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## Global Banking Roundtable: The Next Era Looks Less Risky--And Less Profitable

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Panel Discussion

# Global Banking Roundtable: The Next Era Looks Less Risky--And Less Profitable

As the global credit crisis deepens, Standard & Poor's Ratings Services believes banks around the world face a new era of risk, reward, and regulation. U.S. and European financial institutions, already buffeted by recessions, must cope with fundamental changes to their business--some present, such as government ownership and high funding costs, and others undefined, such as President Barack Obama's financial rescue and economic stimulus plan. The low liquidity and shaky confidence that plague the industry could significantly worsen with further asset-quality deterioration, straining both profitability and capital levels. In our view, the banking system's recovery will be slow and painful, particularly because investors' already diminished expectations for banks' financial performance may still be too high.

To provide insight into where things stand and what might happen in the months ahead, Standard & Poor's analysts gathered in February for roundtable discussions of the most critical issues facing banks, particularly in the U.S. and Europe. Participating analysts were Jay Dhru, global head of financial institutions ratings; Rodrigo Quintanilla, head of North American bank ratings; Michael Zlotnik, head of Europe, Middle East, and Africa bank ratings; and Tanya Azarchs, North American regional criteria officer for bank ratings.

## Panel Discussion

**Q: When we look to the immediate term, what is our assessment of the health of the banks that we rate, and how fragile is the world's banking system right now?**

*Tanya Azarchs:*

The banks are probably the most fragile they've been in living memory. That has to do with a number of different factors. First and foremost, investor confidence has eroded, creating funding difficulties for banks. Funding costs are very high despite interest rates generally dropping.

Secondly, banks are confronting a fairly severe credit cycle. Not only may this recession be longer than the past two recessions, but the decline may be more acute. In addition, banks are coming off of essentially an asset bubble that has impaired collateral values on a variety of loan types. At this point, the credit and economic downturn will affect almost all types of loans. Commercial real estate and commercial lending are following the deterioration in the residential mortgage sector, which encountered problems first. So, both on the liability and asset sides of the balance sheet, banks are confronting more severe challenges than at any time since World War II.

*Michael Zlotnik:*

I think this is a truly global crisis, although different credit markets are at slightly different stages. The U.S. faced the credit market difficulty first, but the crisis has now spread to all regions. It has developed into a deepening worldwide economic recession. How long and how deep the recession will be is one of the open questions that will continue to affect investor sentiment regarding banks' health.

**Q: What has the U.S. government's \$235 billion injection (received of the first \$350 billion) into banks from the U.S. Treasury's Troubled Asset Relief Program (TARP) accomplished?**

*Jay Dhru:*

It has accomplished something very important: The cash infusion created market confidence. Market conditions in the September/October timeframe were very dire, and the government's actions globally served to pull the banking

system back from the brink. The original purpose of the TARP was to work both on capital infusion and on setting a floor for asset valuations. That second part really hasn't happened. So far it's been like adding water to a bathtub without a stopper. If you keep on adding more capital without stabilizing asset values, it can turn into a losing battle. Confidence is the life blood of financial institutions. Until that is restored, it is difficult to restore funding and a normal operating environment.

**Q: How much more capital might the U.S. government need to infuse into banks to make them healthy?**

*Rodrigo Quintanilla:*

I think additional capital support will depend on the path the economy takes and how big the losses are in banks' loan books later this year. To be sure, the market is distinguishing between Tier 1 regulatory capital levels and tangible common equity (TCE) levels. Some of these banks have very low TCE ratios, and to the extent these ratios keep declining, the confidence will not be restored. So if TCE ratios can be rebuilt, either through common equity issuance, or through the banks' own earnings, this will preclude any more meaningful infusion of capital, but it's still a moving target.

The economic stimulus package that the Obama Administration is working on is really trying first to work on the economy and get it back on track. It recognizes that things will probably get worse before they get better and that the economy probably won't show signs of stabilizing until later this year.

**Q: What are the misconceptions about banks' lending practices today?**

*Quintanilla:*

The popular belief is that U.S. banks have been unwilling or unable to lend due to capital constraints or a desire to reduce risk, and that this has resulted in a credit crunch. Naturally this has implications for the economy, so the U.S. government has been devising policies to encourage banks to lend. The data on credit outstanding in the U.S. only tenuously support the thesis that there has been a credit crunch so far in that the amount of borrowing by the various sectors of the economy has continued to grow, if unusually slowly.

