

SPECIAL COMMENT

Implications of a U.S. Rating Action on the Ratings of U.S. Financial Institutions

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Summary

On 13 July 2011, Moody's placed the U.S. government's debt rating on review for possible downgrade.¹ This action has consequences for the ratings of U.S. Financial Institutions that are directly linked to the U.S. government or are otherwise vulnerable to sovereign risk. This special comment outlines the framework used to determine how, and to what extent, the ratings of U.S. Financial Institutions will be affected by any potential change in the rating or rating outlook assigned to the U.S. government. In summary:

- » We have placed on review for possible downgrade debt securities that are directly linked to the rating of the U.S. government. Included is debt issued under the Temporary Liquidity Guarantee Program (TLGP) and the Temporary Corporate Credit Union Stabilization Fund (TCCUSF). The action reflects the FDIC and NCUA guarantees that are unconditional and irrevocably backed by the full faith and credit of the United States government.
- » We have also placed on review for possible downgrade all Aaa senior debt and deposit ratings of U.S. Government-Related Institutions. In addition, we placed the Aa2 subordinated debt ratings of Fannie Mae and Freddie Mac on review for possible downgrade as these ratings benefit from systemic support.
- » The ratings of eight U.S. banks currently benefit from uplift due to Moody's assessment of the likelihood of systemic support. The highest rated of these are The Bank of New York Mellon (deposits at Aaa) and JPMorgan Chase (deposits at Aa1). Moody's notes that in some cases it has rated systemically important banks higher than the government debt rating because governments have an array of tools to assist banks that go beyond the government's ability to service its debt. Over the next week, we will assess the likelihood of systemically important U.S. banks being rated above the U.S. government rating. If we conclude that this outcome is unlikely, we expect that the highest rated of these banks will be placed on review for possible downgrade. A multi-notch move in the U.S. government rating would result in more of these banks being placed on review for possible downgrade.

1 See Moody's report: "[Moody's Places US Aaa Government Bond Rating and Related Ratings on Review for Possible Downgrade](#)", dated July 13, 2011.

- » Moody's currently rates four insurance companies - Teachers Insurance and Annuity Association of America, United Services Automobile Association, New York Life Insurance Company and Northwestern Mutual Life Insurance Company - Aaa for financial strength (insurance finance strength rating, IFSR) on a stand-alone basis. Moody's ratings of insurance companies incorporate our assessments of each insurer's own business and financial profile. However, these assessments are influenced by external conditions which can exert a meaningful influence on insurers' intrinsic financial strength. Over the next week, we will assess each of the four insurer's unique business and investment concentrations relative to the domestic market as well as the short and/or long-term negative drivers of the domestic market. We anticipate that in the case of a one-notch downgrade of the U.S. government, it is unlikely that the IFSRs of these four groups will be affected. A multi-notch rating move could affect them, however, requiring one or more of these insurers being placed on review for possible downgrade.

Introduction

Following our action to place the U.S. government rating on review for possible downgrade, Moody's has also placed on review for possible downgrade the Aaa debt ratings of all securities issued under the FDIC's Temporary Liquidity Guarantee Program (TLGP) and the NCUA's Temporary Corporate Credit Union Stabilization Fund (TCCUSF), as well as the senior long-term debt and deposit ratings of those financial institutions, which are U.S. Government-Related Issuers (GRIs). In addition, we placed the Aa2 subordinated debt ratings of Fannie Mae and Freddie Mac on review for possible downgrade. This Special Comment explains the rationale for these rating actions.

If a U.S. government debt-ceiling-related default were to occur, Moody's would likely downgrade the Aaa U.S. government rating somewhere in the Aa range. A return to a Aaa rating would be unlikely in the near term.

If the debt limit is raised and a default avoided, the Aaa rating would likely be confirmed. Whether the outlook on the rating would be stable or negative would depend upon whether the outcome of the negotiations included meaningful progress toward substantial and credible long-term deficit reduction. A credible agreement on substantial deficit reduction would support a stable outlook; lack of such an agreement would most likely prompt the assignment of a negative outlook.

