

Implications of Potential Ratings Downgrades to Banks as Counterparties (5/10/2012)

Given the continued volatility in the Eurozone, European banks have been downgraded in recent months and are at risk for additional downgrades by one or more of the nationally recognized statistical rating organizations (NRSROs). U.S. bank ratings have also been lowered, or are at risk of downgrade, due in part to the impact of a weak global economy on their earnings prospects, as well as their exposure to the sovereign debt of Eurozone countries. In addition to the fundamental issues related to their core banking operations, the lower ratings could force banks to post additional collateral or possibly face the unwind of related derivatives transactions.

The latter could also impact insurers with respect to their derivatives exposure. Certain state laws require that derivative counterparties (i.e., banks) maintain a minimum credit rating. That is, insurers are not permitted to enter and have exposure to derivative transactions with counterparties that do not meet a minimum rating threshold. Upon the downgrade of a counterparty's rating below the minimum threshold, to be in compliance with applicable state laws, the insurer may be required to terminate, or unwind, any derivative transaction with the counterparty or request a waiver for the said requirement from the regulator. A forced unwind would result in the insurer having to replace the counterparty with one that is "approved" by applicable state law in terms of minimum rating requirement, among other factors, or abandon the derivative transaction altogether, either of which could be costly. Given that approximately 90% of the insurance industry's derivative transactions are used for hedging purposes, there are additional implications from a risk-management standpoint.

Therefore, the states should be cognizant of their applicable derivatives use laws and the potential impact of bank ratings downgrades. In addition, other bank-related investments that might be linked to ratings or have minimum counterparty ratings requirements, such as letters of credit, might also be impacted by the potential for lower bank ratings. The NAIC Capital Markets Bureau will continue to monitor any related trends pertaining to this topic.