*Azarchs:*

A clue to what may lie behind the apparent difference between perception and reality is that although growth in overall credit is positive through at least third-quarter 2008, it is slower than at any time since 1945 and far off of the 8%-10% growth rate of most years. Not even recessionary years in the past had such a low growth rate. It basically says that loans are being replaced as they mature, but no new growth is occurring. However, early indicators of further slowdown are visible in shrinking bank commitments to lend. We believe this portends a contraction in total credit in coming months.

**Q: How big of a contraction in total credit may be on the way, and is it inevitable?**

*Azarchs:*

It's impossible to say. Of course, the new Term-Asset-Backed Securities Loan Facility (TALF) proposal can change everything in that it makes the U.S. government as large as the securitization markets used to be. The real issue is how much loan demand there will be, not just how much money there is to lend.

**Q: How do you view the government's plan to have a fund combining public and private capital to purchase financial institutions' problematic legacy assets with a possible federal guarantee?**

*Azarchs:*

The program of a combined public and private scheme to purchase toxic assets could stabilize their values, though details are scarce at the moment as to how it will work and the degree to which the government will provide any guarantees. The greater the degree to which the program can stabilize the banks' assets, the less capital will be

required. And that equation works from either end, either from stabilizing the assets or allowing them to dip and filling up the bucket on the other side with capital. Stabilizing the value of assets also has the knock-on effect of potentially stabilizing the financial system and markets, and getting liquidity back into the financial markets.

The big question, regardless of who is buying the assets, is how they will price them? It's a very thorny question. We will also monitor the structure of investor participations in the Investment Fund, the Investment Fund's ability to attract private capital, and how the purchase prices compare to the prior carrying values of assets on sellers' books—because the triggering of losses could impinge on capital levels, absent offsetting actions.

**Q: How much in terms of toxic assets are the banks carrying on their loan books?**

*Quintanilla:*

It depends on how we define a toxic asset, but in terms of the securities portfolios, Level 2 and Level 3 type assets are clearly potentially troubled exposures. In terms of loans, we have identified those, and stress-tested those portfolios over time with loss rates to help us assess the vulnerability of the financial system, or of the banking system and individual banks. In a confidence-sensitive business such as banking, there will be more and more concern about asset valuation. So even if assets are valued correctly, there's always going to be a question. Until that's resolved, we're going to be coming back to this discussion.

*Azarchs:*

I think it's difficult to have an actual number, because potentially almost every loan is in a state of deterioration. And how far loans will deteriorate will depend partly on whether or to what degree the economy is fixed.

**Q: Is the situation the same with bad assets in Europe?**

*Zlotnik:*

One of the differences is that many European banks, particularly regional banks with strong retail deposit bases in countries with less-inflated housing markets, are still doing reasonably well. But certainly there are also many banks that have been suffering, and will continue to suffer. We are currently still in a vicious circle that every quarter banks suffer the next round of markdowns on individual assets, even in safe government bonds, due to widening spreads.

*Quintanilla:*

Even if there is a floor on the asset price side, the fundamental issue for banks will remain where to find revenue growth. The banks will have the normal pressures of a recession anyway, so where will the business growth come from?

**Q: What are the pitfalls and benefits of nationalizing banks, and at what point is the bank truly nationalized?**

*Zlotnik:*

Different national governments pursue different approaches in supporting the banking system rather than having one common approach. So far, we have seen nationalization of a handful of banks across Europe. Governments have been reluctant to nationalize banks and only viewed it as the last and least desirable solution. In more cases, the government has injected capital, but stopped short of an outright nationalization, or even majority positions.

*Quintanilla:*

There's been talk about nationalization of banks in the U.S. as one of the paths that the Obama Administration may take. And I think it's important here to be careful with semantics and what the word means. The issues in America are both timing and scope.

Nationalization of banks is what the Federal Deposit Insurance Corp. (FDIC) does year in and year out when it takes a bank into receivership. It doesn't normally hold these banks, but rather sells them to others. So they're nationalized for a very short period of time. In the case of Fannie Mae and Freddie Mac, though, the timeframe is a little less clear in terms of when these companies will revert to the private sector.

Nationalization in the true sense of the word is something that goes against the grain of a market-driven society like the U.S. So we don't see complete nationalization, but the government has in effect historically taken nationalization as an approach to resolving failing banks. That's what the FDIC has done.

