Bank Ratings Headed for BBBs

How the Megatrend May Impact Corporate Cash Investors

Abstract

Recent negative bank ratings actions foretell a secular trend that capital markets-oriented banks are slipping toward the lower tier of investment-grade categories. We believe these ratings downgrades are more than a temporary phenomenon that is easily reversible. While the near-term effect on corporate treasury portfolios will likely be manageable, long-term ramifications require more investor attention.

Cash investors should be aware of the potential supply shortages in the debt markets and the need for robust credit and counterparty research capabilities. Investors also should explore eligible investments in non-financial credits and consider direct investments through separately managed account solutions.

Introduction

It happens so often that we've almost gotten used to it – banks have been beaten up by credit rating agencies time and again since the financial crisis began in 2008. While banks always rode their ratings through the ups and downs of market cycles, what we have observed in recent years may be a megatrend in the making, a trend that may have a long-lasting effect on the financial markets.

If bank ratings are headed for BBBs, and there certainly are indications of that happening, how might that trend impact corporate treasury professionals? How do we rethink our corporate cash investment strategies? What about uninsured bank deposits or counterparty risk management? With these questions in mind, we invite our readers to think through some of the key issues with us.

Large Banks' Ratings Drift toward BBBs

On February 15, 2012, Moody's Investors Service took two separate actions that placed 120 financial institutions and firms worldwide on review for downgrade. In its first action, Moody's placed the ratings of 114 banks in 16 European countries on review for downgrade. In its second action, Moody's announced a negative review of 17 banks and securities firms that are global capital markets intermediaries (GCMIs), with several of those European banks named in the first action also appearing on the second action list.

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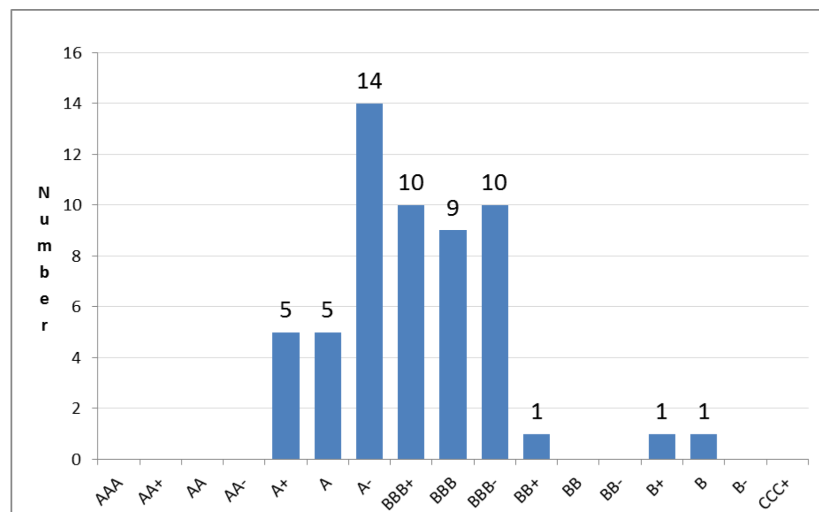
The Moody's action on the 17 GCMIs represents a fundamental shift in the agency's view of banks with capital market operations. In a related credit commentary, Moody's now views the average standalone credit ratings of GCMIs, currently at A2, as moving to "the Baa range."[1] Note that Baa (Moody's nomenclature for BBB) is the lowest

investment-grade credit category. Securities with this rating often are considered ineligible for corporate cash portfolios.

Moody's is not alone in its change of thinking. In some sense, Moody's simply is playing a catch-up game with Standard & Poor's. The two firms have crisscrossed each other in downgrading bank ratings over the last few years. As of February 15, 2012, the S&P ratings of 43 of 56 U.S. banks are in the ratings categories between A- and BBB- (See Figure 1).

Figure 1: S&P Bank Ratings Distribution



Source: S&P Ratings Services[2]

The revised views on banks and financial firms at Moody's and S&P should not be taken lightly. Many of the banks affected by recent ratings actions are the largest and most active issuers of short-term debt or are counterparties to repurchase agreements (repos). If Moody's follows through on its reviews, some banks may lose up to three ratings notches, including some banks that may lose their top tier (P-1) short-term ratings. Those banks may face considerable funding challenges as they rely on short-term debt markets to finance their balance sheets.

