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How The Credit Market Crisis Is Changing The World Of Banking

Primary Credit Analysts:

Tanya Azarchs, New York (1) 212-438-7365; tanya_azarchs@standardandpoors.com
Scott Bugie, Paris (33)1-4420-6680; scott_bugie@standardandpoors.com

Secondary Credit Analysts:

Michael Zlotnik, Frankfurt (49) 69-33-999-150; michael_zlotnik@standardandpoors.com
Rodrigo Quintanilla, New York (1) 212-438-3090; rodrigo_quintanilla@standardandpoors.com
Jayan U Dhru, New York (1) 212-438-7276; jayan_dhru@standardandpoors.com

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How The Credit Market Crisis Is Changing The World Of Banking

Executive Summary

Prospects for the global financial system have rarely looked bleaker than they have for the past four months.

With the credit markets all but shut down and confidence in financial institutions seriously eroded, in Standard & Poor's Ratings Services' opinion, the concerted actions of governments worldwide have been instrumental in pulling the financial system back from the brink of a massive global collapse.

Even if capital markets stabilize, the impact on the real economy--on consumers and corporations--from the contraction in financing and from asset price declines that have already occurred will likely cause more delinquencies and defaults on loans. We expect that, in turn, to bring more earnings and other balance-sheet pressures on banks than they experienced during the troughs of most previous credit cycles.

This damaging series of events is already leading to the most profound changes in the banking industry since the Great Depression. Among the forces that appear likely to alter the nature of the financial services industry significantly are increasing calls for regulation, a wave of bank consolidations as stronger institutions acquire the seriously weakened, and a newfound coordination of global regulatory and central banking initiatives.

These changes, and our view that the global economy's outlook is worsening, are leading us at Standard & Poor's to reassess our view of the creditworthiness of financial institutions. It appears to us that the levels of losses for banks will be much greater than we originally envisioned in our ratings. Thus, our assessment of future industry risk is more pessimistic. In addition, we now believe that funding markets may be prone to periods of illiquidity in the future. Therefore, we are reassessing what we see as the vulnerability of the wholesale-funded banking model.

On the other hand, governments have demonstrated a willingness to provide extraordinary support in the face of the market crisis to a degree that we had not previously anticipated. We will consider all of these factors in a global review of major mature-market financial institutions, which we expect to complete by year-end. In our analysis, we will look at individual institutions' prospects for deteriorating financial performance, but also recognize the significant support governments are providing to these banks. We believe that there could be negative rating actions as a result of this review, but they will likely be tempered by the reflection of government support.

The Factors Shaping The Future Of Banking

Governments generally are taking unprecedented actions more or less in concert worldwide to bring order to the banking sector. Seeking to restore confidence in financial institutions, they have backstopped the markets for repurchase agreements (repos), term loans, and commercial paper. Governments have allowed financial institutions to borrow against a wide variety of collateral to ensure the flow of funding, even as the credit markets retreated. Governments have recapitalized, and even nationalized, banks, and have offered to guarantee bank debt, generally during the next three years. At some point, we believe countries will seek to wean the sector off of these support mechanisms and search for ways to prevent another such crisis. We believe it will be difficult for governments to remove support until the financial markets have stabilized.

As a result of the market upheavals and the response of governments worldwide, we believe several factors will combine to change the face of the banking industry:

- Increased regulation;
- Consolidation of weaker entities;
- Fundamental reconsideration of the "originate to distribute" model;
- Adaptation to higher volatility; and
- Higher losses for this economic cycle.

Increased regulation is inevitable

In our view, the need for wide-ranging, extraordinary government support reflects the fragile state of the global banking industry. Calls for improvements in bank regulation are widespread. The recent government interventions reflect concerns that current bank capital, excluding government support, is not sufficient to carry the industry through the present, more stressful economic scenario.

Therefore, we believe that national regulators eventually may reevaluate the Basel II approach to assessing how much capital banks need to underpin credit risk amid extreme stress scenarios and risk in their trading and investment books. In the interim, regulators appear simply to be asking for higher capital ratios under the current methodology.

We believe other standards may change as well. Regulators and investors may require higher cash buffers, especially for wholesale-funded banks, as opposed to those that have substantial funding from retail deposits. They may also encourage less risk-taking, especially in banks' proprietary trading. Regulation of loan origination standards for residential real estate could facilitate the growth of covered bonds. All of these prudential standards, which will likely be the subject of worldwide policy deliberations, might help make the banking industry less risky, though it is too early for definitive conclusions.

