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More Banks — 11 in Brazil — Face Credit Downgrades

Moody's downgraded the credit ratings of 11 Brazilian banks on June 27 — some a single level, and some three levels. This action was tied to the sovereign debt credit rating of the government of Brazil. All major banks that had credit ratings higher than the Brazilian sovereign debt rating of Baa2 were affected, and these included Banco do Brasil SA, Banco Sanfra, Banco Santander (Brasil), HSBC Bank Brasil — Banco Multiplo SA HSBAR.UL, Banco Bradesco, Banco Itau and Banco Itau Unibanco SA. Moody's put it thus: "Our review indicated that there are few, if any, reasons to believe that these banks would be insulated from a government debt crisis."

The number of loans defined as "bad loans" in the Brazilian banking system hit as 10-year high in May to $1.03 trillion. Dilma Rousseff, the president of Brazil, had been encouraging banks to grant more loans in order to stoke the economy and this was following the policies of her predecessor, former President Luiz Inada Lula da Silva.

This action by Moody's comes on the heels of a review of the ratings of European banks. On June 25, Moody's reduced the credit ratings of 28 out of 33 Spanish banks which had ratings. The reduction, in some cases by as much as four levels, came a few weeks after Moody's reduced the sovereign debt credit rating of the government of Spain to a level just above junk bonds.

Moody's concerns about Spain were similar to those related to Brazil: "The reduced creditworthiness of the Spanish sovereign … affects the government's ability to support the banks. The banks' exposures to commercial real estate will likely cause higher losses, which might increase the likelihood that these banks will require external support."

In May 2012, Moody's downgraded the credit rating of 26 Italian banks. Perhaps more ominously, Moody's also in February 2012 announced that the credit ratings of 114 different financial institutions in 16 different European nations were on review for possible downgrade, citing the sovereign debt crisis of the eurozone as a primary reason for the possible downgrades.

There has been action by Moody's since February. On March 28, seven Portuguese banks were downgraded one to two levels. On May 17, Moody's downgraded 16 Spanish banks by one to three levels. At the end of May, Moody's had downgraded the credit rating of nine Danish financial institutions by one to three levels. On June 6, Moody's downgraded the credit rating of the three largest Austrian banks by two levels.

Not only Europe has been affected by these downgrades in credit rating. On June 22, 2012 Moody's reduced the credit rating of 15 banks, five of which are American banks, including Bank of America, Goldman-Sachs, J.P. Morgan-Chase, and Citigroup.

Other rating services, notably Standard & Poor's and Fitch, had already downgraded many European banks last year. This past April Standard & Poor's downgraded the credit rating of 16 different Spanish banks. Last December Fitch downgraded the credit rating of seven very large banks on both sides of the Atlantic. Moody's actions reflect a general concern by private credit rating services.

Analysts are not viewing these downgrades as anything but bad news. Phllipe Boderau of Pacific Investment Management in London stated: "I'd like to say the views of the rating agencies don't matter anymore but, unfortunately, they do. This is a setback for the banks, particularly when you consider how much progress they have made in making themselves safer and more transparent."

Huw van Steenis, a banking analyst at Morgan Stanley in London, notes: "The more the cost of wholesale funding goes up, the more likely it is that banks will want to retreat closer to a loan- to-deposit ratio of one. That adds to the intense pressure to deleverage, which will be a drag anchor on European economic recovery."

The interconnectivity of banks and governments compounds the problem of these credit reductions. When the sovereign debt of government bonds of European nations is downgraded, then the value of those bonds as assets in bank portfolios drops, when means that the asset-to-debt ratio of banks holding the sovereign debt of these nations drops too and the ability of the banks to loan money shrinks (or the credit rating of banks which continue to have loans at the same monetary level is downgraded).

Banks also hold assets in the form of various corporate security interests such as stocks and bonds. The general decline economically caused by the sovereign debt crisis in Europe means that the value of these assets drops too. Stock loses market value and debt instruments of private corporations held by banks is downgraded.

The light at the end of the tunnel, if there is any, is faint and very far away.