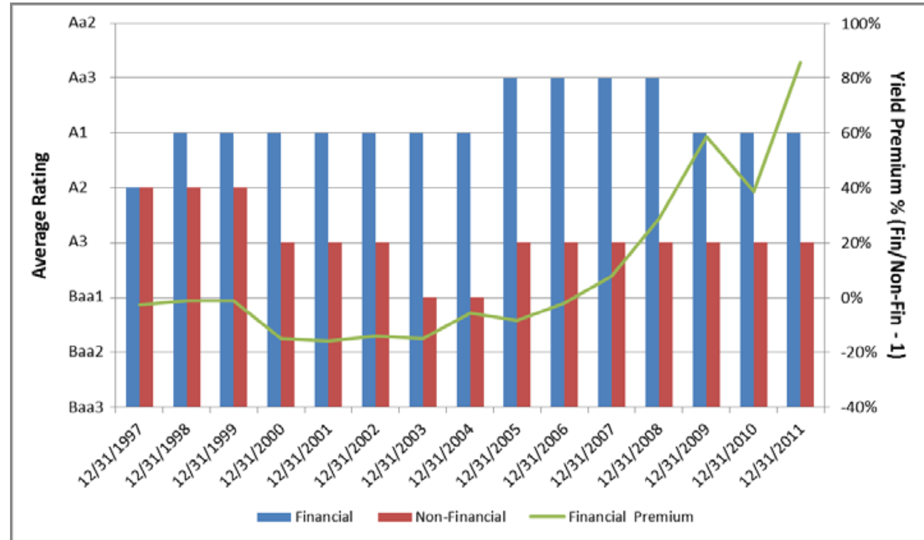
We should note that although Moody's intends to migrate the standalone credit ratings of banks with capital markets operations towards Baa, some banks may retain single-A or even occasional double-A ratings due to their domestic banking franchises and/or some assumed government support. Still, the structural deterioration of global bank ratings to the lower rung of the investment-grade categories cannot be overlooked.

Lower Ratings Validate Market Opinions

In a way, global capital markets banks' road to BBB-land should not be a surprise to market observers. The financial crisis, regulations and resolutions have reduced government support assumptions built into many of the bank ratings. Burgeoning government fiscal deficits lowered sovereign ratings ceilings, further depressing bank

ratings. Economic sluggishness, as well as challenges in the employment, housing and consumer credit sectors, further impacted bank profitability, loan quality, capital positions and so on. Liquidity and capital constraints from the Eurozone debt crisis made banks more vulnerable. It is interesting to note that the markets already seem to be treating bank debt as though it is rated BBB or worse.

Figure 2: Ratings and Yield Premium in Merrill Lynch 1- to 3-Year Corporate Index



Source: Merrill Lynch Global Index System through Bloomberg (1997-2011)

Figure 2 represents the year-end average credit ratings of two sub-indices in the Merrill Lynch 1- to 3-Year Corporate Index – financial and non-financial – since the indices' inception in 1997. "Financial Premium" refers to the average effective yield of the financial sub-index over the non-financial sub-index expressed in percentage terms. All else being equal, bonds with lower ratings are expected to pay a higher yield, expressed as positive percentages in the graph.

Figure 2 shows that the average credit rating of financial debt at one time was three ratings notches higher than non-financial debt. What is striking is that since 2007, yield premium on financials turned positive despite the debt's higher credit ratings. The premium went up to 86% at the end of 2011 despite financial debt's credit rating being at A1 versus a lower A3 for non-financial debt.

The anomaly of higher ratings and higher yield premium since 2008 can only mean one thing: credit ratings overstated the creditworthiness of financial issuers relative to their non-financial counterparts. The implication is that that the average credit rating for financial debt may be lower than A3, which implies BBB or worse.

In short, the ratings agencies' recent moves simply may have confirmed what investors believed for years – that bank ratings were systematically overstated. Investors validated

the long-held market convention that at the same ratings level one should demand higher yield from a financial credit than from a non-financial credit.

Effect on Corporate Cash Investors Varies

The corporate treasury community will feel the impact of the bank ratings megatrend sooner or later. Paradoxically, we think the immediate impact may be quite benign. Long-term effects, however, are more difficult to discern.

Short-term Impact Manageable: For starters, many of the weaker bank credits in Moody's crosshairs already are out of cash investors' portfolios. These include several major U.S. banks and brokerage firms and banks from peripheral Europe and France. For those that remain on investors' shopping lists, money market funds and separate account managers have switched to collateralized lending such as repos or asset-backed commercial paper. Even if some names were to suffer multi-notch downgrades to BBB levels, they may continue to have deposits and central banks to help them fund operations.

Expect Supply Shortage: Over time, however, one should expect the deck of cards to be reshuffled. With successive ratings downgrades and higher costs of funding, some banks may exit certain national markets. Others may abandon capital markets activities altogether. Still others may merge with one another. The net result may be a reduced universe of investible issuers, thus worsening the short-term debt markets' supply shortage.

Uninsured Deposits Riskier: Adding to the supply challenge is the planned expiration of FDIC unlimited insurance on transactional accounts, set to expire at the end of 2012. Lower credit ratings mean higher credit risk in uninsured deposits for corporate depositors. As the list of creditworthy banks dwindles, treasury professionals need to find other channels to substitute uninsured deposits at lower rated banks.

