



Standard & Poor's Downgrade of U.S. Government Long-Term Debt

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Summary

On August 5, 2011, Standard & Poor's (S&P) lowered the credit rating of long-term U.S. government debt from AAA (the highest possible rating) to AA+. The downgrade reflects S&P's judgment that (1) the recent Budget Control Act (P.L. 112-25) falls short of what is needed to stabilize the government's fiscal situation and (2) the capacity of Congress and the Administration to deal with the debt has become less stable, effective, and predictable.

A ratings downgrade is meant to signal the market that an issuer of bonds or other debt securities is less likely to repay interest or principal. In municipal and corporate bond markets, in which investors may choose among many similar debt issues, a downgrade usually leads to higher borrowing costs, as investors demand higher interest rates to compensate for greater perceived risk. U.S. Treasury securities, however, play a unique role in the global financial system, meaning that past experience with downgrades of private or government debt may not apply.

U.S. government bonds have long been considered the "risk-free" baseline against which other investments are measured; they are a global "safe haven" during financial crises; they serve as collateral in a wide range of financial transactions; they are held by many financial institutions around the world, including central banks. Even if holders of Treasury debt wished to switch to other debt instruments, no immediate substitute is available in many cases.

The long-term impact is difficult to gauge. There may be no visible effects, at least in the short run. Many in the market could question whether S&P has special insight into U.S. political dynamics. Hundreds of billions in Treasury securities change hands daily, and each trade represents a judgment about default risk (among many other things). During the recent debt ceiling negotiations, Treasury yields did not rise significantly, nor was there any flight from Treasuries during the first trading sessions after the downgrade.

On the other hand, the downgrade may be a step in a gradual process that erodes the United States' central position in the global financial system and the dollar's role as reserve currency. These developments could make the process of dealing with the U.S. budget and trade deficits more difficult.

The downgrade has implications for other debt markets, but is not likely to produce sudden, disruptive changes. Mutual and money market funds that hold Treasuries may suffer slight losses in value, but it does not appear that the loss of a AAA rating in itself will mandate large amounts of forced selling by these institutions or other investors such as pension funds. S&P also downgraded bonds issued by entities linked to the Treasury, including the Federal Home Loan banks, the Farm Credit System, and Fannie Mae and Freddie Mac. Borrowing costs at those institutions are subject to the same uncertainty that applies to the U.S. Treasury.

Bank regulators issued a statement on August 5, 2011, that depository institutions will not be required to hold more capital to offset greater perceived riskiness of Treasury securities.

The effect on consumer and business interest rates depends on what happens to Treasury interest rates. Many private borrowers pay rates that are implicitly or explicitly linked to Treasury rates; if Treasury securities pay higher interest, mortgage, credit card, automobile, and business loans are likely to become more expensive as well. But the downgrade alone need have no effect on those rates.

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On August 5, 2011, Standard & Poor's (S&P), a prominent credit rating agency, lowered the rating of long-term U.S. government debt from AAA to AA+.¹ The lowered rating reflects S&P's view that the risk that holders of U.S. debt will not receive interest and principal in a timely fashion has increased slightly. In the view of S&P's analysts, the recent debt ceiling agreement passed by Congress (P.L. 112-25, the Budget Control Act of 2011) "falls short of the amount that we believe is necessary to stabilize the general government debt burden by the middle of the decade," and (more generally) "America's governance and policymaking [has become] less stable, less effective, and less predictable than what we previously believed."²

In municipal and corporate debt markets, in which investors may choose among many similar bonds, a ratings downgrade usually leads to higher borrowing costs for the affected firm or governmental entity, as investors demand higher interest rates to compensate for higher perceived risk.³ With U.S. Treasury securities, however, the effect of a downgrade is not straightforward, because Treasuries play a unique role in the global financial system. U.S. government bonds have long been considered the "risk-free" baseline against which other investments are measured; they serve as collateral in a wide range of financial transactions; they are held by many financial institutions around the world, including central banks that use them in monetary policy and exchange rate operations; and they serve as a "safe haven" during financial crises. Even if holders of Treasury debt wished to switch to other debt instruments, no immediate substitute is available in many cases. Thus, the impact of the downgrade is hard to gauge.