A change in the U.S. sovereign rating will have varying degrees of impacts on U.S. financial institutions. We can categorize their ratings into four broad groups: (1) ratings directly linked to Federal Deposit Insurance Corporation (FDIC) guarantees through the Temporary Liquidity Guarantee Program (TLGP) and ratings directly linked to the National Credit Union Administration (NCUA) guarantees through the Temporary Corporate Credit Union Stabilization Fund (TCCUSF); (2) ratings of Government-Related Issuers (GRIs); (3) ratings of systemically important banks, whose ratings are lifted above their Baseline Credit Assessment (BCA) due to Moody's assessment of the likelihood of U.S. government support for those banks, and (4) other rated U.S. financial institutions.

Debt Securities Issued Under the Temporary Liquidity Guarantee Program and Temporary Corporate Credit Union Stabilization Fund are on Review for Possible Downgrade

Debt securities issued under TLGP and TCCUSF are directly linked to the rating of the U.S. government. The ratings reflect the FDIC and NCUA guarantees which are unconditional and irrevocably backed by the full faith and credit of the United States government. These ratings reflect the credit substitution of the U.S. government and as such action on the ratings on TLGP and TCCUSF securities directly followed the rating action taken on the U.S. government. Moody's expects that possible future rating actions on FDIC and NCUA guaranteed securities would mirror any rating actions on the U.S. government until they reached the same ratings level as that implied by the issuers' own senior unsecured debt ratings.

Government-Related Issuers

The ratings of GRIs fall into three broad groups: (1) ratings that benefit from explicit government support (i.e., Fannie Mae and Freddie Mac), (2) ratings that incorporate an assumption of implicit support from the Federal government (i.e., the Federal Home Loan Bank System (FHLBank System), each of the twelve Federal Home Loan Banks (FHLBanks)², the Farm Credit System, the Farm Credit Bank of Texas, and U.S. AgBank), and (3) GRIs whose assets predominantly consists of U.S. government guaranteed loans and securities (i.e., Private Export Funding Corporation (PEFCO), Student Loan Marketing Association (Sallie Mae),³ Resolution Funding Corporation, and Financing Corporation).

Explicit Support - Fannie Mae and Freddie Mac

In regards to Fannie Mae and Freddie Mac, Moody's placed on review for possible downgrade their Aaa senior long-term debt rating and Aa2 subordinated debt rating. Fannie Mae's and Freddie Mac's Prime-1 short-term ratings were affirmed based on Moody's expectation that the long-term ratings are unlikely to fall below the Aa level and that the companies have sufficient access to liquidity in the form of cash and U.S. Treasury securities to allow them to manage through any short-term disruptions in the discount note and debt markets.

The stand-alone financial strength of Fannie Mae and Freddie Mac is well below Aaa⁴. The Aaa and Aa2 senior and subordinated debt ratings reflect the effective credit substitution from the U.S. government and, as a result, we placed the long-term debt ratings of these companies on review for possible downgrade.

² The FHLBank System includes the FHLBank of Atlanta, FHLBank of Boston, FHLBank of Chicago, FHLBank of Cincinnati, FHLBank of Dallas, FHLBank of Des Moines, FHLBank of Indianapolis, FHLBank of New York, FHLBank of Pittsburgh, FHLBank of San Francisco, FHLBank of Seattle, and FHLBank of Topeka.

³ As part of the Sallie Mae Reorganization Act, the Sallie Mae GSE was privatized on December 29, 2004. As part of the privatization, \$1.84 billion of GSE debt was placed into two trusts to be defeased with U.S. government obligations.

⁴ A Baseline Credit Assessment (BCA), which are on a scale of 1 to 21, where a 1 represents the lowest credit risk, are Moody's opinion about an institution's intrinsic or stand-alone financial strength and exclude extraordinary support. Fannie Mae's and Freddie Mac's BCA is a 15 (B2 equivalent on Moody's long-term debt scale).

Implicit Support – FHLBanks System, Farm Credit System, FHLBanks, Farm Credit Bank of Texas and U.S. AgBank

In regards to the FHLBank System and the Farm Credit System, Moody's placed on review for possible downgrade the Aaa senior long-term debt and deposit ratings. We affirmed the Prime-1 short-term ratings reflecting that the ratings are unlikely to fall below the Aa level and that the companies have sufficient access to liquidity in the form of cash and U.S. Treasury securities to allow them to manage through any short-term disruptions in the discount note and debt markets. We also note that the stand-alone financial strength of the FHLBank System (BCA of 5 or a A1 equivalent) and the Farm Credit System (BCA of 4 or a Aa3 equivalent) are each strong enough to warrant a stand-alone Prime-1 rating.

