

June 17, 2009

## Recent Rating Actions Reflect Industry Risk For U.S. Financial Institutions

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# Recent Rating Actions Reflect Industry Risk For U.S. Financial Institutions

Standard & Poor's Ratings Services' June 17, 2009, rating actions on 22 financial institutions reflect the continuation of our broad-ranging reassessment of industry risk for U.S. financial institutions (see "How The Credit-Market Crisis Is Changing The World Of Banking," published Nov. 25, 2008, on RatingsDirect). Specifically, we believe in the future these firms will operate in a less favorable environment than they did during the past. From now on, we expect greater volatility in financial markets during credit cycles and tighter regulatory supervision.

Our overall assessment of the U.S. banking industry incorporates the following key points:

- The industry is now in a transition and will likely undergo material structural changes;
- The loss content of loan portfolios should increase, but recent capital rebuilding should help banks defray these losses;
- Stress tests point to the likelihood of greater losses in the future;
- We don't view regional banks as being highly systemically important;
- Potential losses could increase beyond our current expectations as reflected in the negative outlooks (i.e., a firm's full potential may not be realized).

As a result of the downgrades this week, as well as those since mid-2007, the counterparty ratings on U.S. banks (at the operating subsidiary level) have fallen by an average of two notches, to 'BBB+' today from 'A' before the crisis began in June 2007. We believe the high number of firms with negative outlooks suggests that the ratings could still decline if the credit cycle is longer and/or deeper.

## The Industry Is In Transition

We believe the banking industry is undergoing a structural transformation that may include radical changes with permanent repercussions. Possible changes include increased regulatory oversight, lower profitability, and eventually, higher regulatory capital minimums and stronger governance. Financial institutions are now shedding balance-sheet risk and altering funding profiles and strategies for the marketplace's new conditions. Such a transition period suggests lower ratings as industry players implement changes.

In addition, we have reassessed the relative creditworthiness of many institutions based on their abilities to deal with the increased risks during this transition period. We believe some firms may be better able to weather the risks ahead than others. In the long term, we could foresee ourselves raising ratings if lower earnings and reduced risk are accompanied by stronger risk-adjusted capital and effective governance.

## Losses Have Increased, But Some Capital Rebuilding Should Help Banks

We believe the roots of the current crisis for banks are complex. In brief, we think that competitive dynamics and pressures to produce profits and low-cost and readily available funding led to lax underwriting standards and outsize exposures to some risky asset classes. At the same time, borrowers' appetite for leverage became excessive. Together, these trends appear to have produced a dramatic deterioration in expected loss rates on some loan

types/products, in many cases far more than historical peaks. In addition, the unprecedented and widespread contraction in the funding markets, partly precipitated by investor uncertainty about loss rates in various asset classes, suggests that the liquidity risks confronting financial institutions are much greater than in the past.

The shocks to the financial system undoubtedly contributed to our current expectations of a deeper and more protracted economic slowdown than we had earlier incorporated into ratings. In fact, in December 2008 we lowered our Bank Industry Country Risk Assessment (BICRA) on the U.S. financial system to Group 2 from Group 1. Our BICRA rankings integrate our view of the strengths and weaknesses of a country's banking system compared with those of other countries on a scale ranging from Group 1 (strongest) to Group 10 (weakest). The BICRA downgrade primarily reflects our opinion of the banking systems' ongoing credit deterioration, the need for banks to rebalance their funding profiles, and macroeconomic weakness, among other factors. (See "U.S. BICRA Revised to Group 2 from Group 1 on Increased Credit Deterioration," published Dec. 17, 2008, on RatingsDirect).

To date, most losses have been concentrated in the larger banks' securities portfolios, specifically as these relate to trading assets. These losses have been largely unpredictable, resulting from the mark-to-market of increasingly illiquid securities. Looking ahead, we expect credit losses to come from the more readily predictable loan portfolios, even as mark-to-market issues have not completely dissipated. Some argue that loan portfolios should also be marked to market by front-ending lifetime losses, but that is not our view.