This report provides basic background information on Standard & Poor's and other credit rating firms and analyzes the implications of the downgrade for U.S. government finances and for the markets at large.

The Credit Rating Agencies

Credit rating agencies, of which S&P, Moody's Investors Service, and Fitch Ratings are the largest, are private firms that issue ratings for thousands of bonds and other debt instruments. Ratings consist of letter grades backed by analysis of the creditworthiness of debt issuers. Although there is no legal requirement that issuers of bonds obtain a credit rating, investors place considerable reliance on the judgment of the rating agencies, and they have done so since the mid-1800s.

The rating agencies were unregulated until the Credit Rating Agency Reform Act of 2006 (P.L. 109-291), which was enacted partly in response to the rating agencies' failure to warn investors of the impending collapse of firms like Enron and WorldCom.⁴ The 2006 act requires certain rating agencies to register with the Securities and Exchange Commission (SEC) as "nationally

¹ "Research Update: United States of America Long-Term Rating Lowered To 'AA+' On Political Risks And Rising Debt Burden; Outlook Negative," August 5, 2011, available online at <http://www.standardandpoors.com/home/en/us>. The downgrade applies only to "long-term" instruments, those with maturities of one year or more. S&P continues to rate U.S. short-term debt at the highest level.

² *Ibid.*, p. 3.

³ For example, over the first half of 2011, bonds rated AAA by Moody's Investors Service, S&P's leading competitor, yielded on average 0.13 percent less than bonds rated AA. (Figures obtained from Global Financial Data.)

⁴ See CRS Report RS22519, *Credit Rating Agency Reform Act of 2006*, by Michael V. Seitzinger.

recognized statistical rating organizations” (NRSROs) and to comply with various governance and disclosure requirements.

Congress amended rating agency regulation with the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203), again in response to a perceived failure—this time related to bonds backed by subprime mortgages that were initially rated AAA, but suffered extremely high losses, helping to trigger the 2007-2009 financial crisis. Dodd-Frank mandated new disclosures about rating methodology and performance, increased legal liability for mistaken ratings, created a new system for assigning ratings of complex asset-backed bonds, and required federal agencies to remove references to credit ratings from their regulations.⁵

Although NRSRO operations are now extensively regulated, neither the content of ratings nor the methodology used to determine ratings is subject to government regulation. Thus, there is no governmental authority to challenge S&P’s rating actions.

The other major NRSROs, Moody’s and Fitch, have not issued a downgrade. They have, however, issued statements of concern regarding the creditworthiness of the United States. Moody’s, on August 2, 2011, confirmed the AAA rating for Treasury securities but assigned a “negative outlook.” Moody’s indicated the possibility of a downgrade if “(1) there is a weakening in fiscal discipline in the coming year; (2) further fiscal consolidation measures are not adopted in 2013; (3) the economic outlook deteriorates significantly; or (4) there is an appreciable rise in the US government’s funding costs over and above what is currently expected.”⁶

Fitch indicated in June 2011 that it would place U.S. debt on “Rating Watch Negative,” indicating the possibility of a downgrade, unless the debt ceiling were raised by August 2. In the wake of the Budget Control Act, Fitch issued a statement that “despite the intensity and theatre of political discourse in the United States, there is the political will and capacity to ultimately do the right thing. In Fitch’s opinion, the agreement is an important first step but not the end of the process towards putting in place a credible plan to reduce the budget deficit to a level that would secure the United States’ ‘AAA’ status over the medium-term.”⁷

What the Change Means

According to S&P, an issuer of debt rated AAA has an “extremely strong capacity to meet its financial commitments,” whereas AA issuers have “very strong” capacity. The two differ “only to a small degree.”⁸ Because the United States’ rating is now AA+, the degree of additional risk signaled by the rating change is very small.⁹ The rationale for the change appears to be

⁵ The process of removing references to ratings is underway, but not complete. Examples of such references include risk-based bank capital requirements, in which the amount of capital a bank must hold against a bond is determined by an NRSRO rating. Dodd-Frank also repealed certain statutory references to ratings, such as the prohibition on federally insured thrift institutions owning bonds rated below investment grade by an NRSRO.

