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The Bond Market's Watchmen Keep an Eye on Each Other, Too.

It's healthy and transparent for Kroll to make the rare objection to a Morningstar credit rating.

Who watches the watchers?

The age-old question is littered throughout political and economic thought, as well as popular culture, from the graphic novel "Watchmen" to episodes of "Star Trek" and "The Simpsons." It's typically asked as a prompt for pondering how to provide a check to those in power.

In the bond market, the major credit-rating companies are the gatekeepers. Corporations, governments and structured products must pass muster with them to receive more favorable treatment from investors (or get access to funding at all). The competition for business is intense: S&P Global Ratings, Moody's Investors Service and Fitch Ratings are the "Big Three," with other firms vying for a smaller share. Still, it's rare for any of them to publicly acknowledge one another, let alone question a rival's grades. Usually that's left to money managers, who like to say their in-house analysts are ahead of the game.

That's why it came as such a surprise that Kroll Bond Rating Agency directly criticized Morningstar Credit Ratings' grades on a commercial mortgage bond last week. From Bloomberg News's Adam Tempkin:

> A bond that Morningstar graded is backed by property loans which only have to suffer losses of 4.5 percent before a group of investment-grade noteholders potentially lose money, according to Kroll. Most deals have a bigger cushion now, usually above 5 percent, for the securities rated a step above junk at BBB-.
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> In a report on Thursday, Eric Thompson, senior managing director of the real estate group at Kroll, called Morningstar's ratings a "head scratcher."
> …
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> "For Morningstar to come out with this now doesn't bode well for the broader credit rating agency space," Thompson said in a phone interview. "It's important for the market that rating agencies maintain their discipline, particularly at the late point where we are in the credit cycle."

That sort of commentary is stunning because it just doesn't happen. I'll give you an example. A few years ago, I wrote about how S&P was winning market share over Moody's in the U.S. municipal-bond market, and how some strategists were concerned it was because a methodology change boosted many ratings. Here was S&P's response, which is more or less what you'd expect to hear:

> “Whether someone decides to use one rating or another, we don’t control that,” said Jeff Previdi, one of the primary analysts on the criteria change for S&P. “What we do control is our analytics. We’re going to be measured on our opinions as to how they perform over time, so you can be certain that we’re going to be very careful and informed.”

It’s hard to argue with that. For the largest credit raters, which trace their roots back more than a century, you can understand why the short-term benefit of lowering standards to win more business might not outweigh the longer-term ramifications of their grades not holding up. After all, no history of the financial crisis seems complete without questioning how these companies could have possibly awarded their top scores to subprime mortgage investments, even if the reality is more complicated.

It’s important to note that Kroll isn’t just saying that this commercial mortgage deal is one bad rating, but rather that it’s a red flag for industry practices as a whole. The pool, titled MSC 2019-L2, had a BBB- rating from Morningstar, the lowest investment grade, while Fitch considered it BB-, three steps lower. As Tempkin noted, Morningstar had avoided rating these specific kinds of mortgage bonds, known as “conduit deals,” for two years, before updating its methodology in November. Such changes are by no means nefarious, of course — it would arguably be more alarming if they always remained static — as long as they’re done based on sound analysis.

Kurt Pollem, the head of CMBS ratings and analytics at Morningstar, said the firm was comfortable with its ratings, providing a similar answer as S&P gave me almost five years ago.

> “This pool of loans is of lower leverage, and has better metrics than other pools,” Pollem said. “Our methodology is transparent and calibrated off a data set of 80,000 loans through history. Our view is different than other rating agencies, and the market welcomes diverse credit opinions.”

Investors should also welcome this type of back-and-forth between competing companies. It’s too soon to say whether Kroll’s critique is justified, given its inherent self-interest, but any sort of self-policing among the “watchers” nonetheless feels more noteworthy than a similar rebuke from a strategist or fund manager.

For better or worse, the incentive structure within the credit-rating business tends to tilt toward higher grades — issuers pay for them, so they’ll seek out the best ones. But if the agencies can agree on lines they won’t cross, or at least call each other out from time to time, that only enhances their overall credibility and could help prevent any missteps in the future.

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