UNPRECEDENTED DOWNGRADE: FULL FAITH & CREDIT?

by Steve Brown

On Friday, S&P made it official and downgraded US debt to "AA+" from its sterling "AAA," a rating that our Nation has had since 1917. S&P further elaborated that the US runs about a 33% risk of undergoing a further downgrade due to the lack of deficit control and general political dysfunction. The rating change came despite the Treasury pointing out a $2T mathematical error which S&P acknowledged. Regardless, markets around the world were hit hard, as many worried that holders of Treasuries might be forced to sell, but instead, yields on long-term US debt have fallen (primarily due to ongoing fear around the world and especially in Europe). That is the current net result so far of all of this, but volatility is back with a vengeance, so buckle up for a bumpy ride.

It should also be known that through the weekend employees at large money management firms across the globe worked as they tried to figure out the potential impact on their AAA-rated portfolios (which hold lots of Treasuries) of this unprecedented downgrade and whether they would be in compliance if they continued to hold Treasuries (most can). Fears ran high, as managers talked to clients and worked to assuage fears, but no one had great answers because this move is unmatched and that is further compounded by the fact that the US is the baseline for such ratings (given its strong economic engine and open market structure). After all, if the US isn't AAA-rated anymore, can any country really be? Finally, complicating the picture even more, while S&P downgraded US debt, the other two major ratings firms (Fitch and Moody's) did not, so things remain in flux. Treasury Secretary Geithner said, "S&P has shown really terrible judgment and they've handled themselves very poorly," he added in an attack on the ratings agency."

Hit hard by the US downgrade and sharp weakness in Italian and Spanish debt, both G-7 and G-20 central bank governors also came out over the weekend and issued a statement they are coordinated and will "take all necessary measures to support financial stability and growth." In response, the ECB aggressively bought Italian and Spanish assets, as they worked to quell the European sovereign debt crisis. Worldwide, equity markets dropped and investors jumped into the safety of gold (set a new record high) and dare-we-say-it...Treasuries.

Investing guru Warren Buffet also came out (and was followed by other major investors with similar comments) and said there is "no question that US debt is still AAA" and said the US is the richest nation in the world with a GDP of $48,000 per person and should have no problem meeting its obligations.

For banks, the regulatory agencies seem to agree, after coming out late Friday with guidance that said the risk weights for Treasury securities and other securities issued or guaranteed by the US government, government agencies and government-sponsored entities will not change (for risk weighted capital purposes). In addition, the treatment of such securities under other federal banking agency regulations will also be unaffected, as will most state's pledged accounts. That said; one potential bank impact could come as S&P may consider a downgrade of debentures from FNMA, FHLMC, the FHLBs and top rated insurers. If this occurs, banks could take a hit on GSE debt holdings in their investment portfolios. Bank ratings meanwhile are unchanged (none are AAA), but the equity prices for the sector are taking a beating along with the general market. Investors are spooked about the increased risk of global recession and the ongoing impact on banks.

Finally, some wonder whether the US can ever regain its AAA rating, to which S&P points out five countries (Australia, Canada, Denmark, Finland and Sweden) each have lost their AAA credit rating at some point and eventually regained it. In the meantime, S&P spokespeople say they stand by their decision (which was based on several factors, including damage done to the US reputation over the controversy surrounding the debt ceiling and concerns that underlying public finances are on an unsustainable path). Suffice it to say that volatility is here to stay for now and cash is going to be king until we can find firmer footing.

BANK NEWS

Closing (63):

Bank of Whitman ($549mm, WA) was closed with partial assumption by Columbia State Bank ($4.3B, WA) without premium. Columbia takes over 57% of Whitman's assets and 8 of 10 branches, while the rest to go to the FDIC. Bank of Shorewood ($111mm, IL) was also closed and was purchased by Heartland B&T ($1.6B, IL) without premium.

Liquid

Cash held by US banks surged 8.4% to a record $981B during the week ending July 27, according to Fed data. That's more than 3x the amount held in July of 2008.

Global Bank Job Cuts

The top 50 global banks are cutting jobs at the fastest rate since 2008, as a weak economy squeezes revenue; regulators push firms to hold more capital and companies restructure businesses to improve profitability.

BofA

The NYT is reporting that AIG is planning to sue BofA over hundreds of MBS issues that it purchased but were misrepresented as to quality. This could market the largest MBS related lawsuit by a single investor.

Mortgage Concentration

The top 3 community banks with the largest percent of mortgages-to-assets in 1Q are: Geddes Federal ($462mm, NY) at 86.2%, Priority Bank ($83mm, AR) at 84.7% and Hull Federal ($26mm, MD) at 83.8%.