⁶ Moody’s Investors Service, “Moody’s Confirms US Aaa Rating, Assigns Negative Outlook,” August 2, 2011.

⁷ Fitch Ratings, “Fitch Comments on U.S. Debt Ceiling, Deficit Reduction Agreement & Sovereign Rating,” August 2, 2011.

⁸ Standard & Poor’s, *General Criteria: Understanding Standard & Poor’s Rating Definitions*, June 3, 2009, p. 11, available at http://www2.standardandpoors.com/spf/pdf/products/Ratings_Definitions.pdf.

⁹ The plus sign here means the same as it does on a school grade: AA+ is between AA and AAA. The AA+ rating includes a “negative outlook,” meaning that it might be reduced to AA unless the fiscal situation stabilizes.

qualitative—S&P's opinion about the prospects for political action to change the government's long-term debt path—rather than quantitative. S&P acknowledged that its initial calculations used an inappropriate Congressional Budget Office measure (an “alternate,” rather than “baseline” estimate of future discretionary spending), resulting in a \$2-trillion error, but declined to reconsider the rating change when Treasury analysts noticed the mistake.¹⁰

Thus, the downgrade does not convey any new information to the markets about the U.S. fiscal situation, beyond the pessimism of S&P's analysts themselves. In the context of unsettled global financial markets, however, the historically unprecedented downgrade may affect the confidence and perceptions of market participants and bring changes that are difficult to anticipate. Specific market sectors are linked to the Treasury bond market in different ways.

U.S. Borrowing Costs

One fear arising from the downgrade is that borrowing costs for the U.S. government would have to rise to compensate investors for added risk in holding Treasuries. Such an increase in interest rates could add significantly to the government's debt burden, worsening the fiscal picture. On Monday, August 8, 2011, the first trading day after the downgrade announcement, however, the yields on 10-year Treasury bonds fell; investor interest in buying them remains strong. The secondary (or resale) market for Treasury securities is very active—over half a trillion dollars per day—and each transaction represents a judgment about the government's creditworthiness. Many factors besides ratings affect bond prices, but the impact of a ratings change is generally greater when the issuer is relatively unknown to investors and where there is not an active secondary market producing a constant stream of price information. The downgrade may push yields up in the weeks to come, but S&P's action did not trigger an immediate flight out of Treasuries.

Even in the long run, a lower rating may not lead to higher borrowing costs. Japan was downgraded to AA in 2002, but its government bond yields remained low, well below those of the United States.¹¹ Of course, comparisons between Japan, the United States, and other nations are not simple.

Additional Downgrades of Government-Related Debt

The S&P ratings of most corporate and municipal securities were unaffected by the downgrade.¹² On August 8, 2011, however, S&P announced downgrades of several entities related to the U.S. government, all from AAA to AA+.¹³ Those affected were “agency” securities, obligations of the Federal Home Loan Banks, the Farm Credit System, and Fannie Mae and Freddie Mac. This action is because S&P views these entities as very likely to receive government support should

¹⁰ See Standard & Poor's, “Standard & Poor's Clarifies Assumption Used On Discretionary Spending Growth,” August 6, 2011, available at <http://www.standardandpoors.com/ratings/us-rating-action/en/us/>, and John Bellows, “Just the Facts: S&P's \$2 Trillion Mistake,” *Treasury Notes*, August 6, 2011, available at <http://www.treasury.gov/connect/blog/Pages/Just-the-Facts-SPs-2-Trillion-Mistake.aspx>.

¹¹ Over the past decade, the yield on U.S. 10-year bonds has averaged 4.00%; for Japanese government 10-year bonds, the figure is 1.38%. (Figures from Global Financial Data.)

¹² Standard & Poor's, “Credit FAQ: Understanding Ratings Above The Sovereign,” August 8, 2011, available at <http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245316629788>.

