Moody’s Fires a Shot Across the Bow of U.S. Treasuries by Considering Downgrade – Implications for Stable Value Funds
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On September 11, 2012 Moody’s provided an update on the outlook for the US Government’s credit rating. In this update, Moody’s stated that budget negotiations in 2013 will likely determine the direction of the US government’s current Aaa rating, with negative outlook. The scale of any potential downgrade seems to be limited, as Moody’s indicated it would probably expect to lower the rating to Aa1. This would put Moody’s rating on par with the equivalent S&P rating, following that agency’s downgrade of the US Government’s credit rating in August of last year.

The only way to avoid this move by Moody’s seems to be if the specific policies that result from the budget negotiations produce a stabilization and then downward trend in the ratio of federal debt to GDP over the medium term. If this best case scenario plays out, the rating will likely be affirmed and the outlook returned to stable.

While maintaining the current Aaa rating with a negative outlook is also an option, this is not a long term position that Moody’s seems comfortable taking. If the much discussed “fiscal cliff” would actually materialize and become the method used for debt stabilization, Moody’s could defer judgment and maintain its current rating stance into 2014 as it analyzes how the economy recovers from this fiscal shock.

To see two potential paths that the ratio of federal debt to GDP might take, it’s helpful to consider the last CBO projection from August of this year (see chart). While under the CBO’s Baseline projection the federal debt to GDP ratio declines to 58% of GDP in 2022 from 73% in 2012, this is clearly not the baseline that Moody’s is basing its concerns on. In fact, the term baseline seems somewhat misleading. In many other contexts this is usually seen as equivalent to the central, or most likely, case. In the CBO context, the baseline is simply a projection based on the assumption that current laws governing taxes and spending remain in effect. This essentially means that the baseline scenario assumes that the fiscal cliff will occur and the effects of the fiscal cliff will stay in place.

However, the CBO clearly recognizes that political forces are at play and that attempts will be made to maintain certain policies that have been in effect in the current year. The CBO therefore also presents an alternative scenario. Under this alternative scenario, the fiscal cliff is avoided and the CBO makes certain assumptions, including that the expiring tax provisions will be extended indefinitely and that the automatic spending reductions required by the Budget Control Act do not occur, among others.

While avoiding the fiscal cliff, the alternative scenario sees federal debt to GDP rise to 90% by 2022 – a trajectory that clearly is the kind that has Moody’s concerned. In both the baseline and the alternative scenario, the CBO points out that debt levels would be high by historical standards. In short, there is plenty for Moody’s to worry about and with political uncertainty coming into play, it is not surprising that Moody’s is hedging its bets and providing the proverbial “shot across the bow” with its update.

Implications for stable value
The implications of a potential downgrade in the US credit rating for stable value can broadly be put into two categories: impact on the performance of the underlying portfolios and impact on investment guidelines governing stable value funds and contracts.

Given the high allocation of government securities in stable value portfolios, deterioration in the credit fundamentals of these securities is something that should be watched closely by those in the industry.

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Shot Across the Bow

Based on the 16th Annual SVIA Stable Value Investment & Policy Survey, Treasuries and Agencies made up over 20% of the underlying fund asset allocation in stable value. In addition, most mortgage-backed securities are backed by agency mortgages and account for another 20% of stable value’s underlying fund asset allocation.

Given the very low yield environment and the strong performance of Treasury securities over the past few years, clearly the market currently still believes that US Government debt is a good investment. Treasuries actually performed well following the S&P downgrade last year and as such, the implications of a move by credit rating agencies should not be exaggerated. Still, to the extent that a future downgrade by Moody’s would signal a change in market sentiment around the soundness of investing in US debt, this could affect the performance of the portfolios underlying stable value. Given the very low yields on government securities and their strong performance so far, it is clear that further strong upside potential is limited (unless rates turn negative) whereas the room for yields to increase and US debt to start performing more poorly at some point seems much larger. This is not to say that there is no longer term value of investing in US debt and contracts typically require a minimum allocation to US debt. The point is simply that generally all stable value portfolios will have some level of allocation to US debt and this means that these portfolios are sensitive to performance of this asset class to varying degrees.

With current market values in stable value portfolios generally being substantially above book value, there is plenty of cushion in most portfolios to withstand some return drag, which would be difficult to avoid entirely. Also, credit quality should remain largely unaffected in the short run from a change in interest rates alone. Many managers have been running their portfolios at fairly short durations and with elevated cash buffers, making portfolios better equipped to withstand rising rates if they do materialize.

Of course, the exact effects will depend on the magnitude of any change in the performance of US debt and related securities. The bigger issue is how the US debt situation will ultimately play out, possible cross-over effects to other asset classes and the impact on the overall economy.

A prolonged period of strongly rising rates and/or increasing credit spreads would be most challenging. However, this is unlikely to be triggered by the action of a single rating agency that has already conveyed its intentions.

The more immediate impact of a change in credit rating by Moody’s would be on how investment guidelines contemplate handling the situation. While there are several sets of guidelines that could govern a stable value portfolio, for the purposes of this article we will focus on investment guidelines in wrap agreements.

Wrap Agreement Guidelines:
Wrap agreements tend to have detailed requirements around minimum average credit quality and the credit quality for individual holdings and asset classes. Wrap agreements generally require the average credit quality of portfolios to be solidly investment grade, with many agreements requiring a minimum AA average quality. Based on SVIA’s Stable Value Funds’ Quarterly Characteristics Survey, the average credit quality of wrapped stable value assets was slightly above AA at the end of June 2012.

