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Review Results In Changes To Certain U.S. Financial Institutions' Hybrid Capital Issue Ratings

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On Feb. 24, 2009, Standard & Poor's Ratings Services lowered its issue ratings on 45 U.S. financial institutions, including the majority of rated U.S. banks (see "Issue Ratings On Certain U.S. Financial Institutions' Hybrid Capital Securities Lowered," published Feb. 24, 2009, on RatingsDirect).

The ratings action came after a review of our issue ratings on the hybrid capital securities of certain U.S. financial institutions. We did not change any of the counterparty credit ratings (CCRs) on these companies.

Most types of hybrid capital instruments—such as trust-preferred stock, enhanced trust-preferred stock, and noncumulative perpetual preferred stock—afford equity benefit to issuers, in part, by having ongoing interest or dividend payments that are deferrable or cancelable at the discretion of the issuer, in contrast to the fixed payments associated with conventional debt. This characteristic, coupled with the deep subordination of hybrid capital issues, makes the instruments more risky for investors than debt is.

In assigning ratings to hybrid capital securities, we seek to assess their incremental risks in terms of timely interest or dividend payment and principal recovery in the event of insolvency or bankruptcy, compared to credit risks incorporated in the CCR and issue ratings on conventional debt. We reflect these incremental risks of hybrid capital issues by rating them two or more notches below the CCR. We typically rate subordinated instruments with deferrable coupons two notches below the CCR on the issuer when the CCR is investment grade. One notch is for deferral risk and one for recovery prospects (subordination). Hybrid issues of noninvestment-grade issuers generally are rated at least three notches below the CCR. However, we increase the gap where we view an elevated risk of payment deferral. (See discussion of "Rating the Issue" in "Hybrid Capital Handbook: September 2008 Edition," published Sept. 15, 2008, on RatingsDirect.)

We now believe such treatment is appropriate in the cases we have identified in the course of this review. In accordance with our published criteria (see "Franchise Stability, Confidence Sensitivity, and the Treatment of Hybrid Securities in a Downturn," published Dec. 1, 2008, on RatingsDirect), we identify cases where a wider gap between the CCR and hybrid rating is appropriate. We consider the following overlapping indicators of heightened risk of payment deferral:

- The company has incurred material net losses recently and its near-term financial prospects are poor;
- The company's capital ratios are weak;
- The company is at risk of breaching performance or capital tests that would then require special regulatory approval to continue payments;
- Our CCR on the company is in jeopardy of being lowered to a level that is likely to materially affect its access to and cost of capital (for example, short-term CCR to 'A-2' from 'A-1');
- The company has substantially cut or eliminated its common dividend. Such an action means that a certain line has already been crossed as far as market perception is concerned. Also, virtually all hybrid issues contain so-called "dividend stoppers," whereby the company must continue to make hybrid payments as long as it is paying common dividends. Once the common dividend has been eliminated, the company has a freer hand to

defer payments on its hybrids.

Where we concluded that a specific institution's risks have increased to a significant extent because of a confluence of these factors, we widened the notching to more than three notches below the CCR.

We believe that the risk of hybrid deferrals is broadly elevated across the U.S. financial institutions sector as the sectoral downturn plays its course. Rated banks, brokers, and finance companies are suffering from severe earnings pressure, and we believe this will continue for at least another one-to-two years, given the extent of deterioration in economic conditions and mounting credit loss charges. Although capital-raising actions have helped to maintain capital adequacy so far, these companies' ability to issue new common stock and hybrid capital on acceptable terms is highly constrained. Thus, we are now widening the CCR and hybrid rating gap by an additional notch for nearly all U.S. financial institutions.

In contrast to corporates, we view financial institutions in periods of normal market conditions as particularly loath to defer payments on hybrids because these companies' heavy ongoing funding appetite heightens the importance of preserving capital-markets access. Regulators also have an interest in assuring market stability, and their role is critical for banks and brokers given regulators' authority, including the ability to direct such companies to defer payments.

But market conditions are now far from normal. In our view, there is a risk that if near-term financial performance turns out to be worse than we now assume, regulators could direct companies to defer with increased frequency. Although we believe that regulators would be selective in their approach and that incidents of deferral would still be relatively uncommon, we cannot absolutely rule out the possibility that a more sweeping approach could be taken. Current hybrid issuance by U.S. financial institutions is now virtually dormant, so there is little in this regard that regulators have to worry about protecting.

We had already taken actions in a number of cases to widen the CCR and hybrid rating gap of U.S. (including Citigroup Inc., CIT Group Inc., SunTrust Banks Inc., The Goldman Sachs Group, Morgan Stanley, and TD Banknorth Inc.) and European financial institutions' hybrid capital issues (see "Issues Ratings Lowered on Hybrid Instruments of Some European Banks on Heightened Deferral Risk," published Jan. 28, 2009, on RatingsDirect). In many of these instances, we view the issuers as systemically important in their respective countries of domicile. In such cases, one additional consideration in assessing the deferral risk related to the hybrids is that although the CCR may rely heavily on the assumption that additional extraordinary government support would be forthcoming if necessary to protect the interests of depositors and other creditors, we believe there would always be uncertainty about the government's willingness to protect hybrid capital issue investors. Indeed, whereas Fannie Mae and Freddie Mac have many unique characteristics, the decision to eliminate their preferred dividends in conjunction with the placement of these companies into conservatorship is a stark reminder of how the fortunes of debtholders and hybrid investors can diverge.

We will assess these ratings--as well as the ratings on other financial institutions' hybrid capital issues--further as circumstances warrant. As financial performance recovers to more normal levels, we could raise the issue ratings and narrow the gap between the hybrid rating and CCR. Hybrid capital ratings are potentially more volatile than ratings on conventional debt issues.

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