¹³ Standard & Poor's, “Ratings on Select GREs And FDIC- and NCUA-Guaranteed Debt Lowered After Sovereign Downgrade,” August 8, 2011, available <http://www.standardandpoors.com/home/en/us>.

they encounter financial difficulties. (In the cases of Fannie and Freddie, the promise of support was made explicit when those firms were placed under government conservatorship in 2008.) As a result, their creditworthiness is linked to that of the U.S. Treasury. The impact of the downgrade on their borrowing costs is subject to the same uncertainty as the impact on U.S. debt.

In addition, certain bond issues guaranteed by the Federal Deposit Insurance Corporation and the National Credit Union Administration (as part of emergency programs related to the financial crisis) were downgraded. These downgrades simply reflect the U.S. sovereign downgrade, rather than any new information about the affected debt instruments or the issuers. Certain structured finance instruments backed by government-insured student loans or government leases were also downgraded or given negative outlooks.

Downgrades of Insurers

On August 8, 2011, S&P downgraded five large U.S. insurance groups from AAA to AA+. ¹⁴ The firms were Knights of Columbus, New York Life, Northwestern Mutual, Teachers Insurance and Annuity Association of America (TIAA), and United Services Automobile Association (USAA). The downgrades occurred because these insurers' businesses and assets are highly concentrated in the United States and they have significant holdings in U.S. Treasury and agency securities. Five other insurance groups had their AAA ratings reaffirmed.

Impact on Bank Capital

Federally insured depository institutions hold more than \$300 billion in Treasury securities. ¹⁵ Under the Basel international capital accords, they are required to maintain capital in proportion to the riskiness of their assets. The downgrade to AA+, however, should not have an immediate impact because the Basel II standards assign a zero risk weight to sovereign debt rated AAA through AA-. In addition, many U.S. banks still follow the Basel I standards, which treat all government debt as risk-free.

On August 5, 2011, the same day as S&P's downgrade announcement, the federal banking agencies issued a guidance stating that the risk weights for Treasury securities and other securities issued or guaranteed by the U.S. government, government agencies, and government-sponsored entities would not change. ¹⁶

If yields on newly issued Treasuries were to rise significantly, banks could be forced to raise new capital, even though the regulators did not insist on treating Treasuries as more risky. A rise in interest rates paid by new bonds makes other bonds less valuable. Banks that are publicly traded and subject to SEC accounting rules would have to recognize the loss in value to their Treasury bond portfolios on their financial statements: the fall in asset value would erode banks' capital position. ¹⁷

¹⁴ Standard & Poor's, "Rating Actions Taken On 10 U.S.-Based Insurance Groups Following Sovereign Downgrade," August 8, 2011, available at <http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245316596970>.

¹⁵ Federal Reserve, *Flow of Funds Accounts*, Table. L.209. Latest available figure is end of 1st quarter, 2011.

¹⁶ "Agencies Issue Guidance on Federal Debt," Joint Press Release, August 5, 2011, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20110805a.htm>.

¹⁷ Capital, in the simplest formulation, equals assets minus liabilities. During the crisis, the need for new capital (continued...)

On August 8, 2011, S&P announced that its downgrade of U.S. debt would not have an “immediate or direct impact” on its ratings of U.S. banks.¹⁸

Investment Funds

Another concern is that the downgrade may trigger forced selling of Treasuries by funds and institutions that are required by law or contract to hold only AAA securities. The volume of affected securities may be relatively modest, however. Mutual funds that invest in U.S. government debt generally commit themselves to holding full faith and credit obligations of the government, rather than debt of any particular rating. Money market funds are required to hold the highest -quality, lowest-risk instruments, but they invest in short-term debt, and U.S. short-term obligations were not downgraded. For pension funds, the most common distinction is between investment-grade debt (which includes AA) and below-investment-grade. Unless a substitute for Treasuries can be found, in comparable quantities, there is unlikely to be a flight away from Treasuries to safer investments.

