

## U.S. BICRA Revised To Group 2 From Group 1 On Increased Credit Deterioration

**Primary Credit Analysts:**

Robert Hansen, CFA, New York (1) 212-438-7402; robert\_hansen@standardandpoors.com  
Tanya Azarchs, New York (1) 212-438-7365; tanya\_azarchs@standardandpoors.com

**Secondary Credit Analysts:**

Xavier Chavee, New York (1) 212-438-6834; xavier\_chavee@standardandpoors.com  
John Chambers, CFA, New York (1) 212-438-7344; john\_chambers@standardandpoors.com

NEW YORK (Standard & Poor's) Dec. 17, 2008--Standard & Poor's Ratings Services said today that it revised its Bank Industry Country Risk Assessment (BICRA) on the financial system of the U.S. (AAA/Stable/A-1+) to Group 2 from Group 1. Our BICRA rankings integrate 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). Similarly ranked banking systems to the U.S. include the U.K, Spain, Germany, and Italy (see associated article, "U.K. BICRA Revised To Group 2 From Group 1 On Deteriorating Credit Conditions," published today on RatingsDirect).

The BICRA change primarily reflects the banking system's credit deterioration, which we expect to continue, as well as macroeconomic weakness. The high level of household indebtedness due to aggressive lending to households--through widespread use of home equity credit and innovative mortgage products--during the boom years before the current downturn has contributed to the credit deterioration. At the same time, housing and manufacturing sectors continue to decline, along with household wealth, which is leading to a slowdown in consumer spending. Other negative factors include financial institutions' high exposure to troubled mortgage assets and commercial real estate, intense industry competition, and cyclically low profitability. Despite these current difficulties, the industry has strong, long-term financial performance and an adequate capital position.

"The U.S. banking system has experienced material credit losses, most notably in residential mortgage lending, which are spreading to other loan portfolios like commercial real estate and consumer," said Standard & Poor's credit analyst Robert Hansen. "Although several institutions have issued equity capital in recent quarters and benefited from a supportive government, the industry continues to face increased difficulties."

Standard & Poor's U.S. economists forecast GDP growth to slow to 1.2% in 2008 from 2.2% in 2007, and then drop to negative 1.2% in 2009, which should further pressure credit quality. Furthermore, we expect a moderate increase in unemployment, to 8.5% by late 2009 from 6.5% in late 2008. Economic weakness in Europe and Japan also continues to weigh on U.S. corporations. The U.S. economy's downturn and deleveraging by consumers will likely continue to result in high losses in loans and mortgage-backed securities.

U.S. banks are vulnerable to these worsening conditions due largely to low growth prospects, high leverage, rising gross problematic assets (GPAs), and increased competition. We estimate that GPAs--which include nonperforming loans, delinquent loans, and impaired securities--account for 5%-15% of total assets in the banking industry. For example, the ratio of nonperforming loans to total loans and leases rose to 2.23% in third-quarter 2008, but is still below the cyclical peak of 2.68% in 1992. Residential mortgage delinquencies are also rising quickly, expanding to prime and Alt-A loans from subprime, hurt by home price depreciation and rising unemployment.

We are also witnessing credit losses in other consumer-focused products, including auto loans and credit cards. We believe the banking industry is prone to cyclical lapses in underwriting standards (which normal economic cycles have exacerbated), market valuation extremes, and compensation schemes that reward loan growth. In recent years, increased competition in the U.S. resulted in rapid loan expansion and more lenient credit policies, including higher loan-to-value ratios and low documentation loans. The structure of the industry encourages high levels of competition (unregulated participants have ease of entry) that leads to periodic bouts of overleveraging for borrowers. We also believe that U.S. banks focus on short-term profitability more than European banks do, and this leads to greater risk taking.

Another notable characteristic is that consumer bankruptcy laws favor borrowers. The U.S. banking system has several regulators, which could negatively affect the quality of supervision, although the regulations themselves are generally considered to be well refined.

Offsetting factors include the U.S. banking system's vital role to the economy, which is the world's largest; very strong diversification; stability (political and economic); and solid financial infrastructure. In addition, we view capital as adequate, although somewhat below recent historical levels. Furthermore, insured core deposits provide a relatively stable source of funding; the industry has strong business, geographic, and product diversification; a robust regulatory oversight and accounting framework; and generally good liquidity.

The U.S. banking system also benefits from flexible labor and product markets, an independent monetary authority, and historically high pretax profit margins. In addition, the industry is characterized by strong franchise and increased consolidation among certain participants, which promotes increased stability, in our view.

Under our criteria, we consider the U.S. as "supportive" of its banking system. This means our credit ratings on the country's financial institutions factor in ongoing implicit external support, including advantages derived from bank status--in the form of preferential access to liquidity, prudential regulation, and proactive supervision. In cases of financial stress, when we expect the state to provide extraordinary support to a particular bank, we could elevate the long-term counterparty credit rating above the bank's stand-alone creditworthiness, particularly if we consider the bank to be systemically important to the sector.

Standard & Poor's, a division of The McGraw-Hill Companies (NYSE:MHP), is the world's foremost provider of financial market intelligence, including independent credit ratings, indices, risk evaluation, investment research, and data. With approximately 8,500 employees, including wholly owned affiliates, located in 23 countries, Standard & Poor's is an essential part of the world's financial infrastructure and has played a leading role for more than 140 years in providing investors with the independent benchmarks they need to feel more confident about their investment and financial decisions. For more information, visit [www.standardandpoors.com](http://www.standardandpoors.com).

Copyright © 2009, Standard & Poors, a division of The McGraw-Hill Companies, Inc. (S&P). S&P and/or its third party licensors have exclusive proprietary rights in the data or information provided herein. This data/information may only be used internally for business purposes and shall not be used for any unlawful or unauthorized purposes. Dissemination, distribution or reproduction of this data/information in any form is strictly prohibited except with the prior written permission of S&P. Because of the possibility of human or mechanical error by S&P, its affiliates or its third party licensors, S&P, its affiliates and its third party licensors do not guarantee the accuracy, adequacy, completeness or availability of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. S&P GIVES NO EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE. In no event shall S&P, its affiliates and its third party licensors be liable for any direct, indirect, special or consequential damages in connection with subscribers or others use of the data/information contained herein. Access to the data or information contained herein is subject to termination in the event any agreement with a third-party of information or software is terminated.

Analytic services provided by Standard & Poor's Ratings Services (Ratings Services) are the result of separate activities designed to preserve the independence and objectivity of ratings opinions. The credit ratings and observations contained herein are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. Accordingly, any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision. Ratings are based on information received by Ratings Services. Other divisions of Standard & Poor's may have information that is not available to Ratings Services. Standard & Poor's has established policies and procedures to maintain the confidentiality of non-public information received during the ratings process.

Ratings Services receives compensation for its ratings. Such compensation is normally paid either by the issuers of such securities or third parties participating in marketing the securities. While Standard & Poor's reserves the right to disseminate the rating, it receives no payment for doing so, except for subscriptions to its publications. Additional information about our ratings fees is available at [www.standardandpoors.com/usratingsfees](http://www.standardandpoors.com/usratingsfees).

Any Passwords/user IDs issued by S&P to users are single user-dedicated and may ONLY be used by the individual to whom they have been assigned. No sharing of passwords/user IDs and no simultaneous access via the same password/user ID is permitted. To reprint, translate, or use the data or information other than as provided herein, contact Client Services, 55 Water Street, New York, NY 10041; (1)212.438.7280 or by e-mail to: [research\\_request@standardandpoors.com](mailto:research_request@standardandpoors.com).