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Taking on the Ratings Triopoly.

Jules Kroll sensed opportunity. In the wake of the 2008 financial collapse, the reputations of the Big Three credit-rating companies lay in tatters. Standard & Poor's, Moody's Investors Service, and Fitch Ratings had all blessed various mortgage-backed securities with their highest ratings, despite the often shaky subprime loans underlying the securities. Kroll, who made his mark as a financial crimes private investigator, with offices in more than 15 countries, reckoned he could come up with a better way.

"There was enormous disappointment in the country about the way the rating agencies had behaved," Kroll says. "They really let the country down."

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A man with a nose for ferreting out corruption, Kroll, 74, pocketed more than $100 million when he sold his corporate detective firm, Kroll Associates, to Marsh & McLennan for $1.9 billion in 2004. He'd hunted down billions of dollars of assets concealed by Saddam Hussein, Ferdinand Marcos, Jean-Claude Duvalier, and other dictators. With the ratings business, Kroll thought he recognized a lucrative Act 2. He launched Kroll Bond Rating Agency in 2010.

What he didn't bank on was the entrenched power of the Big Three and the unwillingness of investors, even burned investors, to embrace something new.

Bond raters accredited by the U.S. Securities and Exchange Commission bring in more than $5 billion a year. They had been doing business in more or less the same way since the early 1970s, charging corporations and municipalities billions of dollars a year to have their creditworthiness assessed.

Those companies and governments, in turn, held out the hope of receiving ratings as high as AAA. Payment to the rating companies on some subprime debt deals ran as high as $850,000.

Then came the housing-market collapse and the bond-rating scandal that soon followed. The Big Three came under intense criticism for their role as "key enablers," as a government commission would later report, of the financial meltdown.

Kroll teamed up with Jerome Fons, who had quit his job as managing director of credit policy at Moody's in August 2007, just as the financial system—and Moody's reputation—was teetering on the brink of collapse. A year later, Fons testified to a congressional hearing about what he thought was wrong with the ratings industry. "A large part of the blame can be placed on the inherent conflicts of interest found in the issuer-pays model," he said.

Fons, now Kroll's executive vice president, helped design a rating agency with a completely different model.

Rather than have the issuers pay for a rating, Kroll and Fons figured they could charge the bond buyers, since those folks should be willing to pay for information critical to making a wise investment. The strategy flopped even before it began. Investors made it clear they wouldn't pony up for a service they had long received for free. The service was never launched.

"We all wanted to avoid the conflicts that are inherent in the issuer-paid model," says Fons. "The economics just don't work. Investors don't want to pay." The issuer-paid model is still in place across the industry.

Kroll was only starting to find out what it would take to compete. In 2010, he joined the exclusive rating-agency club by purchasing a tiny company called Lace Financial and picking up its credential. The Big Three received theirs from the SEC back in 1975, when they were designated Nationally Recognized Statistical Rating Organizations. There are now a total of 10 NRSRO firms, including Kroll. The Big Three accounted for 94.5 percent of the industry's $5.4 billion in revenue in 2013, according to the SEC. Kroll now ranks No. 5, behind Toronto-based DBRS, in ratings issued.

The path forward is steep. Many institutions still require their money managers to recognize ratings from only the Big Three, despite their well-publicized failures. Earlier this year, S&P agreed to pay $125 million to the California Public Employees' Retirement System, or Calpers, the largest public pension fund in the U.S., after Calpers alleged the firm had improperly rated three packages of mortgage-backed securities that collapsed in 2007 and 2008. Calpers was one of those institutions whose rating guidelines recognized only the Big Three. It still is one.

"Rating-agency credit assessments are just one input into our investment process," says Calpers spokesman Joe DeAnda, who declined to address why Calpers doesn't recognize ratings by other firms.

After the investor-paid plan didn't pan out, Kroll and Fons figured they'd compete by offering more in-depth analysis, helping investors who do their own independent research. Jim Nadler, president of Kroll Bond Rating, says investors are getting what they need, noting that 25 percent of Kroll's ratings have been issued for securities not rated by any other firm.

Still, it's just a toehold in an immensely lucrative business. Moody's, the only free-standing public company among the Big Three, had a pretax profit margin last year of 43.8 percent, higher than Google or Apple.

"The margins are extraordinary, unlike any industry I've ever been in before," says Kroll, who ran a family printing business before building his global corporate gumshoe practice. Kroll Bond Rating, as a privately held company, doesn't disclose its financial results.

In July 2011, Kroll issued its first rating, for a commercial mortgage-backed security. It was the right place to start. Later that month, Standard & Poor's CMBS business took a huge hit. Investors complained S&P's AAA rating on a portion of an offering was inflated. S&P stunned the CMBS market by abruptly pulling its ratings on a $1.5 billion offering by Goldman Sachs and Citigroup, saying it had discovered flaws in its methodology. Morgan Stanley issued a research note to clients blasting the world's largest rating company.

"The manner in which S&P took its action has severely eroded investor and issuer confidence in its ratings," Morgan Stanley said. S&P's CMBS rating business was thrown into a tailspin from which it hasn't recovered.

S&P's loss was Kroll's gain. In 2011, Standard & Poor's ranked third in the number of CMBS ratings, as compiled by Commercial Mortgage Alert, and Kroll ranked a distant sixth. By 2014, S&P had fallen to the fifth spot while Kroll had ascended to No. 2, rating 65 CMBS deals that raised $53.8

billion from investors last year. Moody's remained No. 1.

Kroll has continued to chip away, and not just in the niche area of CMBSs. One way it has made inroads is with rock-bottom pricing. In March 2012, Connecticut became the first state in the U.S. to hire Kroll to grade and provide analysis for its general obligation bonds. To win the state's business, Kroll offered a discount: an annual introductory rate for three years of just $50,000. That was 91 percent less than Moody's price of $542,525 for fiscal 2014.

Previously, Connecticut did business exclusively with the Big Three. State Treasurer Denise L. Nappier says Kroll was added as a fourth rating company "in the interest of fostering competition." Kroll is banking on other states and corporations following suit.

"It's not a bad business strategy to get people comfortable with your ratings," says Andra Ghent, a professor at Arizona State University who studies the rating business. "It's almost like a loss leader."

More business, of course, brings more scrutiny—no less so when you got your start decrying the model you're now using. On March 17, Kroll reeled in the city of Chicago as a client for its general obligation bonds, assigning a rating of A- and a stable outlook. Less than two months later, Moody's slashed Chicago's rating two notches to junk level (Ba1) after the Illinois Supreme Court rejected a plan to overhaul the state's pension system.

Fitch and Standard & Poor's cut their ratings within three days, and each member of the Big Three set the future outlook as negative. Only Kroll had left its rating untouched, at A- and stable, as of July 2.

Kroll declined to comment on its Chicago decision.

Are those higher ratings justified? "Kroll will say, 'We're better,'" says Lawrence White, a professor at New York University's Leonard N. Stern School of Business. "That may be so, or they may be giving in to make the issuer happy. We won't know until five years from now."

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