BLAST WAVES CAN TRAVEL MILES

by Steve Brown

The downgrade of US debt by S&P, fears the European crisis could mushroom and word municipal debt could be the next area to be blown up by the rating agency, set off a bomb of activity in the markets throughout the world. Volatility was downright ugly and while the markets seem to have found some soft footing this morning, it is still early and much needs to be sorted out. As these issues should be hitting bank's enterprise risk committees, today we examine key areas in play for bankers.

S&P downgraded the credit ratings and related issue ratings on 10 of 12 FHLBs (Chicago and Seattle were already AA+) and the senior debt issued by the FHLB System to "AA+" from "AAA." They also downgraded the Federal Farm Credit Banks; Fannie Mae and Freddie Mac. Since so many debentures and guaranteed mortgages are held by banks concern of future impairment surfaced. In addition, it is important to note that these entities are "split-rated" now (S&P is rating them "AA+", while Moody's and Fitch have them "AAA"). At your next ALCO meeting, make sure you have carefully checked investment polices and scoured the investment portfolio to be sure everything is up to speed to avoid potential problems in the future. Consider making any tweaks to wording as may be necessary in the policies to ensure this issue has been adequately addressed, but take care not to change the overall form or function and make sure the board has reviewed any changes before they are implemented. Of note, S&P kept the "A" rating on subordinated debt rating and a "C" rating on the preferred stock of these entities, so that remains unchanged. That is good news for banks still holding such paper, as it may help avoid further OCI issues.

Another area impacted by the downgrades relates to the 126 FDIC guaranteed debt issues from 30 financial institutions under the Temporary Liquidity Guarantee Program (TLGP) and four NCUA guaranteed debt issues from two corporate credit unions under the Temporary Corporate Credit Union Guarantee Program (TCCUGP). TLGP supported capital markets borrowing for US banks and BHCs during the global credit crisis and the TCCUGP was formed to assist corporate credit unions that ran into financial difficulties as a result of significant losses in their investment portfolios. Community bankers are probably largely ok here, but double check exposures to be sure.

S&P also downgraded 73 funds, including bond funds, exchange-traded funds and hedge funds. These previously AAA rated funds had exposures of 50% or more to the US Treasury or government agency securities and include such names as BlackRock, Federated Investors, Franklin Resources, State Street and Goldman Sachs. Community banks don't usually hold much in the way of mutual funds, but sweep and some customer accounts could be impacted.

Another area to review relates to municipal issuers. Community banks hold a lot of bank qualified municipal securities and take deposits from municipalities scattered all over the country. S&P is currently reviewing ratings on hundreds of municipal issues, as they try to connect the dots to federal support levels. Nine states are currently rated AAA by S&P and despite the downgrade on the US, S&P has indicated they "may still assign an AAA rating to some state and local governments." For the states, S&P said it would consider the issuers ability to maintain stronger credit characteristics than the US; whether the state had a predictable institutional framework that was likely to limit the risk of negative federal intervention and whether the state or municipality mitigated federal intervention through financial flexibility and independent financial management. We are not exactly sure of the arbitrage opportunity here, but given the noise around the US, maybe some governor will move to form their own country.

Despite already feeling the significant blast waves from Dodd-Frank, community bankers will need to stay on top of potential blast reverberations around the ratings downgrade as well for the short term. The good news is that this is not a replay of 2008 and markets are functioning normally. That said, market volatility should cause many banks to test their risk management practices to ensure proper contingency plans are in place and management is aware of the recent elevated risk to earnings, operations, credit, reputation and other factors. Hopefully, the blast waves will soon pass by and banks can take comfort in the fact that the long term impact was a better risk structure.

BANK NEWS

A Trillion

CNNMoney reported that investors lost a trillion dollars in the stock market Monday. For perspective, a packet of one hundred $100 bills is less than 1/2" thick and contains $10k; $100mm fits nicely on a standard pallet; a trillion dollars is a million million or a thousand billion (a 1 followed by 12 zeros). What a day.

Dr. Doom

Nobel Prize winning economist Nouriel Roubini predicts the US and other advanced economies will have a second "severe recession" and said the "decision by Standard & Poor's to downgrade the US at a time of such severe market turmoil and economic weakness only increases the chances of a double dip and even larger fiscal deficits."