**Q: What is the right balance between risk taking and conservative strategies in today's market?**

*Dbru:*

Right now banks are clearly taking less risk. But the more important question is: Based on a bank's risk profile, how is it managing its business? Whether it has a conservative risk profile or a riskier profile, does it have adequate funding diversity; does it have more than adequate liquidity and strong capital levels? Institutions that have a high risk profile and don't have funding diversity and liquidity strength or capital strength have gotten into trouble. So we watch for a matching of the risk profile with the management of risk.

**Q: How effective are government support efforts in Europe?**

*Zlotnik:*

All governments are working feverishly to put the banking sector back on sound footing because that's really the precondition to help the economy get out of a recession or at least avoid an even worse outcome. In Europe, despite all the government support, confidence in the banking sector remains fragile. And banks are still dealing with the legacy problems on their books relating to the deflating bubbles in the housing market and the wider financial markets.

Government initiatives and support will take time to work, given the depth and breadth of the financial and economic crisis. Past experiences in Japan and Scandinavia are supporting that view. I think another concern is whether the government's injection of all the capital and liquidity in the banks is sowing the seeds of the next bubble, in light of ballooning government debt. Also, increasing government influence in banks might lead to politically motivated lending and ill-founded credit decisions in the future.

**Q: How do the ratings reflect government support?**

*Quintanilla:*

We believe significant government intervention intended to stabilize the sector and restore public confidence may balance pressures on large complex financial institutions' future performance caused by increasing bank industry risk and the deepening global economic slowdown. As of December 2008, we started recognizing the government's potential for extraordinary support for systemically important banks in the U.S., applying it to our stand-alone credit analysis, and we had done this in Europe and Asia already. Depending on the extent of additional government support to these banks, we will adjust our stand-alone and issuer credit ratings accordingly, notching them closer or farther apart.

**Q: What lessons can we learn from other countries, such as Japan and Mexico, whose banking systems have experienced problems in the past?**

*Azarchs:*

I think if you look at those two countries, their troubles were precipitated by loan quality problems and not the mark-to-market securities problems that have created most of the losses so far in the U.S. And I think one thing we can learn is that the loans have to be dealt with promptly and aggressively, because the longer it takes to work out

the problems, the more deterioration happens and the longer the issues fester.

For example, in Japan it took more than a decade for the banks to pull out of their funk because the real estate assets that they were holding did not reach a market clearing price, did not trade, did not establish a floor to pricing, and therefore did not recover for all that time. Mexico dealt more rapidly with its problem, but it took a greater toll on the economy than bank rescues are likely to take in the U.S.

But I think the other thing we learn is that these problems are preceded by an asset-price bubble. The challenge is having the banks somehow recognize in their risk management when those bubbles are forming and when it's time to stop lending. Preventing those problems is a better answer than fixing them later.

**Q: What would be a return to normal for banks?**

*Quintanilla:*

The economy needs to be on a steady growth path with controlled inflation and relatively low interest rates. A normal yield curve should be the backdrop. In terms of banking itself, we need a system where confidence has been restored, asset pricing has been restored, and credit losses are following a normalized path rather than stressed-loss rates.

In addition, there has to be ample funding or liquidity with no question as to the collateral values that are being pledged--which is the case right now--and profitability must return to a normalized sort of path. This suggests that normal conditions for a bank don't exist because cycles are always in flux--asset bubbles build and losses or excesses are built into the system.

*Azarchs:*

I think it is difficult to speculate with any precision about what the banking system will look like coming out of this downturn. But it's quite clear that it is not going to be "business as usual." The banks may never be as profitable as they were just five years ago. We're not likely to see 23% or 25% returns on equity again. They may become much more heavily regulated, much more heavily capitalized, and so the return on capital will not likely be as good. They may be viewed much more as utilities. And that's where the regulation comes in, constraining banks on a number of fronts in terms of what they can do.

*Quintanilla:*

Another potential scenario is that big banks are broken apart after a period of consolidation, if we believe the risk to the government was so high partly because the system became very concentrated in a few financial institutions. That concentration could now be reduced. However, what we're seeing now is the opposite--the government is encouraging banks to consolidate.

**Q: How many more banks do you think will fail, and what kind of triggers are you looking at for that?**

*Quintanilla:*

It's hard to speculate on a number. The trigger is clearly a lack of confidence leading to a liquidity run--deposits being pulled out at once--because of an increase in nonperforming assets and the lack of asset pricing that could add to the banks' losses. Those are normally the triggers for a bank failing and for the FDIC to take it over.