We expect more types of previously unregulated financial institutions to come under bank regulatory oversight. In the U.S., for example, authorities are incorporating the large securities firms into the bank regulatory framework, and other finance companies, such as American Express Co., CIT Group Inc., and GMAC LLC, are also applying to become bank holding companies. In our view, this would be a positive factor in our industry risk assessments because the current two-tier system of regulated and unregulated institutions can create different sets of rules and irrational competition.

On another level, as part of their responsibilities as watchdogs for the financial system, the regulatory bodies may become more critical. Governments' roles in preventing periodic market seizures and crises of confidence that will likely arise may become permanent. Regulators may begin to favor more countercyclical reserves and measures to keep bubbles from forming, however difficult that is to achieve as a practical matter. Almost certainly, governments will attempt to improve the infrastructure of the securities markets to reduce systemic risks, possibly creating central clearinghouses for credit derivatives to reduce counterparty risk.

Consolidation of weaker entities

The downturn in the banking industry so far has spurred a wave of consolidation, often hastily arranged with government backing and rock-bottom prices. We believe more consolidation will occur as stronger groups absorb weaker institutions that are unable to survive the recession as independent entities. The stronger financial conglomerates can take advantage of "bargain prices." Some of this consolidation may be opportunistic and

pragmatic. It may create banking groups so large and diversified that their failure would be unthinkable, increasing the potential need for government support in the future.

When conditions return closer to normal, this consolidation may lead to even wider differences in creditworthiness between the large, systemically important banks and the smaller institutions. The current ratings differential among regulated banks in certain mature-market economies is compressed because the smaller banks in these countries typically have not had the same problems as the large ones.

However, not all indicators point to consolidation in financial services. Some types of businesses (e.g., balance-sheet-intensive forms of investment banking, proprietary trading, and higher-risk securitizations) may become the province of a new breed of investment banking institution. We believe the larger hedge funds are building underwriting capacity and may be willing to buy big pieces of securitizations and make markets in certain high-risk securities. This could keep the competitive pressure on banks. Taken together with a focus on lower-risk activities and maintaining higher capital requirements, banks could look more like low-risk, low-return institutions.

At some point, regulators might consider the systemic risks that giant financial organizations pose to be unacceptably large and consequently seek to downsize the megabanks. In particular, the multinational model may prove awkward for regulators if they are forced to use their countries' tax revenues to rescue foreign operations. The markets may also pressure large, unwieldy institutions to break themselves up.

Near term, consolidation will likely happen either when stock prices have become very low or when governments offer assistance. Financing for acquisitions is difficult in the current market, and potential buyers' own stock prices are likely depressed. Even more important, given the general uncertainty surrounding asset values, acquirers are leery of potentially doubling up on their own risks by acquiring other troubled portfolios.

Fundamentally rethinking the "originate to distribute" model

In our opinion, the fate of the securitization, or "originate to distribute," model is crucial to the industry's future returns. Robust liquidity conditions are critical to the securitization and syndicated loan markets. The ability to distribute risk means banks can put capital to use several times during the year rather than just once if banks retain these loans. This turnover of capital can boost banks' returns on equity (ROE). We believe that banks have not yet come to terms with the idea that they may have to keep their loan production entirely on their balance sheets. Nor do we think they are capitalized sufficiently to support the additional assets.

Securitization markets fund \$10 trillion of assets in U.S. markets and \$2 trillion in Europe. By comparison, U.S. banks have about \$8 trillion of loans on their balance sheets. Bank balance sheets would have to swell dramatically to absorb all the assets that banks ordinarily securitize. Capital levels would have to climb even higher, even as banks now are trying to delever.

Thus, we believe the real reason banks are reluctant to retain loans is that the ROE for stand-alone loans is not at the level banks are used to. Historically, equity investors who paid 2x-3x book for a bank expected an ROE of more than 18%. Therefore, banks and investors will likely have to get reacquainted with the 14% ROEs they had 20 years ago.

