Taxation with(out?) bank representation — ANALYSIS
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by Bill Harrington

Within seven days of the UK vote to quit the European Union, the equity markets pummeled EU and US banks, rating agencies announced a range of actions and advisories with respect to both the UK and many of its banks, and the Federal Reserve Board unveiled the results of the 2016 stress tests. In light of the test failures of the US subsidiaries of two of the largest EU banks — Deutsche Bank and Santander — we once again return to the question: Can large banks and financial institutions ride out the next storm?

What may not be immediately apparent is the rules of the game have changed. Rating agencies have factored in a range of government support into the ratings of not only bank debt and deposits, but also for instruments issued by entities that are parties to contractual arrangements with banks.

Are the rating agencies simply being clear-eyed and calling things as they see them? Or is baking the assumption of government support into bank and other ratings convenient for issuers and rating agencies alike but highly inconvenient for taxpayers who will ultimately foot the bill? In other words, is analytical reliance on government support incubating a self-fulfilling prophecy of more bailouts, i.e., higher tax assessments?

The answers to the preceding three questions seem to be no, yes and yes, judging by the methodologies and ratings for sovereign entities, i.e., the providers of government support. Methodologies don’t notch down sovereign ratings to offset the growing liabilities that accrue to sovereign entities under the rating assumption of government backstops for banks and trading partners. Rather, rating agencies often keep sovereign ratings stable and downgrade them only in reaction to surprising events, as was the case with the Fitch and S&P downgrades of the UK this week. Perhaps this is a byproduct of making the rules up as one goes when hewing to an unchanging goal — support the status quo.

What is propped up must come down?

In both the EU and US, rating agencies have a largely unfettered ability to define ratings and to develop methodologies to suit themselves. Regulatory oversight is generally confined to publishing requirements with respect to rating definitions, actions, methodologies and transition over time. However, the content of the foregoing is generally off limits to regulation and regulatory scrutiny.

Moody’s has been especially proactive in exercising its freedom to factor government support into bank and associated ratings and publishing every step of the way. As example, the “Banks” methodology of 7 January is 133 pages long and lists 37 related Moody’s documents — an additional methodology for global banks; six cross-sector methodologies; three requests for comment; and 27 sector comments.

But wait, there’s more! Other methodologies such as those that Moody’s uses to rate ABS when issuers are party to one or more derivative contracts work in tandem with the banks methodology but are not among the 37 documents listed. These ABS methodologies, as well as others not listed, rely heavily on the Counterparty Risk Assessment that Moody’s introduced in a broadly similar precursor bank methodology dated 16 March 2015.

Bank and other large derivative counterparties to ABS also depend on the Counterparty Risk Assessment and have benefitted from it generally being equal to or higher than the respective ratings for deposits and non-secured debt. Many US and EU banks amended the rating triggers in existing derivative contracts with ABS transactions to reference the Counterparty Risk Assessment rather than a debt rating such as the senior unsecured rating. By doing so, many European banks in particular avoided posting collateral or taking other remedial actions that derivative contracts specify are to occur upon breach of a rating trigger.

Moody's has also depended on the Counterparty Risk Assessment to preserve its rating franchise by enabling the awarding of Aaa ratings to new ABS and covered bonds even when the credit profile of a bank counterparty are comparatively weak.

Taxpayers assessed for global counterparty risk?

Moody's introduced the Counterparty Risk Assessment in its "Banks" methodology of 16 March 2015 after having proposed a slightly different forerunner in "Proposal for Introduction of Counterparty Risk Rating," a comment request published on 8 January 2015. Comparatively little changed from this proposal, other than the self-imposed downgrade of the measure to an "assessment" from the initially proposed "rating."

Does this definitional downgrade further immunize Moody's from regulatory scrutiny, at least by the SEC? No, according to a source familiar with the matter. "The examinations conducted by the Office of Credit Ratings may incorporate a review of an NRSRO's compliance with its rating policies, procedures, and methodologies, and the effectiveness of an NRSRO's internal controls with respect to the ratings process, including any inputs to ratings."

The Credit Risk Assessment is certainly an input to many Moody's ratings, one that allowed Moody's to announce that it had upgraded ratings soon after the introduction of the assessment.

Moody's published a comment on the global structured finance sector entitled "Bank Methodology Updates Had Mostly Positive Effects on Global Structured Credit Transactions" on 17 June 2015. "Following our financial institution group's rating changes and assignments of CR assessments to 13 global investment banking groups (GIBs) in May, we have concluded our rating reviews on 53 global structured credit transactions whose credit quality depends on that of the banks. Rating upgrades constituted almost 75% of these actions, and the remainder were confirmations."

The good news continued for the banks, financial institutions and Moody's as the agency announced again and again that the ratings of individual ABS would not be downgraded as the respective transactions were amended to reference the higher Counterparty Risk Assessment rather than the lower unsecured debt ratings in rating triggers.

In sum, Moody's propped up ABS ratings by recalibrating the assessment of derivative contracts and not because banks had improved their capital positions.

Moody's basis for super-Aaa derivative contracts

Moody's entirely forgoes analysis in formulating methodologies for government support of banks and derivative contracts and instead touts well-developed abilities in reading the minds of regulators and perceiving the moods of their respective bodies politic, according to the Banks methodology of 7 January.

"Our approach to government support is similar to that for determining support from an affiliate. Our assessment is designed to be qualitative and flexible in nature, enabling us to incorporate the often subtle real-world shifts that define attitudes to support for bank creditors."

The flexible assessment provides Moody's with a rationale to avoid marking down the ratings in advance to reflect growing interdependency."

“The extent of support incorporated into our ratings reflects the probability of each government’s committing public funds to support a financial institution, and its own capacity to provide that support. However, the global financial crisis has demonstrated that the probability of support is not static and can evolve rapidly, sometimes diminishing rapidly. It may also vary among debt classes for a given institution; for example senior unsecured debts are typically more likely to be supported than junior instruments.”

A Moody’s spokesperson declined to comment.