Lower Yield Potential: As more bank ratings erode, money market funds and other managers may pare back their credit investments and focus on a few highly rated bank names. The process of weeding out lower-rated, higher yielding banks may result in lower yield potential in investment portfolios. Strict diversification rules in pooled liquidity vehicles, such as money market funds, may force managers to turn to still lower yielding U.S. government securities to stay invested. An alternative may be to seek out less liquid investments with unknown risk characteristics.

Challenges Call for Actions

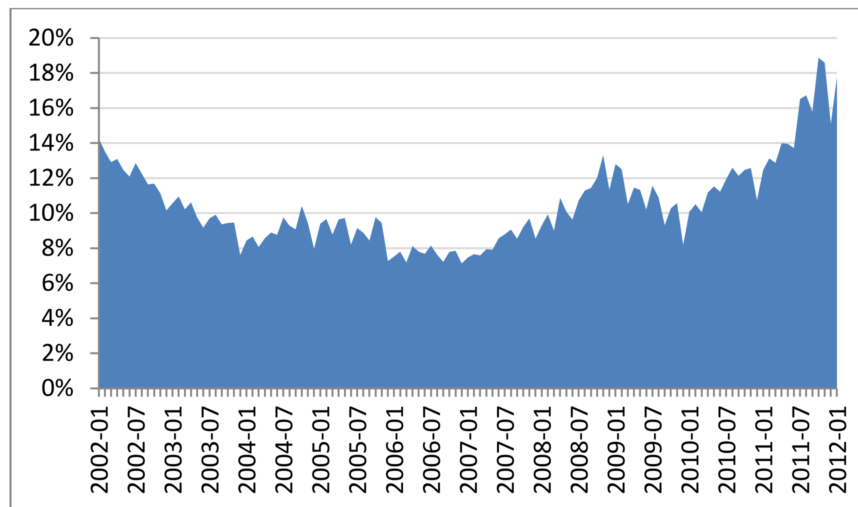
Secular Trend in Place: We think the first thing investors should note is that recent bank ratings changes are more than indicative of the current difficult economic and market conditions. In our opinion, bank ratings may not return to their former glory any time soon. The risk profiles of many global capital markets banks may mean that

they no longer are creditworthy debt issuers or counterparties for the corporate cash investor. Waiting for the storm to pass may not be the best course of action.

More Credit Scrutiny: Recognizing this secular trend, one of the first orders of business for treasury organizations is to build stronger research capabilities for credit analysis and counterparty assessment of banks. Some corporations may develop in-house research capabilities; for others, outside expertise may be sought through separate account management, portfolio credit reviews or outsourced credit research services.

Re-entry of Non-financial Issuers: While the supply shortages are clearly present in the short-term debt market, non-financial corporate issuers recently have increased their issuances. Rather than accessing the debt markets through banks suffering from ratings pressure, corporations with healthy profit margins and strong balance sheets have taken advantage of their own high credit ratings and the market's demand for non-financial paper by tapping the CP market directly.

Figure 3: Non-financial Commercial Paper Outstanding as % of Total



Source: Federal Reserve Commercial Paper Download Program (not seasonally adjusted)

Figure 3 displays the share of commercial paper outstanding of non-financial issuers, as tracked by the Federal Reserve since 2001. It shows that, after bottoming at 7% in 2006, non-financial CP outstanding has been increasing steadily, to as much as 19% in November 2011. We expect this upward trend to continue, providing supply relief and diversification benefits to corporate cash investors.

Separate Account Solutions: The ratings challenges and their implications again point to the inadequacies of simply relying on deposit products or pooled vehicles for corporate cash management. Building self-sufficient cash investment capabilities should help maintain better credit and counterparty risk control and mitigate liquidity

uncertainties in pooled investments. Such capabilities may come from in-house investment expertise or through customized separately managed accounts.

Conclusions

Recent negative bank ratings actions foretell a secular trend that capital markets-oriented banks are slipping towards the lower tier of investment-grade categories. We believe these ratings downgrades are more than a temporary phenomenon that is easily reversible. While the near-term effect on corporate treasury portfolios will likely be manageable, long-term ramifications require more investor attention. Cash investors should be aware of the potential supply shortages in the debt markets and the need for robust credit and counterparty research capabilities. Investors also should explore eligible investments in non-financial credits and consider direct investments through separately managed account solutions.

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[1] See "Special Comment: Challenges for firms with global capital markets operations: Moody's rating reviews and rationale," Moody's Investors Service, February 15, 2012.

[2] See "U.S. banking sector: 4Q '11earnings summary," Standard & Poor's Ratings Services, February 15, 2012.

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