In our opinion, there could be numerous ripple effects if this phenomenon occurs, ranging from reduced access to capital to higher loan pricing, which could limit borrowers' access to funds. This could restrict economic growth. Conversely, there may be other ways to "restart" the securitization markets, perhaps through primary securitization

with more conservative standards, or with government support. The U.S. Treasury, for example, recently allocated a portion of the Troubled Asset Relief Program facility to guarantee the 'AAA' tranches of consumer securitizations (those backed with credit-card loans, auto loans, and student loans). We believe that several governments will try various schemes to restart the securitization markets that many observers believe are crucial to the future availability of credit.

Governments may also impose new regulations on underwriting standards to underpin credit quality, like those incorporated in the European covered bond rules. So it seems to us that the "originate to distribute" model will remain viable, if to varying degrees in different regions. Securitization should revive, though it may be less aimed at reducing capital requirements and more on-balance-sheet, like covered bonds.

Current loan pricing indicates that wider spreads will likely compensate for some of the lower velocity of capital and higher capital requirements. We are skeptical that these will stick in more benign economic environments. More likely, banking will become a lower-risk, lower-volatility, but lower-return business. As long as risk-adjusted returns are strong, we don't believe we'll need to lower bank ratings. In any case, emphasizing in our credit analyses capital and risk-taking would naturally deemphasize the earnings component of a bank's credit profile. Banks' earnings are cyclical, so we believe the real issue is banks' potential losses in a recession and whether they have sufficient capital to withstand them.

Adapting to greater volatility

In many respects, the credit markets haven't had a crisis like the current one since the Great Depression. The dislocation of 1998 was comparatively limited in scope and duration, although in hindsight, it may have been a preview of what could come. It is now evident that the interconnection of the global financial system facilitates the transmission of troubles in one jurisdiction or market to others and increases the potential for system-wide upheavals. Securities are widely distributed to investors without regard to national boundaries, which made the global sale and acceptance of higher-yielding but new and sometimes untested instruments that much easier.

Similarly, synthetic equivalents--mostly in derivatives form--to cash instruments provide greater liquidity and greater pricing transparency on a variety of market instruments, but they multiply the number of players exposed to the risks in question. Funding is sourced worldwide, so that problems in one area can result in a withdrawal of liquidity in others. This interconnectedness seems to be one cost of a modern and global financial system. We believe that the turbulence in and seizing up of the debt markets during the past year may occur more frequently in the future if regulatory regimes are not aligned.

Higher losses for this economic cycle

We believe that the trough in many countries' business cycles during the next two years will be more severe than in previous cycles. This is because the economic expansion that preceded the current downturn created a significant overhang of debt in many countries, particularly in the household, construction, and leveraged loans segments. The ensuing dislocation in credit markets, and particularly the freeze in the securitization markets that had been dubbed by some commentators a "shadow banking system" because it became a substantial provider of credit, is intensifying the impact of what would otherwise be a reduction of excess debt.

Indeed, in the U.S., a painful correction in the household sector is already well under way. This downturn appears particularly difficult for the financial industry because, in addition to the asset-quality downturn, banks must manage a contraction of the structured finance markets and depressed capital markets that hurt their investment-banking businesses.

Implications For Ratings On Financial Institutions

The rapidly shifting operating environment for financial institutions has several implications for their creditworthiness:

- Our perception of industry risk is higher;
- We believe extreme high and lows in the credit cycle result in larger losses during the trough;
- Franchise stability and market confidence are critical components of credit;
- We will focus more on capital;
- Government support becomes explicit in our ratings;
- We view certain classes of securities as riskier.

Industry risk is higher

Industry risk is an important element of our analytical criteria (see "S&P's Banking Industry Country Risk Assessments: Global Annual Roundup," published on RatingsDirect Aug. 9, 2007). Among the factors in the operating environment that can affect bank stability are the competitive dynamics of the institutions in the market; the legal and regulatory framework governing critical aspects of financial institutions' behavior and that of their customers; and the condition of borrowers. The lessons learned from the still-evolving financial crisis have led us to raise our assessment of bank industry risk. This will depress our stand-alone ratings on the banks. We believe more volatility in funding markets is likely, and with it an increase in the probability of systemic risk. Some of that will likely be triggered by volatility in asset prices that raises issues of confidence in bank balance sheets for market participants.

Also, although we don't believe that accelerating lifetime losses into current marks to market of the balance sheets is the right way to analyze loan books, we recognize that market participants frequently do so. We believe that can destabilize financial institutions in periods of financial stress. More near-term, access to capital and funding outside of government support is very difficult. Higher capital requirements and poor economic prospects could also depress returns and limit access to capital.