The FHLBank System (BCA of 5 or a A1 equivalent) benefits from four notches of support uplift from the U.S. government, while the Farm Credit System (BCA of 4 or a Aa3 equivalent) benefits from three notches of support uplift. Moody's would expect that the senior long-term debt ratings of both GRIs would follow in lock-step any rating actions on the U.S. government until they reached the same rating level as that implied by their stand-alone financial strength.

We also placed on review for possible downgrade the Aaa long-term deposit ratings of all 12 FHLBanks as all have deposit ratings of Aaa. All 12 of the FHLBanks deposit ratings benefit from four notches of support uplift from the U.S. government and would likely follow in lock-step any rating actions on the U.S. government until they reached the same rating level as that implied by their stand-alone financial strength.

In regard to the Farm Credit Bank of Texas and U.S. AgBank, we placed the Aa2 long-term issuer ratings on review for possible downgrade as these ratings benefit from one notch of support uplift from the U.S. government.

We affirmed (1) the A2 subordinated debt rating of the FHLBank of Chicago, (2) the A1 subordinated debt, A2 cumulative preferred stock and A3 non-cumulative preferred stock ratings of the Farm Credit Bank of Texas, and (3) the A3 non-cumulative preferred stock ratings of U.S. AgBank as those ratings do not benefit from U.S. government support.

Asset Support – PEFCO, Student Loan Marketing Association, Resolution Funding Corporation, Financing Corporation

The stand-alone strength of PEFCO, Sallie Mae, Resolution Funding Corporation, Financing Corporation is a 1, or Aaa equivalent, principally because the assets of these entities are U.S. government guaranteed. As a result, any change in ratings on the U.S. government will also impact the ratings of these GRIs. We affirmed PEFCO's Prime-1 short-term rating, reflecting its liquid asset base of U.S. government guaranteed securities and loans.

Moody's expects the ratings on PEFCO, Sallie Mae, Resolution Funding Corporation, and Financing Corporation will continue to move in lock-step with the U.S. sovereign rating.

Systemically Important U.S. Banks

The deposit and senior debt ratings of eight U.S. banking organizations currently benefit from uplift due to Moody's assessment of the likelihood of systemic support (see figure 1). Of these eight, the ratings of three are already on review for possible downgrade: Bank of America, Citigroup and Wells Fargo. The degree of support uplift for those three ranges from 3 to 5 notches above their baseline credit assessments, reflecting the unusual degree of support each bank received during the crisis. The pending review will consider whether to remove this unusual uplift and include only pre-crisis levels of government support. Each is already rated several notches below the U.S. government ratings and is unlikely to be further affected should there be a one-notch downgrade of the U.S. government. A multi-notch rating move could affect them, however.

The degree of support uplift for the other five banks is limited to only 1 or 2 notches. The rating outlook for all five banks is negative. A downgrade of the U.S. government could put additional pressure on these ratings. However, in some cases systemically important banks may be rated higher than the government debt rating under Moody's bank rating methodology, because governments and central banks have an array of tools – financial as well as non-financial – to assist banks⁵ even when the government itself is having difficulty servicing its debt. Over the next week, we will assess the likelihood of systemically important banks being rated above the U.S. rating. If we conclude that this is unlikely, it may result in one or more of these banks being placed on review for possible downgrade. However, a downgrade of U.S. government rating by only one notch would likely only affect those banks rated at the highest levels, specifically Bank of New York Mellon and JPMorgan Chase.

Figure 1 below shows the possible impact on the eight banking organizations that currently benefit from uplift in their ratings due to systemic support. The figure shows the possible impact on the bank deposit rating for each bank, based on Moody's Joint Default Analysis (JDA) framework, reflecting lower ratings for the U.S. sovereign as support provider and assuming a return to Moody's pre-crisis systemic support assumptions for Wells Fargo, Bank of America, and Citigroup.

