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Credit FAQ:

S&P Responds To Market's Questions About Its Risk-Adjusted Capital Framework For Banks

Primary Credit Analysts:
Bernard de Longevialle, Paris (33) 1-4420-7334; bernard_delongevialle@standardandpoors.com
Charles D Rauch, New York (1) 212-438-7401; charles_rauch@standardandpoors.com
Elie Heriard Dubreuil, Paris (33) 1 4420 6748; elie_heriard_dubreuil@standardandpoors.com

Secondary Credit Analysts:
Naoko Nemoto, Tokyo (81) 3-4550-8720; naoko_nemoto@standardandpoors.com
Angelica Bala, Mexico City (52) 55-5081-4405; angelica_bala@standardandpoors.com
Michael Vine, Melbourne (61) 3-9631-2102; mike_vine@standardandpoors.com

Additional Secondary Credit Analysts:
Thierry Grunspan, Paris (33) 1-4420-6739; thierry_grunspan@standardandpoors.com
Lidia Parfeniuk, Toronto (1) 416-507-2517; lidia_parfeniuk@standardandpoors.com
Ritesh Maheshwari, Singapore (65) 6239-6308; ritesh_maheshwari@standardandpoors.com

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Credit FAQ:

S&P Responds To Market's Questions About Its Risk-Adjusted Capital Framework For Banks

Standard & Poor's Ratings Services presents key questions that market participants have raised--and our answers--about our proposed risk-adjusted capital framework (RACF). Briefly, we're modifying our approach to measuring the capital of financial institutions worldwide. Earlier this year, we solicited feedback on the RACF with the publication of a request for comment: "Standard & Poor's Risk-Adjusted Capital Framework For Financial Institutions," originally published April 15, 2008, on RatingsDirect.

Since then, we've received more than 50 formal written comments. Plus, we sought feedback through more than 100 meetings globally with representatives of banks, industry associations, regulators, investors, and other market participants. Most of them appreciate our endeavor to develop a complementary risk-adjusted capital measure to Basel II that is globally consistent and potentially less procyclical. However, a number of institutions and industry associations expressed concerns and raised questions about our proposed approach.

We've considered all suggestions, and are incorporating some of them in the RACF, as explained below. We've also explained why we haven't incorporated other suggestions. Although there is no single answer to the complex issue of the measurement and comparison of capitalization, we believe our RACF will usefully complement existing measures. We intend to use it to help us analyze the creditworthiness of financial institutions worldwide, but also to make it publicly available with the goal of making our ratings approach as transparent as possible.

In light of the current market dislocations, Standard & Poor's also decided to extend the backtesting exercise that feeds into RACF's benchmarks and postpone publication of our detailed methodology to the first quarter of 2009. In the meantime, we'll continue to exchange views with market participants, collect additional feedback, and continue to communicate our opinion regarding our approach to analyzing capital.

Frequently Asked Questions

Why are you introducing yet another measure for capital?

- We want to update and refine our capital measure in light of Basel II. Our proposed RACF is not something new but a continuation of what we're already doing.
- We want to facilitate our comparisons of a bank's risk-adjusted capital levels with those of other banks within a given country as well as internationally and to present our own assessment of risks.
- We believe that the marketplace is better served by having several quantitative indicators of risk-adjusted capitalization rather than just one.
- Finally, Standard & Poor's is committed to the transparency of our criteria and ratings methodologies.

Our proposed RACF is evolutionary.

We consider our proposed RACF as evolutionary, not revolutionary. For years, to complement regulatory ratios, we've been relying on our own measures and definitions of capital: adjusted common equity (ACE) and adjusted total equity (ATE). For details about how we adjust those ratios to come up with our key capital and earnings measures, see "Financial Institutions Group Provides More Transparency Into Adjustments Made To Bank Data," published April 26, 2007, on RatingsDirect.

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Until now, we've used a bank's ratios of ACE and ATE to published Basel I risk assets, making qualitative adjustments to the ratios as we deem analytically appropriate for our rating analysis. Now, thanks to banks' increased disclosure as part of Basel II's Pillar 3, we can quantitatively and following a consistent framework adjust risk-weighted assets (RWA) to compute our risk-adjusted capital (RAC) ratio.