At the same time, we recognize that certain trends, if they materialize, may enhance financial institutions' creditworthiness. A more concentrated industry of more broadly diversified institutions should produce greater stability, ensuring government support for these larger, more systemically important banks. Certain weaker institutions with the riskiest practices are failing or are being acquired. This could support more rational risk pricing and help boost returns, at least temporarily. Higher capital levels in relation to risks are clearly also conducive to improved creditworthiness. These factors could eventually result in higher ratings.

Extreme highs and lows in the credit cycle result in greater losses during the trough

The protracted nature of the market dislocation and the rapidity and severity of asset deterioration have stressed financial institutions' earnings capacity and levels of capitalization. As a longer global recession becomes more probable, we expect higher levels of stress than those experienced during a typical business-cycle trough. This has the potential to change our ratings significantly.

To assess this critical element, we are projecting the losses we envision for financial institutions in mature market economies. We expect higher-than-typical losses for certain loans in U.S. institution portfolios (see "Rated U.S. Banks Likely To Weather Market Difficulties," published May 6, 2008, on RatingsDirect), and more ordinary

peak-of-cycle losses elsewhere. Financial institutions with greater proportional exposures to riskier assets will likely suffer proportionally greater loan losses. Applying our loss projections of individual bank asset exposures will be important in differentiating bank creditworthiness.

Franchise stability and market confidence are critical components of credit

Our fundamental criteria on assessment of liquidity focus on the stability of funding sources, where core retail deposits are preferable to wholesale sources of funds, particularly if they are short term. However, we are reassessing the value of the mitigants to a reliance on wholesale funding: diversity of funding sources, asset liquidity, and matching of funding sources to asset liquidity. In light of our assessment that capital markets will be more prone to volatility in the future, we will have less tolerance in the ratings for reliance on short-term wholesale funding, and for relative confidence sensitivity of financial institutions' business models.

In our view, franchise stability and market confidence are important in the financial sector. Although most financial institutions are vulnerable to an erosion of confidence (because they are typically highly levered and fund most of their assets with debt), some wholesale banks and nonbank finance companies are more vulnerable than others depending on their business models and funding mix. For instance, specialist lenders that depend on short-term wholesale funding and financial institutions with large trading operations are particularly sensitive to an erosion of confidence.

Although we have always differentiated by institution type with regard to funding, we intend to apply the lessons learned during this dislocation to our analysis. Factors that indicate the relative degree of confidence sensitivity are:

- How much the bank's business model depends on a perception of strong creditworthiness (the higher the dependence, the more confidence-sensitive an institution is likely to be);
- Simplicity/transparency versus complexity/opacity of accounts (simple and transparent institutions are less confidence-sensitive than are complex and opaque institutions);
- Existence of explicit credit triggers in derivatives contracts and borrowing agreements (e.g., when collateral requirements increase upon a ratings downgrade);
- Wholesale versus retail funding (the higher the proportion of wholesale funding to total funding, the more confidence-sensitive an institution is likely to be).

We believe that financial institutions most exposed to volatile markets and loss of investor and counterparty confidence will likely continue to be vulnerable to loss of market access. Consequently, "sudden default" risk will likely remain a characteristic of financial institutions, although the significant measures of governments around the world to shore up funding markets should reduce this risk to some degree.

The investment banking businesses of securities trading and prime brokerages are particularly confidence-sensitive, because they require a high volume of daily cash, securities, and derivative transactions with counterparties to maintain inventory positions. Counterparties of these business lines want to be confident that trades will be settled in accordance with industry norms and that obligations under derivative contracts, including those to post collateral, will be met. A critically damaging development for investment banks is a loss of access to daily cash and derivative transactions at any price or collateral haircut.

Of course, for all banking institutions, a worst-case scenario due to erosion of confidence is a significant outflow of wholesale or retail customer deposits (a bank run). In our opinion, various governments' recent actions to raise or enact retail deposit protections, albeit temporarily, largely allay the concerns about bank runs.