Indeed, we believe the "hold-to-maturity" or accrual accounting method is more appropriate for loans, as it takes into account portfolios' earnings power to cover defaults as they occur. However, even recognizing losses as they occur can create significant earnings volatility and capital erosion. In addition, many banks started this credit cycle with low reserve levels for what we believe their peak losses will be. The need to raise reserves will, in our view, exacerbate earnings volatility during the next two years and intensify the need to bolster capital.

Capital-boosting actions following the government's stress testing were, in our view, a positive development countervailing these negative industry trends (see "The U.S. Federal Reserve's Stress Test Results: The Beginning of the End or the End of the Beginning for U.S. Banks?," published May 12, 2009, on RatingsDirect). These common-equity raises signal banks' renewed access to capital, and will likely act as a buffer against future expected losses. They also improve the quality of capital, which, in our view, had become outweighed with lower-quality hybrid capital.

Without these and earlier capital raisings, ratings would most likely have been substantially lower at least for a handful of institutions. Banks will undoubtedly use some of the fresh capital to absorb losses. However, it remains to be seen whether banks will be willing or required to replenish lost capital to retain higher levels of capital permanently. If we were convinced that banks have entered a new era of permanently higher risk-adjusted capitalization, we would again reassess our view of banks' vulnerability to economic volatility, which is an important element of our assessment of industry risk.

## **Stress Tests Indicate Greater Losses In The Future**

In reassessing our expectations for asset-quality trends for individual financial institutions, as well as the impact of those trends on capital and earnings, we have used stress testing to identify firms that appeared more vulnerable to losses than peers (see "What Stress Tests Reveal About U.S. Banks' Capital Needs," published April 29, 2009, on RatingsDirect). Our published base-case loss rate assumptions are broadly comparable to the more adverse scenario

under the government's Supervisory Capital Assessment Program.

Based on our current assumptions of a severe U.S. recession bottoming in late 2009 with a GDP decline of 3.9% in 2009 and unemployment reaching 9.7%, we believe that all our rated banks (including those not cited in this article) will suffer a total of \$460 billion of loan losses for 2009 and 2010, and \$28 billion of securities losses. Considering reserve builds of \$144 billion, it is very clear that the projected \$512 billion in preprovision operating earnings during these two years will not offset these charges, so that most banks will not be profitable in those years. Capital erosion would lead to additional capital requirements of \$37 billion for 10 banks whose tangible common ratios could fall below 4% of risk-weighted assets if our base-case assumptions materialize.

Our base-case approach forms the basis of our expectations. The results are significantly more negative for the stress case, which includes assumed loss rates that are generally 50% higher than in the base case. We have not incorporated such a stress into our capital analysis or our ratings. Still, it demonstrates the superior balance-sheet strength of the banks that can survive such stress. Stronger banks have lower relative credit risk. Similarly, those that fare particularly poorly in this scenario would naturally tend to have lower ratings than their peers, based on greater credit risk.

In considering the results of the stress tests, we adjusted for some individual banks' superior or inferior performance in various asset classes, as well as other factors that might affect their creditworthiness, including pretax preprovision net revenues, geographic or product concentration, financial flexibility, and the like. We also included a review of toxic assets or vulnerabilities in the securities portfolios on a case-by-case basis.

Importantly, we assessed each bank's performance under stress in relation to its rating category, and assigned an important weight to financial flexibility and likelihood of accessing capital markets effectively. Banks that we expect to perform worse than similarly rated peers merited a more severe downgrade. We also evaluated capitalization under our new risk-adjusted capital framework (see "Methodology And Assumptions: Risk-Adjusted Capital Framework For Financial Institutions," published April 21, 2009, on RatingsDirect), but given its relatively new development, we also considered more traditional capital ratios. We consider the 4% total common equity-to-risk-weighted assets capital ratio to be a minimum to retain an investment-grade rating through a cycle. An 8% level coming out of a down-cycle would be more consistent with a 'AA' rating, in our view.

