TD Economics

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Data Release: Credit rating agency Standard and Poor's downgrades several euro zone sovereigns

- Credit rating agency Standard and Poor's (S&P's) yesterday lowered the long-term sovereign ratings on Cyprus, Italy, Portugal, and Spain by two notches; lowered the long-term sovereign ratings on Austria, France, Malta, Slovakia, and Slovenia, by one notch; and affirmed the long-term sovereign ratings on Belgium, Estonia, Finland, Germany, Ireland, Luxembourg, and the Netherlands.
- The outlooks on the long-term ratings on Austria, Belgium, Cyprus, Estonia, Finland, France, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovenia, and Spain are negative. The negative outlook reflects S&P's belief that there is at least a one-in-three chance that these ratings will be lowered in 2012 or 2013.
- The outlooks on the long-term ratings on Germany and Slovakia are stable.
- All ratings have been removed from CreditWatch, where they were placed with negative implications on Dec. 5, 2011 (except for Cyprus, which was first placed on CreditWatch on Aug. 12, 2011).

Key Implications

Immediate repercussions:

- In terms of collateral haircuts at the European Central Bank, S&P's sovereign downgrades will have no impact because the ECB considers the best available credit assessment to assign haircuts. In other words, it would take downgrades by the remaining three credit rating agencies (i.e., Moody's, Fitch, and DBRS) to put any of these sovereigns at risk of falling to a lower quality collateral category at the ECB. Even under that scenario, only Italy would have crossed the threshold and fallen into a higher haircut category. Therefore, regarding liquidity operations with the ECB, the additional costs for banks tapping the ECB liquidity lines will come in the form of larger margin calls due to rising yields, but not from higher haircuts.
- Regarding the immediate impact of yesterday's downgrades on European banks balance sheets, it will again depend on the relative changes on sovereign yields as a result of the downgrades. Those institutions with large exposures to downgraded sovereigns will be under pressure when European stock markets re-open on Monday. However, we have to keep in mind a couple of mitigating factors. First, holdings of those sovereign bonds that have not been downgraded will likely see valuations rise, which will counter the negative impact of the downgrades. Second, sovereign bond holdings being marked by banks as hold-to-maturity are, for accounting purposes, shielded from the fall-out of the downgrade. Those positions will not suffer the erosion caused by higher yields.
- Another key element to monitor in the coming weeks will be S&P's action on the credit rating of the European Financial Stability Facility (EFSF). At the time of announcing the credit review on December 5, S&P's had signaled the EFSF would be downgraded by the same number of

notches as France. John Chambers, chairman of S&P's sovereign rating committee, yesterday said that preserving the EFSF triple-A status would require the four remaining AAA-rated guarantors to increase their commitments. Such a move will find a lot of resistance in those countries.

- If the EFSF loses its triple-A rating, its funding costs will rise, making the bail-out programs for Greece, Ireland, and Portugal more onerous. How sizeable this effect will be remains to be seen. A priori, one could speculate that eligibility rules similar to those utilized by the ECB to assign haircuts would still allow many institutional investors to keep their holdings of EFSF debt, and more importantly, to continue buying fresh EFSF issuance in the near future. Therefore, the impact on EFSF funding costs might not be very dramatic in the short term.
- In all, the immediate repercussions of today's rating actions will end the lull induced by the Holidays' break, but tensions in sovereign bond markets and the European banking system could still remain within the ranges recently observed. This would likely require the ECB stepping up its SMP purchases in secondary bond markets in the coming days to prevent a sharp escalation in yields.

Short-term

- Today's S&P's rating action coincided with the temporary suspension of negotiations between Greece and private bondholders on the Greek debt swap. If the details on the debt exchange are not finalized by the end of this month, it will be very difficult to implement it before a large Greek debt redemption on March 20. This increases the risk of a unilateral Greek default. There is also the risk that a deal is finalized, but it achieves less than universal participation. In that case, it will be up to Greece's euro zone partners to increase their contributions in order to prevent the second bail-out program from unraveling. Today's downgrades make the latter a more remote possibility. It is hard to imagine political leaders in France, Italy and Spain (the larger EFSF guarantors after Germany) could secure domestic support for a larger Greek bail-out at the same time they will be calling for deeper fiscal adjustments at home.
- The continued escalation of the sovereign debt crisis will further complicate the challenges European banks are facing to comply with higher capital ratios by midyear. Raising fresh capital is proving extremely difficult for most European banks. This leaves shrinking bank assets as the only viable alternative, but one that will accelerate the economic slowdown across the euro zone.
- Against this backdrop, the common currency area is headed for a recession this year. Developments in the coming weeks will likely reaffirm our view that euro zone GDP will contract by around 1.2% in 2012.
- In short, be ready for rising financial volatility in the short term, and for things in Europe to get worse before they get better.

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Country	To (Long Term / Outlook / Short Term)	From (Long Term / Outlook / Short Term)
Germany	AAA / Stable / A-1+	AAA / Watch Neg / A-1+
Finland	AAA / Negative / A-1+	AAA / Watch Neg / A-1+
Luxembourg	AAA / Negative / A-1+	AAA / Watch Neg / A-1+
Netherlands	AAA / Negative / A-1+	AAA / Watch Neg / A-1+
Belgium	AA / Negative / A-1+	AA / Watch Neg / A-1+

Estonia	AA- / Negative / A-1+	AA- / Watch Neg / A-1+
Ireland	BBB+ / Negative / A-2	BBB+ / Watch Neg / A-2
One-Notch Downgrades		
Austria	AA+ / Negative / A-1+	AAA / Watch Neg / A-1+
France	AA+ / Negative / A-1+	AAA / Watch Neg / A-1+
Slovenia	A+ / Negative / A-1	AA- / Watch Neg / A-1+
Slovak Republic	A / Stable / A-1	A+ / Watch Neg / A-1
Malta	A- / Negative / A-2	A / Watch Neg / A-1
Two-Notch Downgrades		
Spain	A / Negative / A-1	AA- / Watch Neg / A-1+
Italy	BBB+ / Negative / A-2	A / Watch Neg / A-1
Cyprus	BB+ / Negative / B	BBB / Watch Neg / A-3
Portugal	BB / Negative / B	BBB- / Watch Neg / A-3