How investment guidelines capture credit ratings can differ, especially with respect to ratings from multiple agencies. Most wrap agreements require at least two ratings, with some requiring three. When ratings differ among ratings agencies, most agreements take the middle rating when there are three ratings and the lower of two when there are two. When S&P downgraded US debt last year, the impact on guidelines was limited since under most guidelines US debt was still considered AAA when following the “middle of three” rule.

If Moody’s were to change their rating to Aa1, as they indicated they might, under many wrap guidelines the assigned rating would drop as well. Depending on the structure of individual portfolios and the required average credit quality, there could be instances where portfolios are pushed out of compliance. In addition, guidelines might prevent any further purchases of government debt as there are minimum “at purchase” requirements. If these state that

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government and related debt has to be purchased at AAA, it effectively shuts off a large part of the market for reinvestment. Wrap providers and managers will have to work through Moody’s downgrade if it occurs, as they did with the S&P downgrade in August 2011. This situation, however, presents more complications as it now involves two of the three major debt rating agencies. They should plan for the possibility ahead of time, so they know how the issue could be addressed. There are several mechanics to address the issue from a guideline perspective; the acceptability of each will depend on the exact circumstance and risk tolerance of the parties involved. Some of the options are highlighted below.

Typically, investment guidelines require a minimum allocation to US government securities. The question for issuers is whether this represents a credit-quality preference, or a sector preference. If it is the latter, then the following three approaches are options:

- Deem US government debt to be rated AAA for guideline purposes, irrespective of the ratings that rating agencies assign to it. The benefit of this approach is that it is relatively straightforward, does not need to be updated for rating agency changes, is fairly easy to implement and can address both the average credit quality and at-purchase issues at the same time. The downside is that it does not contemplate very severe scenarios where deeming the debt AAA is no longer appropriate and exposes a wrap provider to a risk it did not agree to take on.

- Another approach would be to apply the highest rating of three rating agencies. This again would be fairly simple to implement as a guideline change, but obviously only works if Fitch retains its AAA rating on the US, which is also not certain. While this could be a quick stop-gap measure, it’s unlikely to be a good solution.

- A third approach would be to make no guideline changes and let current guidelines govern what needs to occur. This would be easiest from a contractual standpoint as it requires no new agreement to be reached. It could have major consequences for the portfolios, and introduce many complexities. If a portfolio is out of compliance on an average credit quality basis driven by the downgrade, the manager would become a forced seller of lower rated assets while having to find AA or better rated assets to reinvest in. At the same time, if the at-purchase requirement for government debt is AAA, the proceeds from the sold assets could not be used to buy government debt and the manager might be challenged to find enough highly rated securities in other sectors without breaching sector limits. The portfolio would thus probably end up with a large over allocation to cash. Given these

AARP Highlights

for them as they edge toward retirement.” Here’s why:

- 17 percent of the boomers when first surveyed in 2010 were jobless and looking for work.
- 12 percent although reemployed reported that they had been unemployed.
- 40 percent reported experiencing some decline in income.
- 51 percent said they were less secure financially than they had been before the crisis and had experienced difficulty making ends meet.
- 67 percent of boomers had experienced some reduction in retirement savings balances.

As the chart illustrates, the major reasons boomers reported that they had difficulty making ends meet during the recession were an increase in every day expenses, a decline in household income, and extraordinary and unexpected expenses.
% of boomers were uncomfortable with their level of debt.

The report found that whether or not boomers were saving for retirement was highly dependent on their employment status. Half stated they were saving for retirement. The percentage rises to 67 percent for those who were continuously employed but drops to 41 percent for those who have experienced unemployment and declines even further to 17 percent for those who are currently unemployed. While these numbers might seem encouraging given the recession, when boomers were asked about the size of their retirement nest eggs, 51 percent reported balances under $100,000, which is woefully insufficient for most given their proximity to retirement.

For the other half of boomers who reported they were not saving for retirement, 75 percent said they had saved for retirement in the past, but they also reported having saved less than $100,000 in total. While none of the savings statistics were very encouraging, the report found that boomers were aware of the shortcomings of their saving habits and had taken steps to move themselves towards a more financially secure future.

### AARP Highlights

Interestingly, boomers did not give loss or reduction of savings as a reason they had difficulty making ends meet. Some 67 percent of boomers reported some reduction in retirement savings balances during the recession. The 67 percent who reported a reduction in savings balances were also nearly the same regardless of employment status or gender. However, boomers seemed to have weathered this setback surprisingly well since 60 percent also reported that they were somewhat positive about the future of their retirement savings. Further, 10 percent reported that their retirement savings balances had been restored to pre-crisis levels and almost half reported that balances were moving in a positive direction.

The report found that boomers did make efforts to live within their means. In fact, the majority cut back on expenses, withdrew money from a savings account or delayed medical care and/or filling prescriptions. Some 37 percent stopped or cut back on savings for retirement, while 31 percent stopped or reduced non-retirement savings. The chart details the different strategies boomers deployed to live within their means.

The report also focused on how the crisis affected boomers’ attitudes towards debt and savings. The report found 45 percent of boomers were either somewhat or very uncomfortable with their level of debt. For the 15 percent who were jobless that participated in the surveys, the percentage rose to 66 percent that were uncomfortable with their level of debt.

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