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Behind Chicago's Rift With Moody's: Rater's Tough New Stance.

CHICAGO — More than a year before Moody's Investors Service downgraded Chicago's bonds to junk status, one of its senior analysts asked top city officials to explain why the third-largest U.S. city was healthier than a troubled island commonwealth flirting with insolvency, according to people familiar with the conversation.

"Help me understand why Chicago is different than Puerto Rico?" said the Moody's analyst, Rachel Cortez, during a February 2014 meeting that Mayor Rahm Emanuel attended, two of these people said. A spokesman for Moody's and Ms. Cortez said the firm doesn't discuss "private meetings with issuers or other capital-market participants."

The exchange inside City Hall came to embody a more aggressive stance by the world's second-largest ratings firm as Moody's cut Chicago's credit rating by seven notches over a two-year period. City officials were taken aback by the Puerto Rico comment and then angered by Moody's final move to junk in May 2015, a stance that differed from more optimistic conclusions made by other ratings firms. Since last summer, the city has left the Moody's Corp. unit off four bond deals.

Mr. Emanuel through a spokeswoman declined an interview request. He has described Moody's downgrade of Chicago's bonds to junk as irresponsible and premature, accusing the firm of playing politics.

Tim Blake, a Moody's managing director who heads its public pension task force, said the firm is "rationally applying" its ratings models. "Our job is to make judgments on credit risk as we see it," said Mr. Blake, noting some issuers with improved pension situations have been upgraded.

Other cities and counties from California to Florida are reconsidering their relationship with Moody's as it expands its stricter ratings approach around the U.S., threatening a seal of approval that for decades was all but a necessity in the municipal-bond world.

Santa Clara County, Calif., omitted Moody's from its past two deals because of the firm's disagreement over how some property-tax revenues were to be distributed. "We became convinced that Moody's was not being responsible and so therefore we moved away from them," said Jeff Smith, who oversees the operations of the county, which includes San Jose. "We don't think it has had, or will have, any effect on our ability to sell bonds."

The latest government to back away from Moody's is Miami-Dade County, which last week decided to hire Kroll Bond Rating Agency Inc. instead of Moody's for its $534 million sale of airport bonds. Kroll's rating is two notches higher than Moody's.

"We wanted a fresh set of eyes," said Anne Lee, chief financial officer of the Miami-Dade aviation department, of the decision to not hire Moody's, which she adds charges "30% to 40%" more than other rivals.

A Moody’s spokesman declined to comment.

Moody’s metamorphosis began after the 2008 crisis as ratings firms drew criticism in Congress and from regulators for their rosy grades on mortgage bonds that went sour. For local governments, the key change came in 2013 when Moody’s decided it would no longer rely on cities’ and states’ targets for investment returns when it calculates pension liabilities—one of the biggest costs shouldered by local governments. Moody’s own estimates are more conservative, meaning holes in pension funds look bigger.

As Moody’s adopted the stricter ratings methodology, it diverged from rivals Standard & Poor’s Ratings Services and Fitch Ratings in its assessment of problems facing local governments across the U.S. From 2002 to 2007, Moody’s and S&P upgraded issuers at about the same rate. But from 2008 to 2014, S&P had seven upgrades for every one of Moody’s, according to a recent Nuveen Asset Management LLC report.

Horacio Aldrete, who leads S&P’s U.S. local government group, said the firm’s ratings methodologies reflect the low default levels among state and local governments in recent years. “Our view is that credit quality is generally strong, a position that has been borne out in recent years,” Mr. Aldrete said.

Fitch said it maintains “a relatively balanced view on U.S. municipal credit and that often places us somewhere in between” other ratings firms, said Dan Champeau, a managing director in its U.S. public finance group.

Nowhere did the Moody’s shift lead to a more public drama than in Chicago, where top city officials including Mr. Emanuel attempted to sway Moody’s even as the firm increasingly came to see the city as an outlier with a shrinking number of options to avert a full-blown fiscal crisis.

Moody’s suggested that Mr. Emanuel should be more open to tax increases as part of plans to confront one of the nation’s deepest municipal pension shortfalls, according to people familiar with the matter, and the mayor made public comments supporting such a move. He eventually proposed a pension overhaul that included a property-tax increase of $250 million over five years.

“Most investors want rating agencies to operate like referees standing on the sideline. Moody’s appears to be less inclined to do that in recent years,” said Christopher Mier, a managing director at Chicago-based Loop Capital who oversees the firm’s municipal analytics group.

The city’s efforts to convince Moody’s didn’t slow a series of downgrades that began with a three-notch swoop in July 2013, following the change to its methodology for pension liabilities.

Mr. Emanuel pushed the city’s finance department and other senior officials, people familiar with the matter said, to figure out a fix even as frustration mounted at City Hall that Moody’s didn’t maintain consistent standards, the people said. In January 2014, Moody’s made additional changes to its methodology that increased the importance of debt and pensions and de-emphasized other economic factors, undercutting a city argument about the strength of Chicago’s economy.

In March 2014, a team of Chicago officials flew to New York without Mr. Emanuel for a meeting at Moody’s Manhattan offices. In a conference room overlooking construction at the former site of the World Trade Center, Chicago officials outlined the plan to address the city’s $20 billion pension hole, plus alternative approaches and funding plans if Mr. Emanuel’s overhaul was struck down by the courts in the years ahead, the people said.

But Moody’s analysts didn’t give a strong reaction one way or the other as to whether they were swayed by the city's plan, the people said.

Mr. Emanuel eventually won state approval for his pension cuts, but on May 8, the Illinois Supreme Court rejected a separate overhaul of state pensions similar to Mr. Emanuel's legislation. Moody's analysts called that day to say they wanted to talk the following Monday.

On the morning of May 11, city officials assured Moody's the ruling wouldn't derail its pension changes, according to people familiar with the matter. But by the afternoon, Mr. Emanuel was presented with the news, as he sat at his desk in his fifth-floor City Hall office: Moody's planned to slash the city's ratings two levels to Ba1—one notch into junk status, the people said.

Mr. Emanuel had few words to say in response as officials discussed next steps, according to people familiar with the situation, pitching in with phone calls with large creditors to say he was available to answer any questions.

The saga has left some city officials wondering whether Moody's has overstepped its bounds with Chicago. "It is one thing to point out the current financial situation. It is another to give political advice," said Alderman Patrick O'Connor, a city council ally of the mayor.

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