CHANGES TO DEBT RATINGS, CAPITAL & THE BRITISH

by Steve Brown

As the banking crisis continues and we prepare for yet another year, the Brits have come up with an interesting capital concept that may eventually make it over to our shores. Contingent capital, as it is called, allows banks to convert existing subordinated debt into capital notes that

carry a fixed maturity. These notes are converted into equity if Tier 1 capital falls below some baseline level. The idea may or may not work in the US, but it is nice to see at least some solution being floated to try and find additional sources of capital for banks as the crisis grinds on.

As long as we are on the subject of bank capital, we thought community bankers might be interested to know how the rating agencies view various forms of capital. While there have been many changes to basic methodologies by the rating agencies since the crisis began, here are some of the most critical components bankers should know. Whether one is getting ready to raise capital or just wondering how the bank may be evaluated in the future this information should be helpful.

Analysis completed by the rating agencies predictably found that stress in the industry is so severe, bank default probabilities have jumped. That isn't surprising when you consider both banks and holding companies struggling (or restricted) in making coupon payments or forced to restructure principal repayment.

Given this and other factors, rating agencies have begun to more actively modify bank credit ratings. To capture risk, rating agencies have had to try and link ratings to the stand-alone intrinsic strength of the underlying bank, adjust for any systemic "too-big-to-fail" support and take into account the fact that certain capital structures are inherently riskier than others (by widening potential ratings assigned along the scale). Even specific country factors are incorporated, as actions show some governments are more apt to support (or interfere with) bank troubles.

Perhaps one of the most difficult areas for rating agencies to ascertain the risk is when it comes to individual bank regulatory actions. For instance, trying to calculate when one regulator might intervene and prevent a coupon payment on one bank versus another is nearly impossible. Sometimes, such regulatory action occurs even though reported data on the entity may not yet reflect much strain. This is one major conundrum that has frozen bank holding company lending and debt issuance in its tracks and left the rating agencies scratching their heads. It is simply not possible to predict the probability of government intervention that could result in losses greater than originally calculated. The problem is that this not only heightens the risk profile of the institution, but it wipes out capital sources until normalcy returns.

Before the current crisis began, rating agencies typically rated any issued debt to its maturity, without taking into account extension risk. It was assumed that debt would be called at maturity, reissued if needed and that coupon suspension would be a rarity. As the current crisis has shown, this is not the case. Given such unpredictability and significant mark to market risk, lending to banks has been close to non-existent.

Here is how the rating agencies view different types of debt issuance as a proxy for those banks considering moving down this path. For bank holding companies with substantial double leverage, a 2 notch to 4 notch downgrade below the bank's debt rating is more common. That means if the bank is rated BBB, the holding company might be as low as BB (2 notches, highly speculative) or even CC (4 notches below, extremely speculative).

No matter what the actual risk, this means that for at least the foreseeable future, raising capital outside existing common shareholders is going to be expensive. Let's hope the British are onto something that finds its way to our continent soon.

BANK NEWS

Liquidity Exit

The Fed has proposed a program whereby they would sell term (< 1Y) deposits via auction (or other yet to be decided method) to banks as a way to extract a portion of the $1T in reserves that are currently in the monetary system. Similar to the Fed's reverse repo program, the Fed would purchase cash at a market rate of interest. These deposits could then be pledged at the discount window for collateral.

New Trick

For the first time, the FDIC utilized an option agreement whereby it received options from NY Community Bancorp ($44B, NY) after the bank purchased Amtrust Bank from receivership. The Agreement, which allows the FDIC to profit should the shares of the acquiring bank rise due to the perceived value created from the acquisition, is expected to be utilized more often going forward. We credit NY Community Bancorp for thinking to include the option, as that attribute helped put them ahead of 13 other bidders. We also credit the FDIC, as last week they exercised the option and booked an approximate $23mm gain.

Unemployment

Goldman Sachs projects the unemployment rate will climb to 10.75% by mid 2011 from 10% currently.