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Regulatory and Transactional Implications of Recent Moody's Bank Ratings Downgrades

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Earlier this week, Moody's Investor Services downgraded the credit ratings of 10 regional banks and put 17 other banks under review or gave their rating a negative outlook. Notwithstanding the downgrades, most of the institutions remain investment grade under most definitions. Moody's action follows Fitch's downgrade of U.S. sovereign credit by one notch on August 1, 2023, and is likely to raise both transactional and regulatory implications for the affected banks as well as for their counterparties and customers.

Numerous contracts, such as the International Swaps and Derivatives Association ("ISDA") master agreements for derivatives (over the counter swaps, securities-based swaps and options) often include provisions referencing generally a credit "downgrade" or a failure to meet a specific credit rating as: (a) additional termination events; (b) events of default; or (c) grounds for insecurity. These events may trigger a closeout or requests for additional credit support. Given that these credit rating thresholds are subject to counterparties' individual negotiation, each transactional agreement, confirmation or a credit support document referencing a credit downgrade or a credit rating must be individually reviewed.

To the extent that the affected banks trade futures or options on futures through futures commission merchants ("FCM"), relevant FCM agreements and clearing arrangements must also be reviewed since they too may be impacted by a bank's downgrade or a negative change in credit ratings. Likewise, if Moody's action applies to the banks that are also registered as FCMs or swap dealers ("SD"), there could be an impact on their clearing arrangements with the derivatives clearing organizations ("DCOs") as well as on their SD capital and their SD risk management programs. Commodity Futures Trading Commission ("CFTC") regulations also specifically reference "credit risk" as a factor to consider for SDs in connection with design and implementation of risk-based margin models for uncleared swaps.

In the event that the affected banks act as third-party services providers (*e.g.*, as reporting counterparties or valuation agents), or as custodians or depositories, or as commodity trading advisors ("CTAs") or asset managers and commodity pool operators ("CPOs"), additional disclosures or amendments to standard disclosures may need to be made to the customers and to the National Futures Association ("NFA") if the downgrade may materially impact these entities' operations.

Credit risk assessments also are important under various Securities and Exchange Commission ("SEC") rules and in the context of trading various SEC-regulated instruments. For example, they are pertinent to the manner in which a securities broker-dealer computes its net capital under Rule 15c3-1, as well as to the manner in which a security-based swap dealer computes its net capital under Rule 18a-1 and an OTC derivatives dealer computes its capital under Rule 15c3-1f. Credit risk assessments also are a component of the ongoing monitoring process a security-based swap dealer must undertake under the margin rule applicable to those dealers (Rule 18a-3) and to a security-based swap dealer's ability to use a model-based approach to calculating initial margin. Determining whether an instrument involves "minimal credit risk" also is important to the ability of a money market fund to acquire that instrument. Further, as is the case with CFTC-regulated products, the margin provisions under certain brokerage or clearing agreements could be implicated by a downgrade.

Credit ratings downgrades may also impact certain lending or securitization transactions. For example, in many secured financing deals or securitization transactions, collateral accounts must be kept at a depositary that qualifies as an "Eligible Institution" and certain transaction parties, including trustees and certificate administrators, are required to maintain minimum rating requirements. The criteria to be "Eligible Institution" or to serve in those roles includes, among other things, a minimum short-term and/or long-term unsecured debt rating. To the extent that a bank's credit rating drops below a certain level, the borrower and other obligors may be required to move these accounts to another institution or to replace itself in that role.

As many of our readers will remember, section 939A of the Dodd-Frank Act removed reliance on credit ratings from most prudential bank regulations. Thus, these downgrades will not have any direct impact on the institutions' treatment by the federal bank regulators. However, the regulators will be watching very closely in their supervisory capacity if these downgrades lead to any liquidity or capital challenges to the institutions, and will likely point to last week's interagency update to their Guidance on Liquidity Risks and Contingency Planning.

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