DOW JONES

THE WALL STREET JOURNAL.

Morningstar 's Move Into Bond Ratings Hits Bumps

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1,208 words
9 January 2020
The Wall Street Journal
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English

In mid-November, bond investors got an unwelcome surprise from one of the main ratings firms in a hot corner of the bond market: About 25% of the bonds that it had rated were likely to be downgraded.

Several days later, after calls poured in from confused investors, ratings firm DBRS Morningstar Inc. backtracked and said it had made an error. It was instead likely to upgrade about 25% of the bonds and downgrade only about 3%.

"It certainly isn't confidence-inspiring," said Jason Callan, senior portfolio manager at Columbia Threadneedle Investments in Minneapolis, which owns about $4 billion of the bonds in question.

Morningstar , known for its mutual-fund ratings, has hit a rough patch in its quest to become a big player in the bond-rating business. In its biggest-ever acquisition, Morningstar bought rival DBRS Inc. from two private-equity firms for $669 million in July, catapulting itself into the No. 4 spot globally behind longtime industry leaders Moody's Corp ., S&P Global Inc . and Fitch Ratings .

Morningstar says it is trying to improve the quality of bond ratings. Credit-rating firms were criticized for helping cause the 2008 financial crisis by giving overly optimistic assessments of securities that turned out to be toxic, costing investors hundreds of billions in losses.

"We do not believe there has been adequate change to restore investor trust," Morningstar Chief Executive Kunal Kapoor said at the time of the deal. The Chicago-based firm hopes to reach the scale necessary for it to be a serious alternative to the three top ratings firms.

But early challenges show the extent of the hurdles the firm faces in its efforts to improve bond ratings. Morningstar 's error, which occurred while it was integrating its ratings system with that of DBRS, also came around the time that it was working to win ratings assignments on hotel deals by potentially applying new assumptions more favorable to bond issuers.

Claire Mezzanotte, group managing director at DBRS Morningstar, said in a statement that the integration is progressing as planned. The firm also says it isn't using a new methodology for the deals because it is still reviewing comments it received on its proposed new approach.

The ratings in question are in a segment of the $1.2 trillion market for commercial mortgage-backed securities, which are bonds tied to loans on malls, office buildings, hotels and the like. The affected securities are backed by only one property or borrower and are known as single-asset, single-borrower deals. Morningstar had established a strong foothold in this market before its merger with DBRS.

Such deals can be riskier than larger, more diversified commercial bond deals because they concentrate investors' fate in one asset or borrower.

Borrowers issued a record $47.6 billion of these bonds last year, according to mortgage tracker Trepp LLC. Nearly half of that volume came in the fourth quarter, thanks in part to a number of large hotel deals.

The sector is competitive for ratings firms, which are hired by the entities that sell the debt. Higher ratings mean lower interest costs for bond issuers. This creates an incentive for issuers to shop around for the best ratings and hire the ratings firms that give them the most favorable grades, creating a conflict of interest for the firms.

Kroll Bond Rating Agency Inc ., a DBRS Morningstar rival, was ready for last year's late influx of single-asset, single-borrower deals. The firm's new approach for rating the deals, released in September, allowed more debt to get rated, avoiding more costly unrated debt and potentially lowering interest expenses for issuers. A Kroll spokeswoman said in an email, "We believe it is inaccurate to look at one aspect of a given methodology in isolation and conclude that, based on it in and of itself, the methodology is more favorable to issuers."

Meanwhile, DBRS Morningstar was working on integrating DBRS and Morningstar 's methodologies. When it made its erroneous downgrade warning in mid-November, the firm had just proposed an integrated approach that would blend "the best of each of the legacy firms' previous single-asset, single borrower methodologies," Erin Stafford, the firm's head of North American commercial mortgage-backed securities analysis, said in a Dec. 13 webinar.

