipalities to the capital markets. Accordingly, it is imperative that these agencies

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1/ Moody's Municipal Credit Report, July 25, 1975.

2/ *Id*.

3/ Moody's Municipal Credit Report, Oct. 2, 1975.

4/ Moody's Municipal Credit Report, Oct. 29, 1975.

perform with independence, diligence and consistency. Based upon the record of this investigation, it appears that both Moody's and S&P failed, in a number of respects, to make either diligent inquiry into data which called for further investigation, or to adjust their ratings of the City's securities based on known data in a manner consistent with standards upon which prior ratings had been based.