# Moody’s announces significant downturn in ratings of mid-sized banks

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When the Fitch rating agency downgraded the US credit rating earlier this month from AAA to AA+, the response in the financial markets and the business media was a collective “so what” shrug of the shoulders.

The Biden administration, however, more conscious of the possible impact on the global position of the US dollar, hit out. Its reaction, articulated by US Treasury secretary Janet Yellen, was along the lines of “how dare they do that” when the US economy and its financial system are so strong.

In its decision Moody’s downgraded the ratings for 10 medium-sized banks, named six banks for a possible review, including some larger ones, and changed the outlook on 11 others from stable to negative.

The banks whose ratings were downgraded comprised middle-sized banks hit by the rise in interest rates by the Fed which has led to a cut in the market value of their financial assets and commercial and real estate loans.

The Moody’s statement pointed to the existence of unrealised losses on the banks’ books—the issue which led to the downfall of Silicon Valley Bank, First Republic and Signature in March, three of the four largest bank failure in US history.

Uninsured depositors in the banks, including companies and very wealthy individuals, were bailed by the combined actions of the Federal Reserve, the Federal Deposit Insurance Corporation, and the US Treasury on the basis that the failures posed the danger of “systemic” risk. But these actions raised the question of whether there was now an implicit guarantee that the US government and its agencies would act in the same way whenever there was a failure.

Pointing to the ongoing fallout from the Fed interest rate hikes, the Moody’s statement noted that most regional banks had comparatively low capital compared to larger banks.

“In the current high-rate environment, this leaves some banks with sizable unrealized losses that are not reflected in their regulatory capital ratios vulnerable to a loss of investor confidence. Further, we expect a US recession in early 2024 will worsen banks’ asset quality and increase the potential for capital erosion.”

In research carried out by a team of academic economists, it has been estimated that the full extent of unrealised losses resulting from the fall in the value of Treasury bonds they piled into during the era of virtually free money under the Fed’s quantitative easing program could be as high as $2 trillion.

The Moody’s action led to a fall in the stocks of a number of regional banks.

According to a report in the *Wall Street Journal* (WSJ), “The reaction suggests the sector remains vulnerable to the problems that stirred a panic this spring after the failures of several midsize lenders: devalued bonds, jittery investors, deposit withdrawals and higher costs.”

Jill Cetina, Moody’s associate managing director and one of the authors of the report, told the WSJ: “There has been more funding pressure, more deposit pressure in the US banking system than we have seen in a long time.”

The report said the hiking of interest rates by the Fed—supposedly to combat inflation but in reality directed to suppressing the wage demands of the working class by slowing growth and even creating a recession—“continues to have a material impact on the US banking system’s funding and its economic capital.”

The effects are moving from the smaller and medium-sized banks up the ladder. Larger banks, including

Bank of New York Mellon, Northern Trust, State Street and US Bancorp, were among those which were under review.

So far, the main issue has been the losses, both unrealised and real, on the financial assets held by banks. But a potentially much bigger financial storm is building up in the commercial and real estate (CRE) sector.

There has been what was described Robert Gottliebsen, the business commentator for the *Australian*, as a “staggering fall in the value of office blocks in leading American cities, including New York, San Francisco, Los Angeles, Chicago and Atlanta.”

Commercial property, in which many smaller and not-so-small banks are involved, has been hit from two directions. The value of commercial loans has fallen because of the Fed’s interest rate hikes.

At the same time the demand for office space is declining because of the development of working from home, which began during the COVID-19 pandemic and continues under conditions of a tight labour market, in which office staff are able to insist on the avoidance of sometimes long commutes.

Speaking to the *Financial Times* on the fall in bank stocks following the Moody’s report, the president of Camelotta Advisors said: “The banks tend to be a canary in the coal mine for the economy. Part of the concern is downtowns in America seem to be ghost towns, and we haven’t seen any real financial repercussions yet, but I think the banks are potentially looking at some real estate losses.”

The Moody’s report said that asset risk was rising for small and midsize banks with large CRE exposure and while asset quality metrics “remain solid” they have begun to deteriorate.

Elaborating further it said: “To date, stress on US banks has been reflected almost exclusively in funding and interest rate risk related to monetary policy tightening, but a worsening in asset quality will likely come.”

Pointing to what it said was a leading indicator, the Senior Loan Officer Opinion Survey, it noted the already tightening credit conditions indicated a deceleration of lending to corporations starting early next year that could be as deep as in the 2000–2001 recession.

Under conditions of recession, which, at this stage, it has predicted will be “mild,” and rising unemployment, it noted that history suggested that “recessions associated with banking strains are both deeper and more protracted, and sharper downturn is possible if bank lending standards continued to tighten.”

The focus so far has been on the problems of smaller banks but that does not gainsay their importance because, as the report indicated, they are “important providers of credit to small businesses that employ about half of the US workforce.”

Moody’s warnings about bank losses were underscored the following day when it was reported that US banks lost a total of $19 billion on loan losses in the second quarter, the highest level in more than three years.

The growing stress on working-class families and the poor was reflected in the losses on credit card debt which came in at $10.7 billion.

There was also a significant jump in CRE loans on premises not occupied by the owner which came in at $1.17 billion—the highest level in more than a decade.

At every stage in the growing financial turmoil, they carry out bailouts, the message from the heads of the financial establishment—Fed chair Jerome Powell and Yellen—is that the US banking system is “sound and resilient.” Facts and figures are starting to paint a different picture.