Ms. Stafford said in an interview the correction resulted from the fact that new Morningstar assumptions were superseding old ones used by DBRS. However, when the firm ran a statistical analysis of the possible impacts on transactions DBRS had previously rated under its old criteria, it failed to account for one of the key assumptions, the firm said in its correction. Once accounted for, the likely downgrade trends reversed.

A review by The Wall Street Journal of the firm's proposed methodology found that it mirrored the old approach used by Morningstar except that it increased the proportion of rated debt that one class of properties -- hotels -- could obtain.

"My hypothetical is they're sitting around the table saying 'we can get these deals, but we need to modify this particular parameter,'" said Rick Michalek, a former Moody's Corp. analyst who testified to congressional investigators in 2010 about the pressures analysts faced in rating the complex securities that went sour in the financial crisis.

Five big hotel deals closed in December, Trepp data show. Kroll was hired to rate two, while DBRS Morningstar got three, including a nearly $1 billion refinancing of a luxury hotel in Miami Beach and a $370 million acquisition mortgage for a luxury resort in Dana Point, Calif. Two smaller deals didn't get rated.

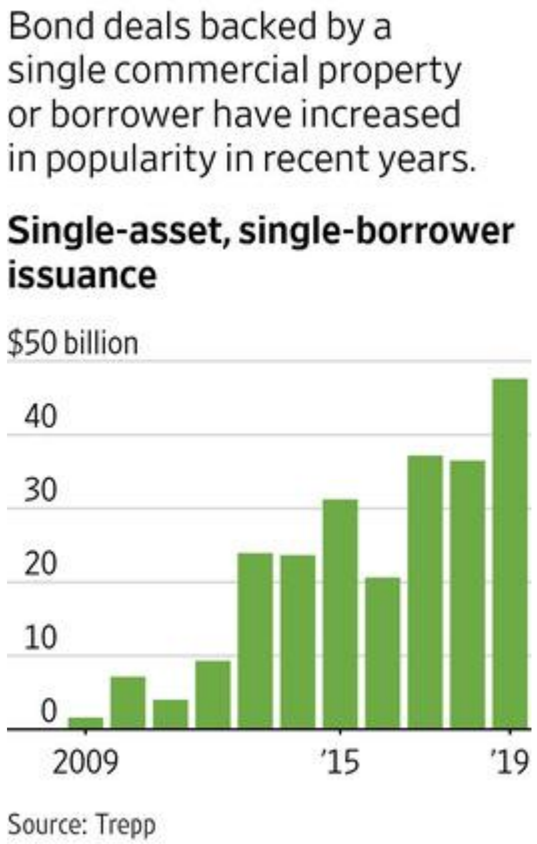
Goldman Sachs Group Inc . handled the Miami Beach and Dana Point deals. The firm said in prospectuses that it showed the deals to five ratings firms to obtain "preliminary feedback" on how they might rate the securities and picked two firms based on the favorability of their grades. A Goldman spokeswoman declined to comment.

In the interview, Ms. Stafford of DBRS Morningstar said concerns over winning deals played no role in the firm's decision to change its methodology. She also said the firm didn't use the new methodology to rate the hotel deals because the firm was still awaiting public comments on the new approach it proposed in November. Under SEC rules, ratings firms generally publish a new methodology for public comment and review comments before implementing the new approach. An SEC spokesman didn't respond to a request for comment.

A Journal review of the firm's ratings on the $370 million luxury hotel deal in California found that some of the assumptions applied were consistent with DBRS Morningstar's proposed approach to rating hotel deals. For securities rated at the lowest investment-grade level, for instance, DBRS Morningstar's input for determining the size of the tranche exceeded what was allowed under Morningstar 's previous methodology but matched its proposed new methodology.

Ms. Stafford said in a statement that the California hotel deal had "unique aspects" that drove the rating, such as hotel quality and historical performance, among others.

(See related letter: "Letters to the Editor: Morningstar : Competition Will Lead to Better Ratings" -- WSJ Jan. 25, 2020)



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