Increased focus on capital adequacy

Banks worldwide have raised more than \$500 billion of private capital in the form of equity and hybrid capital during the past 18 months. In light of the massive capital infusions and possible failings in regulatory measures of capital sufficiency (Basle I, II), we are placing more emphasis on risk-adjusted capital (RAC) measures. We are developing our own framework for assessing RAC that is more risk-sensitive than Basel I and more conservative in most cases than Basel II as it currently stands, particularly with regard to market risk capital and private equity risk (see "S&P Requests Comments On Its Global Risk-Adjusted Capital Framework For Financial Institutions," published April 15, 2008, on RatingsDirect).

Government support becomes explicit

Partly because of the confidence-sensitive nature of the banking industry, particularly in the context of highly developed capital markets, we view ongoing 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). This principally comes through prudential regulation and access to central bank liquidity, which mitigate the high leverage and funding mismatches inherent in bank business models. Without these benefits, bank balance sheets would be very different. We build this type of support in to our stand-alone ratings on banks in supportive countries. In our view, it is neither possible nor appropriate analytically to fully disentangle bank stand-alone creditworthiness from everyday external government support factors.

A stand-alone rating reflects a bank's strategies, performance, and prospects, including whatever government support or intervention the bank typically receives in the normal course of business. However, it excludes credit for any extraordinary government assistance or influence that might be expected in a crisis.

Due to the worsening situation in the financial sector, governments, central banks, and regulators in most mature economies have taken a wide range of support measures to alleviate funding constraints and bolster depositor confidence. These measures underpin the creditworthiness of most banks operating in those countries, and are consistent with our classification of the governments as "supportive" in that they promote system-wide stability through the regulatory, legal, and liquidity frameworks that delimit bank operations. Therefore, our stand-alone ratings also integrate these system-wide measures introduced to address near-term liquidity and funding concerns.

Excluded from our stand-alone credit analysis, however, is future specific government intervention for financial institutions under stress. Recently, many governments have intervened directly as a result of or in anticipation of deeper solvency pressures at specific institutions. This has taken the form of nationalization, direct investment, and promotion of private-sector mergers and acquisitions. We view the first two as the most meaningful and as indicators of a government's intention to provide further support.

When the actual or anticipated direct government aid is material and directed at a specific institution under stress, we typically lift the counterparty credit rating (CCR) of the aided institution above the institution's stand-alone creditworthiness. This will happen with increasing frequency for banks. In such cases, we intend to disclose the stand-alone ratings to better highlight the support we incorporate in the CCRs.

A banking institution's relative importance to a country's financial system and economy--its systemic importance--indicates the likelihood the institution will receive direct government support when under stress. To maintain stability in the financial sector, most governments have a policy objective to maintain the creditworthiness of systemically important banks at a level at which the banks can operate. That implies access to funding at a rate that permits an adequate spread on loans.

When governments directly aid specific financial institutions under stress, or make clear their willingness to support others that may require aid, we do not expect the CCR on the supported institutions to fall to a level that would preclude them from continuing profitable operations. Rather, as a result of increasing government support, we would expect to see fewer downgrades.

This means that, in cases of severe stress, the stand-alone rating may diverge substantially from the CCR. As governments withdraw direct aid (e.g., sell their bank shares) and the banks under severe stress convalesce, stand-alone ratings and the CCRs will converge (or the problem banks will not heal and be wound down). We expect this dynamic to play out during the next several years for many banking institutions.

Certain classes of securities look riskier

As we see new cases of resolutions of failed banks, and the way in which various classes of securities are dealt with, we may alter our ratings on those types of instruments to reflect different default probabilities. For example, we have traditionally rated investment-grade financial holding companies (excluding insurance company holding companies) one notch lower than their operating companies (two notches in noninvestment grade) to recognize the higher probability of default for the holding company. A stronger buyer may acquire the operating company in a regulatory-assisted transaction upon failure, whereas the holding company may be left behind.

In addition, on an ongoing basis, holding companies typically depend on the ability to upstream cash from their underlying subsidiaries, which regulators can curtail in the case of banks or brokers. We have seen no distinct pattern of resolutions that would cause us to change this notching convention at this time. In some instances holding-company creditors were distinctly disadvantaged, while in others both holding company and operating company creditors were rescued.

We expect regulators to balance the reactions of investors and the impact on confidence in the financial system with minimizing the cost of rescues for taxpayers. As we see different patterns emerge, and potentially more wholesale funding at the bank level treated more in line with that of the holding company, we will consider either widening or narrowing the notching.