FIGURE 1

Impact of U.S. Downgrade on Systemically Supported Banks

	BFSR	BCA	Long-term Deposit Rating	JDA support bucket	JDA outcome if U.S. Sovereign Rating goes to:		
					Aa1	Aa2	Aa3
Bank Of New York Mellon Corporation, The	B+	Aa2	Aaa	Very High	Aa1	Aa2	Aa2
JPMorgan Chase & Co.	B	Aa3	Aa1	Very High	Aa2	Aa2	Aa3
State Street Corporation	B	Aa3	Aa2	High	Aa2	Aa2	Aa3
Goldman Sachs	B-	A1	Aa3	High	Aa3	Aa3	Aa3
Wells Fargo & Company	C+	A2	Aa2 RUR	Very High	Aa3	Aa3	A1
Morgan Stanley	C	A3	A1	High	A1	A1	A2
Bank Of America Corporation	C-	Baa2	Aa3 RUR	Very High	A2	A2	A2
Citigroup Inc.	C-	Baa2	A1 RUR	Very High	A2	A2	A2

5 See "Financial Crisis More Closely Aligns Bank Credit Risk and Government Ratings in Non-Aaa Countries," May 2009.

Other U.S. Financial Institutions

Moody's currently rates four insurance companies Aaa for financial strength (insurance finance strength rating, IFSR) on a stand-alone basis. These four include Teachers Insurance and Annuity Association of America, United Services Automobile Association, New York Life Insurance Company and Northwestern Mutual Life Insurance Company.⁶

Moody's ratings of insurance companies incorporate our assessments of each insurer's own business and financial profile⁷. However, these assessments are influenced by external conditions which can exert a meaningful influence on insurers' intrinsic financial strength⁸.

Broadly speaking, we see a correlation in the credit quality of insurers and the countries in which they operate. We believe an insurer's ability to sell its products is, in part, linked to country-specific trends and developments. Weakness in a country's economic, social, judicial, institutional and general business conditions can degrade an insurer's ability to operate. Furthermore, weakness in a country's own balance sheet and the ramifications of any austerity measures taken to improve one's own balance sheet on the broader economy can also negatively impact insurers.

In addition, insurers often have substantial direct investment exposures to domestic government obligations as well as other obligations within the local market. Therefore, their own profiles may correlate to the government's credit profile. These other investment exposures may be to entities that are directly supported by the local government or otherwise subject to the same set of economic factors that cause the government's credit profile to falter.

Over the next week, we will assess each of the four insurer's unique business and investment concentrations relative to the domestic market as well as the short and/or long term negative drivers of the domestic market. We anticipate that in the case of a one-notch downgrade of the U.S. government, it is unlikely that the IFSRs of these four groups will be affected. A multi-notch rating move could affect them, however, requiring one or more of these insurers being placed on review for possible downgrade.

The highest rated U.S. banks on a stand-alone basis, US Bancorp and Commerce Bancshares, Inc., have bank financial strength ratings (BFSRs) of B+ and bank deposit ratings of Aa2. Similar to insurance companies, the operating environment can exert a meaningful influence on banks intrinsic financial strength. However, we anticipate that in the case of a one-notch downgrade of the U.S. government it is unlikely that the BFSRs or other ratings of these banks would be affected.

⁶ Ultimate parent operating company listed herein. TIAA, NWM, and NYL each own operating companies which are also rated Aaa IFS.

⁷ For further reference, consider reviewing Moody's rating methodologies for each individual insurance sector.

⁸ A country's insurance industry typically plays an important role in the efficient functioning of that country's economy, facilitating the transfer of various types of risk and providing financial capital to businesses via their investments in fixed income and equity securities. Accordingly, Moody's recognizes that governments may elect to provide support to stressed insurers in certain situations. However, we do not consider the provision of support by governments to be sufficiently likely or reliable to support a general presumption of direct government support in our insurance ratings on top of the influence already incorporated in our insurance ratings from our assessment of the economic, social, judicial, institutional and general business conditions in any particular country. See Special Comment, [Moody's Insurance Ratings Emphasize Intrinsic Financial Strength; No General Presumption of Government Support](#), October 2010 (124033)

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