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BofA, Wells Fargo Cut by Moody's on Waning U.S. Support (2)
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(Updates with analyst's comments starting in fifth paragraph.)

By Hugh Son, Dakin Campbell and Donal Griffin

Sept. 21 (Bloomberg) -- Bank of America Corp. and Wells Fargo & Co. had long-term credit ratings downgraded by Moody's Investors Service, which said U.S. support has become less likely if lenders get into financial trouble.

Citigroup Inc.'s short-term rating also was cut by Moody's, which said today "there is an increased possibility that the government might allow a large financial institution to fail, taking the view that contagion could be limited." Citigroup's stand-alone credit has improved, Moody's said in a statement, leading the service to confirm the bank's long-term rating.

The downgrade questions whether the largest banks will always be "too big to fail," a status conferred in 2008 when they received government rescues to keep the financial system from collapsing. Lawmakers have since overhauled regulations to head off a repeat of the bailouts and ordered regulators to set up a system for seizing and dismantling banks that founder.

Bank of America, the biggest U.S. lender by assets, had its ratings cut two levels to Baa1 from A2 for long-term senior debt, and to Prime-2 from Prime-1 for short-term debt, Moody's said. The outlook for long-term senior ratings at the Charlotte, North Carolina-based company remains negative, indicating another cut may be ahead.

Litigation Costs

"It makes sense they would get hit the hardest; there are real questions about Bank of America's assets and the extent of their litigation liabilities," said Michael Shemi, a director at Christofferson, Robb & Co., a New York-based firm with $1.4 billion in assets that invests in credit markets.

Bank of America was the day's worst performer in the Dow Jones Industrial Average, falling 7.5 percent to $6.38 at 4 p.m. in New York Stock Exchange composite trading. New York-based Citigroup slipped 5.2 percent to $25.52, while San Francisco- based Wells Fargo dropped 3.9 percent to $23.71.

Wells Fargo's senior debt was downgraded one level to A2 from A1, according to a Moody's statement. The outlook remains negative on the senior long-term ratings.

Citigroup had its short-term credit ratings cut to Prime 2 from Prime 1. Moody's confirmed the lender's A3 long-term rating, and the A1 long-term and Prime-1 short-term ratings of Citibank N.A., saying the bank's stand-alone credit profile had improved. Liquidity has "strengthened significantly in the past two years and is robust," Moody's said.

U.S. Support

The three firms benefited more than others from underlying government support, according to Moody’s. Five other banks have ratings that include the assumption of some support from the U.S., according to Moody’s: JPMorgan Chase & Co., the second- biggest U.S. bank, Morgan Stanley, Goldman Sachs Group Inc., State Street Corp. and Bank of New York Mellon Corp. These firms aren’t under review, said Abbas Qasim, a Moody’s spokesman.

Moody’s isn’t abandoning the idea of government help, saying in its Citigroup statement that the rating’s new assumptions represent a pre-crisis level of support. The rating for Bank of America now incorporates two levels of “uplift due to systemic support, down from four notches previously,”
Moody’s wrote.

Bank of America was unprofitable in three of the four quarters ended June 30 as Chief Executive Officer Brian T.
Moynihan, 51, booked more than $30 billion in charges tied to soured mortgages.

Mortgage Disputes

The lender dropped by about half this year in New York trading as Moynihan settled disputes over defective loans. Under so-called representation and warranty clauses, mortgage bond investors can demand that the bank buy back any loans based on faulty information about borrowers and properties.

“The risk to Bank of America, which has clearly generated a lot of litigation and reps and warranties, is particularly significant,” David Fanger, a senior vice president with Moody’s, said in an interview. “We don’t see those adverse outcomes as significant for a Wells Fargo or a Citigroup, given the different mixes” of loan holdings.

Bank of America disputed Moody’s decision.

“Our ratings should be higher,” the company said in a statement. Still, “to minimize any potential impact of this decision on our business, we have been managing our liquidity carefully and we have prefunded our planned borrowing needs for the year.”

Impact of Downgrade

While Moody’s said Bank of America has made “significant progress” in improving its capital levels, it didn’t upgrade the firm’s stand-alone ratings because of continuing risks from mortgage operations.

Lower ratings could weaken liquidity, limit access to credit markets and pressure businesses that rely on trading revenue, the bank said in an Aug. 4 regulatory filing. A downgrade by one level at all rating firms could trigger demands for $1.5 billion in collateral and termination payments tied to derivatives and trading agreements as of June 30, the bank said.

The impact of Moody’s decision by itself “at this point is unknown,” said Jerry Dubrowski, a spokesman for the bank. The bank had about $400 billion in liquidity at midyear, enough for two years without going to the markets, he said.

The downgrades may not have a significant impact on banks’ day-to-day funding, said Nancy Bush, an analyst and contributing editor at SNL Financial, the bank-research firm in Charlottesville, Virginia.

Slack Demand

"The irony is that no one needs funding right now, they have all the funding they need," Bush said. "Moody's downgraded in an environment in which the banks are so much stronger than in 2008."

The cost to protect Bank of America's debt from default for five years jumped to 380 basis points at 12:38 p.m. from 340 before the downgrade, according to broker Phoenix Partners Group. Credit-default swaps, which typically fall as investor confidence improves and rise as it deteriorates, pay the buyer face value if a borrower fails to meet its obligations, less the value of the defaulted debt. A basis point equals $1,000 annually on a contract protecting $10 million of debt.

Bank of America's $2 billion of 5 percent notes due in May 2021 tumbled 1.65 cents on the dollar to 93.10 cents with a yield of 5.95 percent, according to Trace, the bond-price reporting system of the Financial Industry Regulatory Authority.

Wells Fargo, led by CEO John Stumpf, 58, has repaid $25 billion in U.S. funds and built capital to meet regulatory thresholds and guard against further declines in housing prices.

In March, regulators gave the bank permission to increase its dividend to 12 cents a share and buy back 200 million shares.

Bank of America has also repaid $45 billion in bailout funds.

Systemic Support

Moody's decision "solely reflects a change in their assumption regarding systemic support," Wells Fargo said in a statement.

Citigroup, the third-biggest U.S. bank, posted $29.3 billion in losses tied to subprime mortgages for 2008 and 2009 combined and took a $45 billion bailout from taxpayers, which has since been repaid. Under CEO Vikram Pandit, the bank has since sold troubled assets and returned to profitability.

"We completely disagree with Moody's change to Citigroup's short-term rating," Citigroup said in a statement. "It does not accurately reflect the significant progress Citi has made since Moody's last rated Citi more than two and a half years ago."

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