We considered earnings volatility as well as capital adequacy in the downgrades. For the highest rating categories, we have greater sensitivity for prospective annual losses. Even for the 'A' category, we expect only modest losses in a severe recession. For the bulk of the institutions that could experience two years of substantial losses, individual capital scores are now in the 'BBB' range or lower. Clearly, when a bank expects substantial losses during the next two years, but capital is still sufficient, the score is 'BBB'.

Our rating actions also demonstrate our recognition of the banking business's high confidence sensitivity following the liquidity stresses of 2008. Banks can, in our view, be more vulnerable to liquidity pressures if they rely on funding from noncustomer-related sources. Alternately, they can suffer a flight of clients beyond those that provide them with funding if doubts about their creditworthiness arise. This is particularly acute in certain business activities like investment banking, and trust or derivatives businesses. For this reason we emphasize the importance of core deposit funding, diversity of funding sources, and robust liquidity management. The rapidity and unpredictability with which money-market funding can evaporate means that firms whose liquidity depends on it to a substantial degree may not be able to achieve above-average ratings regardless of their profitability metrics.

## **We Don't View Regional Banks As Highly Systemically Important**

Apart from the standalone characteristics of each bank, we view ongoing system support from government authorities as an essential part of bank creditworthiness in good times and bad (see "External Support Key In Rating Private Sector Banks Worldwide," published Feb. 27, 2007, on RatingsDirect). We believe government supportive intervention will continue to be broadly available to stabilize the sector and restore public confidence. With the exception of Wells Fargo, we do not view these regional banks as highly systemically important (see "Twelve Major U.S. and European Financial Institutions Have Ratings Lowered, Outlooks Revised," published Dec. 19, 2008, on RatingsDirect).

The practical result of this approach is that none of these financial institutions at the group or operating-company level is assigned an issuer credit rating higher than its standalone assessment in the form of uplift in notches. Although we believe Wells would receive government support if it needed it, we do not believe that such highly rated banks are likely to need government support, and therefore do not build in any notches of uplift to our rating on Wells. As of today, only four U.S. financial institutions have received a rating uplift from their standalone assessment: Citigroup Inc., Bank of America Corp., The Goldman Sachs Group Inc., and Morgan Stanley.

## **Negative Outlooks Mean Potential Losses Could Increase**

In accordance with our published criteria, the assessment of stand-alone creditworthiness for each institution reflects not only banks' asset quality, earnings, capital, and funding discussed above, but also the more qualitative issues of risk appetite, risk-management capabilities, strategy, market position, and diversification that comprise financial institutions' business profiles. The business profile expresses the potential ratings level for an institution based on its business mix, market position, management, and strategy.

If, over time, the financial profile does not fulfill the potential expressed in our current assessment of the business profile, then we could lower the ratings. We have generally assigned negative outlooks where we see the greatest discrepancy between the business and financial profile assessments. Ratings reflect our view that the firm can achieve its potential. However, if the financial profile deteriorates, we could reassess our opinions of the business profile, particularly as it relates to risk management and strategy, lowering our expectations of the firm's ability to perform to its potential in the medium term.

During the next year or two, we still expect the ratings trends to be negative as the credit cycle still has the potential to surprise many institutions, particularly those with material credit exposures to higher-risk products and/or the most depressed regional economies, which is incorporated in their respective negative outlooks. In addition, as the financial markets stabilize, extraordinary government support, which has been extended to a wide variety of institutions beyond those that are assessed as highly systemically important, could be scaled back. Those banks that have received higher ratings because of expectations of further government support if needed could converge to a level closer to their standalone profiles at that time, which could be lower than current issuer credit ratings.

As the cycle turns, we will revisit our assessment of industry risk in light of possible structural changes in the industry. If we believe that they result in better risk controls--whether these are imposed internally or by legislation or regulation--and lower volatility of performance, our risk assessment could improve. With it, so will our ratings on individual banks. Another potential positive factor could be that the industry will be required to maintain

permanently higher levels of risk-adjusted capital. Absent an improved assessment of industry risk, a mere cyclical improvement in performance is unlikely to lead to a large number of upgrades.

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