II-6.26: Twelve German banks downgraded by Moody's

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Translated Article

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MAIN INFORMATION

On 16 November 2011, Moody's downgraded twelve public-sector German banks, after regulatory changes in Germany and the EU.

CONTEXT AND SUMMARY

Moody's is a credit rating agency. It assesses the solvency of borrowers such as companies, banks or States. This assessment leads to a credit rating which reflects the agency's opinion on the risk of such borrowings.

Credit rating agencies use different methodologies depending on the type of borrower it assesses. When rating banks, credit rating agencies' take, *inter alia,* into account "the support uplift" available to such institutions (i.e. the chances that banks will be rescued in case of failure).

Following its methodology, Moody's took rating actions on 16 November 2011 on twelve German *Landesbanken banks* (public-sector banks) because of a German regulatory change affecting banks' "support uplift". The rationale behind such rating action is twofold: first, it takes into account the new German regulatory regime described below, and, second, it encompasses the outcome of such new regime on existing EU law.

On 1 January 2011 came into force in Germany a new bank resolution regime, which changed German banks' support environment. The new regime allows the regulator to only support the systematically implicated part of the bank, while imposing losses on all its other debts through a partial liquidation of the bank. Because, as mentioned, the methodology used by agency to assess banks' solvency takes into account "the support uplift" available banks, Moody's consequently had to immediately include such regulatory change in its assessment in order to establish whether or not such change would affect the banks' ratings. Moody's clearly reckoned that it did, as it downgraded the rating of twelve German banks.

Moody's explained that it was the measures "being taken by authorities to reduce the likelihood, predictability and extent of future support" which had prompted its rating actions. According to its methodology, Moody's had therefore no other option but to take rating actions, especially as it interpreted the change in Germany's legal environment to be more than just a symbolic step towards enhancing financial discipline; indeed, Moody's deems that such regulatory change increases the chances that "bondholders, including senior creditors, may have to shoulder some of the cost of future bank bail-outs".

The agency also departed from a mere German-based legal analysis, so as to take into account the current European regulatory context.

First, Moody's included in its reasoning the recent and numerous European-wide policies which intend to "have bondholders share the burden of future bank support in the interest of taxpayers", and concluded that the chances of most EU banks to benefit from rescued plans had in fact decreased.

Second, Moody's assessed the new German regulatory regime under the scope of existing EU regulations. Indeed, ever since the European Commission –the approval of which is mandatory for all public support awarded to banks (i.e. state aid)– has increasingly linked its approval to strict conditions (particularly for public-sector banks that required support more than once), Moody's has been of the view that EU rules could become an obstacle for some Landesbanken in obtaining additional support. Moody's especially noticed that, while the Commission has the power to reject restructuring plans put forward by banks (leading to their potential unwinding), most arrangements for an orderly unwinding of Landesbanken had been made before the new German resolution regime became effective; for that reason, Moody's expressed its fear that the new German regime could, combined with EU law, raise even more uncertainty for bondholders if the Commission was to deny approval for support in future cases of distress.

Therefore, based on both German and EU law, Moody's had to reduce in its rating assessment the "support assumptions for German public-sector banks" required by its methodology, and consequently downgraded the rating of twelve German banks.

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BRIEF COMMENTARY

While Moody's rating action is nothing more that the result of a quantitative assessment based on the mere addition of its methodology's solvency criteria, the sources and the outcomes of such decision say a lot about our current market and supervisory paradigm. Indeed, and simply put, it was the recent regulatory changes at both national and EU level that drove Moody's to take rating actions on twelve German banks: it was the German strengthening of regulation which increasingly made banks pass for more vulnerable in case of potential market failure, and consequently justified their negative rating. This means that the banks' downgrading did not come from banks' (in)solvency per say, nor from their economic behavior, but from a regulatory change, i.e. an exogenous element to banks. Moody's decision therefore depicts a new economic reasoning: one that would rather analyze exogenous criteria rather than endogenous ones to assess an institutions' solvency. Indeed, it was not the intrinsic weakening of banks that led the agency to downgrade them, but the exogenous criterion of a regulatory change. We have therefore gone from an excessive assessment of institutions' solvency based on exclusively internal information, to an assessment based exclusively on market indicators and structure. We moved from a pre-crisis endogenous reasoning which considered the market as having no impact on institutions (but rather as being the mere reflection of institutions' solvency), to a state of mind which considers that all institutions are on the market and are affected by it. Therefore, in the same way the European Commission considers from now on audit firms to be market agents (when they used to be considered as internal economic actors), banks are also analyzed as being directly affected by exogenous factors. This new paradigm only takes in what is exogenous and ripped out from financial firms. Following such reasoning, and as Moody's decision to downgrade German banks illustrates, regulation itself could be considered as being nothing more than another brick in the wall of financial markets, another exogenous element weighing against what used to be exclusively endogenous. From that standpoint, regulation finds itself, as any other exogenous element, being awarded with a systematically important function. Yet, neither paradigm is correct, since they both exclusively rely on one criterion rather than the other. They embrace a too Manichean view of financial supervision: either exclusively endogenous, or exclusively exogenous. But only taken together will such criterion be efficient. Indeed, exclusive internal information leads to regulators' blinkered supervision, while mere external information conveys to all economic, market and even regulatory information a systematically important role. The latter view, which currently seems to be increasingly adopted, is even more hazardous that the former, as it therefore contributes giving everything a systematic dimension.