

## **S&P Downgrade of the United States Sovereign Credit Rating to AA+ from AAA: Is There an Immediate Impact on the Ratings of the Money Center Banks?**

**By Anil Lalchand**

Co-Director, Credit Research, Global Developed Credit  
DoubleLine Capital LP

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On Friday August 5, 2011, Standard and Poor's ("S&P") took the historic action of lowering the sovereign credit rating of the United States from AAA to AA+ with a negative outlook. S&P also affirmed the A-1+ short-term rating. We don't believe this action will have an immediate ratings impact on the U.S. money center banks. U.S. banks have increased their deposits for the past several years and as a result have reduced their reliance on wholesale funding markets, including the repurchase agreement ("repo") markets. In addition, U.S. banks have more capital and liquidity now than they did in 2008. That said, in the short-term, the market impact may well experience turbulence considering the money center banks own a sizeable amount of U.S. Treasuries.

On August 8, 2011 S&P stated that the lowering of the sovereign credit rating of the U.S. would not have an immediate or direct impact on the stated ratings of U.S. banks since none of the banks rated by S&P in the U.S. has an issuer credit rating higher than the U.S. sovereign rating. In addition, S&P specifically stated that the U.S. sovereign downgrade does not alter the government support assumptions that are factored into the agency's ratings on the major banks.

On Monday, August 8, the financial sector was indeed hit hard in the U.S. capital markets as bank credit spreads widened considerably and bank stocks plunged 11% in their biggest one-day drop since April 2009. It seems that investors may have been questioning how well the major U.S. banks will weather a slowing economy after an unprecedented downgrade of the sovereign credit rating of the U.S. An indirect impact of the U.S. downgrade is that it erodes the confidence consumers and businesses have in the economy; this could exacerbate the slowdown in economic growth. There may be other "knock-on effects" of the U.S. downgrade, such as changing rates, currency-market volatility and widening credit spreads, all of which may affect the revenue streams of the money center banks. The financial sector suffers disproportionately (in terms of lower stock prices and wider credit spreads) when the economy falters. High unemployment and low consumer confidence means fewer loans for the banks. Any pullback in bank lending could undermine an already weak recovery.

Another widely discussed topic is the impact on money market funds as a result of the potential for forced selling of Treasuries in the event of a downgrade. The decision by S&P to affirm the A-1+ short-term rating, even as it lowered the long-term rating to AA+ from AAA, should limit the impact on money

market funds and provide a level of stability as money market funds won't be forced to sell Treasuries, which are pledged as collateral in the marketplace for repos. The concern is that lenders may demand a higher level of Treasury collateral for the same amount of cash. However, this is more likely to depend on changes in price volatility of Treasuries rather than just a downgrade itself. Following the downgrade announcement by S&P, the federal banking agencies released a joint statement reiterating no change to the risk based capital guidelines. Therefore, risk-based weightings on Treasuries and U.S. agencies will remain unchanged at zero.

It is important to look at the money center banks in the context of everything that is going on and not solely in the context of the U.S. debt issue. As we wrote in a DoubleLine white paper published on July 5, 2011, "U.S. Bank Exposure to Peripheral Europe: More Than Meets the Eye?", U.S. banks are not immune to the problems in Europe. U.S. banks' exposures to Europe's periphery do not end with direct exposures. U.S. banks could have additional indirect exposures to periphery countries (beyond what is disclosed) via cross-guarantees or holdings of other banks that may have their own exposure to these troubled countries. Over the longer term, the ongoing challenges in Europe and U.S. banks' exposures to Europe combined with indirect impacts of the U.S. sovereign downgrade and a slowing global economy will undoubtedly present challenges for the U.S. banks, which could impact their creditworthiness.

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