THE WALL STREET JOURNAL.

**Regional Banks Get Downgrade And Stocks Edge Down --- Reaction suggests sector remains at risk to problems that stirred spring panic**

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899 words
9 August 2023
The Wall Street Journal
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English


Moody's Investors Service downgraded 10 regional banks, sending bank shares down and renewing concerns about the health of the sector amid higher interest rates and recent failures.

The KBW Nasdaq Bank Index and the SPDR S&P Regional Banking ETF both slipped about 1%.

The Moody's downgrades late Monday hit the regional powerhouse M&T Bank as well as a number of smaller banks. Webster Financial, BOK Financial and Old National Bancorp were among the other banks that Moody's downgraded. Shares of all of those banks traded lower.

The reaction suggests the sector remains vulnerable to the problems that stirred a panic this spring after the failures of several midsize lenders: devalued bonds, jittery investors, deposit withdrawals and higher costs.

"There has been more funding pressure, more deposit pressure in the U.S. banking system than we have seen in a long time," Jill Cetina, Moody's associate managing director and one of the writers on the research report, told The Wall Street Journal.

At the same time, markets broadly are on edge about the possibility of a pullback. Stocks have managed to zoom higher for much of the year, despite a persistent fear about how the Federal Reserve's higher-for-longer interest rates will play out across the economy.

The banking sector has been under particular scrutiny ever since Silicon Valley Bank, Signature Bank and First Republic Bank collapsed earlier this year. The banks were caught flat-footed byhigher interest rates, which have forced lenders to pay more for deposits and weakened the value of their securities and loans. Deposits at many regional banks have stabilized after a hairy first quarter, but investors are still worried.

Bank stocks broadly are down for the year, with the KBW Nasdaq off by 13%. The S&P 500 is up 17% even with last week's decline.

All of the Moody's cuts were by a single notch, and all the banks remain investment-grade. "Big picture, we think that U.S. banks are still very strong," Cetina said.

Moody's said it would review its ratings on several other larger banks, including U.S. Bancorp, Truist Financial, Bank of New York Mellon and State Street.

The firm assigned a negative outlook to PNC Financial Services Group, Citizens Financial Group and Fifth Third Bancorp, among others.

Bank shares were down across the board. Stocks were broadly lower, with the major indexes down.

Shares of megabanks also fell. Bank of America, Citigroup, JPMorgan Chase and Wells Fargo all traded lower.

The Federal Reserve's campaign to lift interest rates to combat inflation "continues to have a material impact on the U.S. banking system's funding and its economic capital," Moody's said in its report.

Higher rates have continued to reduce the value of bonds and other assets owned by regional banks, leaving the lenders with "sizable unrealized losses" and vulnerable to share-price drops if investors get spooked, Moody's said.

Customers have been shifting cash into accounts that pay higher interest, driving up costs for lenders and eroding profitability.

"There remains a significant risk that systemwide deposits will resume their decline in coming quarters," Moody's said.

The biggest banks have been relatively immune from this year's bank crisis. JPMorgan, Wells Fargo and Bank of America all reported higher profits in the second quarter, boosted by their ability to charge more on loans.

And while even the largest banks are paying more in interest to keep yield-hungry customers from yanking their deposits, the extra expense can be hard on smaller banks that often don't have big fee-based businesses to lean on.

"Everybody's kind of feeling that pressure," Terry Dolan, chief financial officer at U.S. Bancorp, said in an interview with The Wall Street Journal last month. "The smaller the bank, you're probably going to have a bit more."

Chris Marinac, director of research at Janney Montgomery Scott, said second-quarter results showed the sector remains sound and that the slump in bank stocks Tuesday reflected a "knee-jerk reaction" to the downgrades.

"There's not fabulous profitability, but they can still make money," he said. "Moody's has now shouted an alarm bell that really isn't anything new."

M&T declined to comment. BOK Financial said the downgrade was driven by factors that influence the broader industry, rather than just the Oklahoma-based bank specifically. The bank said it is "positioned well to compete and grow" and that it didn't expect the downgrade to have a "material impact."

Moody's also pointed to the prospect that a recession in early 2024 could erode demand for loans and lead to loan defaults.

Banks could be hit by problems in commercial real estate, the firm said, including higher interest rates, vacant offices due to the shift toward remote work, and reduced availability of credit.

Shares of European banks also dropped Tuesday after the Italian government announced a windfall tax on local lenders.

If it is passed, local banks would place a one-off levy of 40% on income from higher interest rates.

The Italian bank giant Intesa Sanpaolo shed nearly 9%, its worst session in more than a year. UniCredit fell 6%.

 


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