*Azarchs:*

I think the government has clearly identified the banks that are systemically important, effectively saying that they will not be allowed to fail in the sense of default. They may not survive in their current form, but they will not be allowed to fail. It's the smaller banks that are at risk of outright failure.

**Zlotnik:**

In Western Europe, I think the triggers are relatively similar. The key risk of sudden failure for banks is certainly related to their liquidity situation--partly mitigated by massive central bank support--as well as any signs of loss of confidence. We don't expect any systemically important major European banks to fail. This is reflected in our ratings, where we've said that we believe the systemically important banks will be supported. But we cannot rule out that banks in Europe--not necessarily rated by Standard & Poor's--with weakened franchises and weak earnings and risk profiles will not survive the present downturn in their current form.

**Q: What Does Goldman Sachs and Morgan Stanley becoming commercial banks mean for existing commercial banks?**

**Azarchs:**

I don't think that either Goldman Sachs or Morgan Stanley as bank holding companies is going to change all that dramatically in the near term. They may expand a few of their banking operations, but it's not going to make a huge difference. They're going to continue to be what they are. The same probably goes for GMAC and the other finance companies that just received bank holding company status.

The whole purpose of turning them into banks is to give them access to the liquidity facilities of the Fed and potentially put them under greater regulation. That could eventually level the playing field, which might be good for all players, particularly the commercial banks. It could help prevent some of the irrational competition in the marketplace that some would argue created many of the highly competitive and aggressive underwriting standards in the bank lending markets.

**Q: What do you think the bank of the future looks like? What does it do, what doesn't it do?**

**Dhru:**

I think these are the questions that we have been talking about throughout this discussion. Banks have conflicting pressures: On the one hand, there's pressure to deleverage, and on the other hand we're seeing tremendous opportunities to reintermediate the structured finance market that has effectively disappeared.

Presently, we're seeing a real retrenchment in banks globally. Longer term, they may emerge as lower-risk-taking and less-profitable businesses, although they may gradually start taking a little more risk. But I think the lessons learned from this cycle will be hard to forget.

**Q: How do you view bank mergers?**

**Zlotnik:**

As usual, the devil is in the details concerning the rationale behind mergers. I think adapting to a new world of banking will require reduced banking capacity and potentially fewer banks that are more focused on core banking activities. I guess mergers will be inevitable, but such mergers will come at a cost, often in terms of job losses. Some governments might shy away from doing that when the economy is suffering already. And as we know, mergers usually are associated with heavy restructuring costs, which someone will need to bear. The banks currently can't bear these costs, given their poor earnings outlook. So mergers will come, but they won't solve all the problems.

**Dhru:**

Just in the U.S., there are about 7,000 banks. There's clearly overcapacity in the banking system. During the next several years, fundamental and painful choices will need to be made.

**Q: When will it be safe to securitize loans again?**

*Azarchs:*

I think to securitize, a couple things have to happen. One is investors have to be willing to buy securitizations. That will only happen if they become much more comfortable with the level of credit enhancement built into those structures. There are certain government programs that are aimed at kick-starting the securitization market, which is generally recognized as being responsible for funding a substantial part of the economy's financing needs--almost as much as the banks themselves.

The government's announced support in the form of a major \$1 trillion program to purchase a variety of assets (TALF) including 'AAA' rated securities backed by a variety of asset classes might also help to revive the securitization markets.

**Q: Is there a future for stand-alone investment banks?**

*Azarchs:*

I think they could continue to exist. It is unclear whether some of the mergers with commercial banks worked very well. In fact, they don't work very well generally. Culture clashes can create an inordinate amount of acquisition integration risk. I think investment banks will go back to their roots as pure intermediators and make less use of their balance sheets, because that's the part that truly brought them down.

**Q: Has the financial system just gotten so complex that nobody really understands it anymore, and would additional regulation and oversight help this situation?**

*Dhru:*

There is clearly a return to the basics right now. The system was absolutely complex, interwoven, and very few people understood the interconnectedness. The success of the back-to-basics approach will depend on how it's managed. Just throwing more regulation at the financial system is not the answer. It needs to be appropriate regulation that levels the playing field so that there is not a two-tiered regulatory system in which unregulated and regulated entities are in the same business.

The second thing is a focus on more disclosure and more transparency. It's really not just a question of more disclosure but the appropriate level of disclosure for the asset classes. And at the end of it, investors clearly have the responsibility to understand what they're buying. How some of these systemic and regulatory issues are addressed will show us how the system will move forward.

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