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New Moody's Report Criticizes Rivals for Easy Ratings on CMBS

Says Rivals Give Investment-Grade Ratings to Securities That Don't Deserve Them

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Moody's Investors Service on Thursday blasted competitors for failing to get tougher with lenders in the red-hot commercial mortgage-backed securities business.

In a research report, the New York credit-ratings firm raised concerns about poor underwriting practices in the $500 billion market.

Moody's said that, in response to weakening lending standards, it has been increasing the financial cushion it requires lenders to provide to qualify for investment-grade ratings on the securities, which many institutional investors require before they buy.

The report criticized other ratings firms for requiring much smaller cushions. The gap is particularly wide in the lowest-rated slice of securities in the investment-grade category, the report said.

"We're saying [that group] isn't investment grade at all," said Tad Philipp, a Moody's director and the lead author of the report. "Others are saying it's all investment grade."

Ratings firms periodically take jabs at one another, in a bid to win more business.

Moody's is by far the most active rater of CMBS, and underwriters generally can't go to market with a new issue without a Moody's rating on its top slice of securities. Rivals said that allows the ratings giant to criticize the industry without the risk of losing business.

"They're still getting paid a lot of money to rate these deals," said Ken Cheng, of Morningstar Credit Ratings LLC. "It's easy for them to wag their finger."

Huxley Somerville, head of U.S. CMBS for Fitch Ratings, said in a written statement that Fitch has been "steadfast" in toughening its ratings "to address underwriting erosion for

the last few years and will continue to raise levels in response to further declines."
The latest scuffle comes as firms are still trying to shake off criticism for the role they played in the financial crisis. Firms gave investment-grade ratings to billions of dollars' worth of bonds that fell into default, resulting in huge losses for investors.

The report notes that "poor underwriting at the precrisis peak was just eight years ago," and quotes philosopher George Santayana: "Those who cannot remember the past are condemned to repeat it."

Ratings for mortgage-backed securities have been under scrutiny recently. Standard & Poor's Ratings Services last week settled with regulators over its alleged failure to disclose to investors that it had revised its methodology for CMBS, effectively loosening its criteria, as recently as 2012. The New York firm agreed to pay the Securities and Exchange Commission $77 million and take a one-year hiatus from rating certain CMBS deals. Standard & Poor's also is negotiating a settlement for its ratings practices leading up to the financial crisis.

An S&P spokesman declined to comment.

The Wall Street business of creating and securitizing huge pools of commercial mortgages soared before the crash, with about $225 billion of new issues in 2007, before shriveling to almost nothing in the early years of the downturn. It has been steadily rebounding since, with about $100 billion in new issues last year.

Many industry participants believe underwriting is getting looser. One big concern: the steadily increasing values that underwriters are putting on properties, which enables them to loan more to their owners.

Some investors are concerned that those higher values are largely due to the low-interest-rate environment, which might not last for long.

"There's no question standards are being loosened," said Edward Shugrue III, chief executive of money manager Talmage LLC, which has $1.2 billion of assets under management, mostly in commercial mortgage securities.

Others are less worried. Marc Peterson, who heads the commercial mortgage securities group for Des Moines-based financial-services giant Principal Financial Group , said cash flows of properties are expected to improve as the economy rebounds.

"I don't know that we have the same level of concern as Moody's," Mr. Peterson said. Principal manages about $7.2 billion in commercial mortgage securities.

Moody's said in its report that it has been increasing the amount of "credit enhancement" it requires to provide investment-grade ratings on CMBS because lenders are loosening their standards. Credit enhancement essentially is the amount of cushion bond investors have before they suffer losses in default situations.

Moody's said rivals aren't boosting their credit enhancement requirements but should.

Moody's tougher stance has cost it a small amount of business, because it is no longer rating the lowest-rated investment grade slice of many CMBS deals. In the fourth quarter of 2014, there were 12 deals that included junior slices that Moody's didn't rate, although Moody's did rate the senior slices of those deals.

Mary Jane Potthoff, a managing director in DBRS Inc.'s CMBS division, said it, too, has become stricter when analyzing the cash flow of the commercial properties that serve as the collateral for the CMBS loans.

"I do agree that credit quality and underwriting standards have been slipping," she said.