The Final Step to End Too-Big-To-Fail?

How Additional Bank Rating Downgrades May Impact Institutional Cash Investors

Abstract

As Federal banking authorities work to implement rules to allow for the quick and efficient dissolution of too-big-to-fail banks, ratings once again are under assault, and most large U.S. banks could lose their access to the short-term markets toward the end of 2013. The anticipated negative rating moves will be the direct result of reduced government support for holding company debt, not deteriorating operating or financial results at the respective banks. Corporate treasurers should review their investment policies and existing exposure to the affected bank names. The FDIC initiative may be a precursor to similar events in other countries, as well. Increased risk and reduced supply again argue for flexible portfolio strategies through separately managed accounts.

Introduction

Just a few months ago, we wrote about the trend of deteriorating creditworthiness of large banks. A major cause behind this credit deterioration has been a reduced assumption of government support for "too-big-to-fail" banks. A recent report from Moody's rating service suggests that a new initiative at the Federal Reserve and FDIC may trigger another round of bank ratings downgrades toward the end of 2013. If this occurs, even the highest rated bank credits no longer may qualify as approved investments for most corporate liquidity accounts. Institutional cash investors need to be aware of this latest development and prepare their game plan now.

The Slippery Slope of Bank Credit Quality

In the decade leading up to the 2008 financial crisis, financial institutions in the U.S. consistently received higher credit ratings than their non-financial peers. But the revelation of many financial firms' exposure to sub-prime assets and derivatives and a dramatic decline in investor confidence eventually resulted in a number of bank failures, forced mergers, substantial charge-offs, regulatory and litigation penalties and, of course, ratings downgrades.

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As we wrote in March 2012 and again in March 2013, many previous "marquee" bank names no longer qualify as worthy investments for corporate cash portfolios, primarily due to lower credit ratings. However, some practitioners continue to conclude that, given their size and importance to the overall economy, large financial institutions are safe because they will receive government backing in times of distress. This flawed assumption was addressed with a stern reminder in a special commentary from Moody's on March 27, 2013.

Moody's Reassessment of U.S. Government Support for Banks

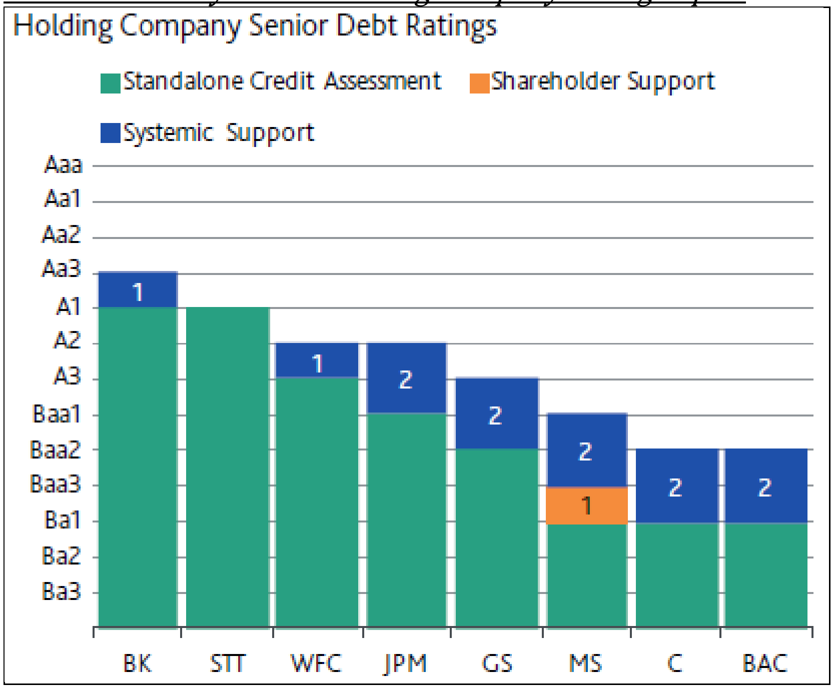
In their special comment titled, "Reassessing Systemic Support in US Bank Ratings – an Update and FAQs,"[1] Moody's ratings analysts revisited the legal structure that allows the FDIC to resolve a failing systemically important financial institution (SIFI). Moody's determined that if the Federal government moves to implement the so-called "Title II Orderly Liquidation Authority (OLA)," the FDIC will have the authority to force creditors of a failing bank holding company to take losses before lending any support.

Based on outreach efforts conducted by the FDIC throughout 2012, Moody's determined that the FDIC likely will adopt the Title II OLA as the "single entry receiver" which can require a "bail-in" from the shareholders and creditors of a troubled bank holding company before a "bail-out" is considered.[2] Moody's further determined that authorities may adopt such measures before the end of 2013.

Moody's assessment of the timing of the Title II OLA adoption led the rating agency to believe that by the end of 2013, seven U.S. SIFIs likely will be downgraded due to increased risk of principal loss. The anticipated negative rating moves will be the direct result of reduced government support for holding company debt, not deteriorating operating or financial results at the respective banks.

In total, Moody's identified eight SIFIs that may be impacted: **Bank of New York Mellon (BK), State Street (STT), Wells Fargo (WFC), JPMorgan Chase (JPM), Goldman Sachs (GS), Morgan Stanley (MS), Citigroup (C) and Bank of America (BAC).** Because the OLA authority primarily addresses systemic concerns, regional banks likely will not face ratings pressure.