Another riskier class of securities is hybrid capital securities. We typically rate hybrid capital securities of investment-grade financial institutions two notches under our CCR on the issuing institution. The lower issue rating reflects the payment deferral risk and the hybrid's deep subordination under liquidation.

In the more stressful environment that we project for the medium-term, the financial condition of a higher number of regulated financial institutions may erode to the point where regulators intervene and force suspension of hybrid payments. Or the institution itself could opt to suspend payment to preserve cash and capital. We are analyzing issuers' hybrid securities to assess if the issuer's stand-alone credit profile, the structure of the hybrids, and the regulatory practices concerning hybrid securities in the applicable jurisdiction combine to increase the risk of payment deferral. If we find this to be true, it would result in a hybrid issue rating that is three or more notches below the CCR on the issuer.

In identifying cases that warrant a wider gap between the CCR on the issuer and the issue rating on the hybrid securities, we assess the following indicators of heightened risk of deferral:

- The issuer has incurred material net losses recently, and its near-term financial prospects are poor.
- The issuer is at risk of breaching minimum regulatory capital requirements or other performance tests that would

require special regulatory approval to continue payments on its hybrid securities.

- The issuer's creditworthiness erodes to a level that could materially affect its access to and cost of capital. In mature economies, this is often when the CCR falls below the 'A' category.
- The company has substantially cut or eliminated its common dividend. This means the issuer has already crossed a certain line as far as market perception is concerned.

Importantly, we view the issuer's stand-alone financial profile as the key indicator of potential pressure to defer payments on hybrid securities. In cases where our CCR on a financial institution is higher than the institution's stand-alone credit due to specific government intervention, we have widened the gap between the hybrid rating and the CCR. We generally believe that governments are less willing to support hybrid capital issues to the same extent as more senior obligations, as the nationalizations of Fannie Mae and Freddie Mac in the U.S. and Northern Rock PLC in the U.K. attest.

As financial performance recovers to more normal levels, we could raise the issue ratings and thus narrow the gap between the hybrid rating and the CCR. From this perspective, the issue ratings on hybrid capital securities are potentially more volatile than issue ratings on conventional debt issues.

Most outstanding Tier I hybrid capital securities of banking groups around the world have "intermediate-strong" equity content under our hybrid capital methodology (see "Hybrid Capital Handbook: September 2008 Edition," published Sept. 15, 2008, on RatingsDirect). Based on a preliminary review, we believe that we will assign the same intermediate-strong classification to many of the new preferred shares that are part of the government support measures. This provisional conclusion is subject to our review of the specific terms and conditions defined in the documentation for actual issuances.

We include hybrid capital securities with intermediate-strong equity content in our key measure of adjusted total equity, to an amount equal to 33% of adjusted common equity, defined as tangible common equity plus retained earnings. We limit the amount of hybrid securities in our capital measures because of their fixed coupon payments and issuers' greater reluctance to defer hybrid payments compared with common dividends.

The Road Ahead

The global financial system is clearly going through some of the most profound changes since the Great Depression. Most market participants and observers did not expect the unprecedented rapidity of the unwinding of risk that had built up during the past decade. It appears that the concerted actions of central governments are pulling the global financial system back from an even more serious global dislocation. While the systemic risk appears to have been somewhat contained, two concerns remain: that this could instead be a false dawn and indeed systemic risk has not been contained; and that the losses related to the cyclical downturn and a global recession have not yet played out. During the next few weeks, we will undertake a portfolio review of major global issuers to assess the impact of these issues on the stand-alone and government-supported financial strength.

It is too soon to tell if this credit market crisis will lead to fundamental change in investor behavior and risk taking. To be sure, participants around the world will not easily forget the lessons learned. More regulation appears inevitable to many. In our opinion, the two-tier regulatory system was indeed one contributor to the buildup in risk. Risk premiums have returned, and private-sector liquidity has all but disappeared. How the latter is restored will have a significant impact on the future state of banking. Finally, banks and investors may fundamentally revisit risk

appetite (credit, concentration, correlation, volatility, and complex on- and off-balance-sheet exposure) and risk management. For confidence to return to the financial system, these issues will have to be resolved to the satisfaction of the major participants. The stakes are high, but we have little doubt the markets will find a way to achieve that.

Standard & Poor's Related Research On RatingsDirect

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