Collateral and Margin

Treasury securities are used extensively as collateral in a number of major financial markets, including the repurchase (repo) market, which is a source of short-term financing for many financial and nonfinancial businesses, and derivatives markets, in which traders speculate on financial variables, such as stock and commodity prices, and hedge business risk arising from those same variables. A repo transaction involves a short-term loan with a Treasury security pledged as collateral. Many derivatives traders are required to post margin payments to cover their potential losses; Treasury securities are a favored form of margin because they allow traders to earn a small return on their margin accounts. The amount of Treasuries employed in these markets may be as high as \$4 trillion.¹⁹

The downgrade may lead market participants to insist that Treasuries receive a “haircut” in these transactions. This would imply that the amount of money loaned against a Treasury bill would be discounted relative to face value, or that traders would have to post more Treasury securities to control a given derivatives position. (Collateral terms in these markets are generally not regulated, but are set by private contracts.) Either change would raise transaction costs in these markets: in the repo market, short-term borrowing costs would rise slightly, and the cost of hedging or speculating with derivatives would also go up. The extent of the change depends on the extent to which market perceptions of the riskiness of Treasury securities change.

(...continued)

triggered asset sales, which further depressed asset prices, leading to new demands for capital. An extreme spike in Treasury yields could lead to a similar spiral, absent federal intervention.

¹⁸ Standard & Poor's, “U.S. Bank Ratings Are Unaffected By The Downgrade Of The Sovereign” August 8, 2011, available at <http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245316617263>.

¹⁹ Damien Paletta and Matt Phillips, “S&P Strips U.S. of Top Credit Rating,” *Wall Street Journal*, August 6, 2011.

Consumers and Businesses

Some consumer rates are explicitly tied to Treasury rates—some adjustable rate mortgages, for example, are set at a fixed premium over the yield of Treasury bonds of a given maturity. Many other rates in which there is no formal link still reflect changes in Treasury yields, which serve as a benchmark for the risk-free return. Within this framework, the following observations about the impact of the downgrade on consumer and business interest rates are possible:

- the downgrade does not automatically imply higher rates for business and consumer borrowers;
- only if the downgrade leads to a significant increase in Treasury rates will there be a significant impact on consumer and business borrowing costs; and
- a long-term shift away from the use of Treasuries as a benchmark for other rates could change the way interest rates are determined, but what the effect would be on the availability and cost of credit is uncertain.

The downgrades of Fannie Mae and Freddie Mac, which provide financing for over half of U.S. home mortgages, could cause a rise in mortgage rates if those institutions face higher borrowing costs. However, because Fannie and Freddie are now explicitly backed by the U.S. Treasury, it is not clear that their cost of credit will rise unless Treasury rates also rise.

The Longer-Term Outlook

In the long run, the status of Treasury bonds depends on the success or failure in dealing with long-term budget problems. The Standard & Poor's downgrade is a single step in what may be a long process. In the intermediate term, two scenarios seem most plausible.

First, the markets may shrug off the downgrade. Does S&P have any special information about the U.S. political situation that others lack? While the rating change comes in a period of financial uncertainty, including a sharp decline in world stock markets, the initial market response—bidding up Treasury bond prices and lowering yields—suggests at the very least that the downgrade has not brought about any watershed revaluation of U.S. debt. It may be that for some time “Treasuries will remain the world's least ugly safe asset.”²⁰ Again, there is the problem of finding a substitute for Treasuries as a safe-haven store of value.

On the other hand, the downgrade may be part of a gradual shift away from reliance on the United States as the center of the global financial system. According to the head of Pimco, a large bond investment firm, the downgrade “will over time erode the standing of the global public goods [the United States] supplies—from the dollar as the world's reserve currency to its financial markets as the best place for other countries to deposit savings. This will weaken the effectiveness of the [United States] as the global anchor, accelerating the unsteady migration to a multipolar system.”²¹ Foreigners now hold trillions in Treasury debt—their perceptions and actions will have significant implications for the value of Treasury securities and the cost of financing that debt. Reserve currency status gives the United States access to cheaper financing

²⁰ Nouriel Roubini, “Mission Impossible: Stop Another Recession,” *Financial Times*, August 8, 2011, p. 9.

²¹ Mohamed El-Erian, “Downgrade of U.S. Debt Rating Heralds a New Era,” *Financial Times*, August 8, 2011, p. 9.

and the ability to borrow in its own currency; loss of that status could raise the cost of borrowing from abroad. But the long-run position of the United States in the global economy depends more on fiscal and economic developments than rating agency decisions.

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