Exhibit 1: Moody's Bank Holding Company Ratings Uplift



Source: See Endnote 1.

Credit Ratings Implications of OLA Implementation

Moody's revised assessment of bank holding companies leads us to believe that, should the FDIC adopt the new regulatory framework, ratings at seven of the eight banks may see downgrades of one or more notches. Exhibit 1, included with the Moody's Special Comment, provides a hint of the potential actions. The numbers highlighted in blue are the number of ratings "uplift" from implicit government support that is received today. The adoption of OLA may cause the rating agency to take away those uplifting notches, resulting in ratings downgrades.

As Exhibit 1 indicates, Bank of New York Mellon and Wells Fargo potentially could be downgraded by one notch, while JPMorgan, Goldman Sachs, Morgan Stanley, Citigroup and Bank of America could lose up to two notches. State Street is the only firm with no implicit government support and, thus, is not currently facing ratings pressure.

We note that at Baa status, MS, C and BAC already are ineligible for most money market funds and corporate cash portfolios. Goldman Sachs also is likely to join the Baa camp soon. BK should remain a highly rated name even after the expected downgrade. JPM and WFC are rated A2, and a downgrade to A3 could place their short-term debt ratings at P-2, a level that likely will shut them out of the commercial paper market and from many corporate cash portfolios. When two of the strongest and most widely held U.S. financial credits fall out of compliance with money market funds and corporate cash portfolios, there likely will be a significant impact on the overall money markets, as well as individual cash portfolios.

Please note that, although this ratings discussion focuses solely on Moody's, we will not be surprised if Standard & Poor's and Fitch Ratings take similar actions. Taking the observation a step further, even if the FDIC fails to implement OLA this year, the path is set for U.S. and global financial regulators to further distance themselves from too-big-to-fail liabilities, in our opinion. Banks in other countries likely will face similar circumstances, if they have not already. The haircuts forced on large deposits (initially on insured deposits, as well) during the Cypriot debt crisis continue to serve as a reminder that the game rules already have changed. Investors should not and cannot simply look to an institution's size and its relative importance to the financial system as a guarantee of safety. Regulators have become increasingly willing to have creditors pay for banking mistakes before a helping hand is extended.

Corporate Treasurers Should Spring into Action

Investment Policy and Portfolio Review: For the typical manager of corporate cash portfolios, life will become more difficult as six of the eight largest U.S. banking firms no longer may be creditworthy investments. A review of investment policies, as well as portfolios, may be in order. If a policy does not permit BBB-level investments or Tier-2 level commercial paper, this may be a good time to review existing holdings with a focus on maturities beyond the end of 2013. We note that our ratings discussions are narrowly focused on bank holding company debt, not deposits or bank level debt.

Review of Prime Money Market Fund Holdings: Since the typical cash investor maintains substantial balances in money market funds, treasurers also need to determine if their chosen funds are vulnerable to potential ratings actions. This assessment should include a review of bank debt holdings with maturities beyond 2013. They also should demand substantive answers from fund managers as to their plans regarding these positions and their plans to keep portfolios fully invested without such names.

Review of Other Bank Exposures: As we outlined earlier, the FDIC's OLA initiative may be a harbinger of things to come regarding too-big-to-fail bank issues. Investors should look at their non-investment bank exposure that could be similarly affected. They also should look at banks in other jurisdictions that may be subject to the "bail-in" threat.

Resolve Supply Constraint through Separately Managed Accounts: Supply constraint has been a perennial issue for cash investors since the Federal Reserve reduced short-term interest rates to near zero at the end of 2008. Implementation of OLA and related ratings downgrades likely will worsen the supply constraint even more, driving many U.S. bank borrowers out of the market. We again advise treasury professionals to consider separate accounts to diversify away from the diminishing pool of short-term securities shared by money market funds. Alternative security choices may include non-financial and quasi-government issuers in the U.S. and abroad, as well as top quality asset-backed securities collateralized with prime quality credit cards and auto receivables.

Conclusions – Be Prepared for Things to Come

As Federal banking authorities work to implement rules to resolve too-big-to-fail banking institutions, bank ratings once again are under assault, and most large U.S. banks could lose access to the short-term liquidity markets before the end of 2013. Corporate treasurers should review their investment policies and existing exposures to the affected bank names and quickly devise a game plan. The FDIC initiative also may be a sign of things to come for large financial firms in other countries. The increased risk and reduced investment choices again argue for more flexible portfolio strategies achieved through separately managed accounts.

Our ratings discussions are narrowly focused on the eight largest bank holding companies potentially impacted by reduced government support assumptions. There is no indication of ratings impact on operating bank ratings, although the Cypriot deposit haircuts serve as a stern reminder that a different model may be used elsewhere. Also, these discussions are not limited to Moody's rating actions, as other agencies likely will take similar actions in response to the new regulatory mantra of "bail-ins" before "bail-outs."

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[1] David Fanger et al, Special Comment: Reassessing systemic support in US bank ratings – An update and FAQs, Moody's Investors Service, March 27, 2013, http://www.moodys.com/research/Reassessing-Systemic-Support-in-US-Bank-Ratings-An-Update-and--PBC_151786 (requires subscription)

[2] Please refer to our March 2013 article on more discussions on the Single Entry Receivership.

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