It facilitates comparison and includes a closer look at an individual bank's risk.
The RAC ratio will help us to maintain the comparability and consistency of our ratings. As we've mentioned in previous publications, the numerator and denominator of Basel II ratios integrate discrepancies that we believe make direct comparisons among banks difficult and potentially misleading.

Definitions of Tier 1 capital and core Tier 1 capital vary from country to country. In an increasing number of countries, Tier 1 capital includes significant amounts of hybrid securities. Regulatory risk assets can also differ markedly from institution to institution for the same underlying risks. By contrast, both the denominator and the numerator of our RAC ratio will draw on globally consistent methodologies and therefore will in our view aid in comparative analysis. Our RACF will also factor in our own assessments of certain risks, which may differ from that of regulators or financial institutions. For example, we consider that the current regulatory treatment of the trading book doesn't reflect the magnitude of the underlying risks.

Several quantitative measures of capital are better than one.
We view our RAC ratio as a complement to and not a substitute for Basel II. All approaches generally lead to a simplification of the underlying economic reality. In addition to, in our view, minimizing model risk, having several quantitative indicators of capitalization gives us a more nuanced opinion about financial institutions' capitalization. We'll use our RAC ratio as a starting point for analyzing a bank's Basel II ratio output and its internal Pillar 2 assessment. By analyzing the differences among these data, we believe that we'll be able to reach a more informed opinion about a bank's capital adequacy. Standard & Poor's will continue to refer to regulatory capital ratios in our analysis and publications. In particular, the Basel II ratios constitute key inputs for many aspects of our analysis, especially our assessment of a bank's enterprise risk management (ERM), risk profile, and capital.

It's a quantitative formalization of our qualitative opinion.
We believe that the RAC ratio will make our approach to assessing a bank's capital adequacy much more transparent to all market constituents--including investors and issuers. As we mentioned in our Request For Comment, the RAC ratio is not a change in our opinion about capital for financial institutions, but the quantitative formalization of our qualitative opinion. We don't expect the introduction of the RAC ratio to lead to rating changes. However, it should allow market constituents to have a much clearer view of our opinion about a bank's risk-adjusted capital level and to what extent it can affect the ratings.

Why don't you wait for Basel II improvements before deciding whether or not to disclose the RAC ratio?

We welcome the numerous expected improvements to Basel II and may adapt our approach to factor in any resulting changes to regulatory measures. More globally consistent and comparable regulatory ratios to some extent would probably reduce the need for a complementary measure like the RAC ratio. But until then, we believe the RACF addresses what we consider are the Basel II distortions to the comparability of regulatory ratios.

The Basel Committee on Banking Supervision stated in the introduction of Basel II that it "has designed the Framework to be a more forward-looking approach to capital adequacy supervision, one that has the capacity to evolve with time." For example, regulators are now working on the "Incremental Event Risk Charge" (IERC) to upgrade trading book treatments, mostly dating from 1996.

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We anticipate that banks with large capital market operations are likely to consider preparing themselves for increased regulatory capital requirements for market risk flowing from the IERC. Preliminary estimates show that they could rise by 3x to 6x in January 2010 when the IERC and the modeling of default and migration risk take effect. These extra capital risk weights, we believe, could rise even further in January 2011 if the IERC is extended to other risks (such as equity or spread risks).

Standard & Poor's will consider adapting the RACF to these changes in the regulatory treatment of the trading book. The RAC ratio, which we expect to introduce in 2009, will include a multiple to regulatory capital requirements for the trading book that may no longer be needed once the IERC fully takes effect. We'll continue to closely monitor regulatory developments and update our RACF accordingly as we consider appropriate. For more details about our opinion and proposed approach to risk weights in the trading book, see the article "Trading Losses At Financial Institutions Underscore Need For Greater Market Risk Capital," published April 15, 2008, on RatingsDirect.

What is the value of the RAC ratio compared with Basel II internal-ratings-based estimates?

Standard & Poor's believes that there is value in "expert-based" risk weights as well as in quantitative output from models.

Our "benchmark risk weights," our starting points for capital analysis, express our opinion about risk relativities among asset classes and countries. They should provide a useful, independent, and complementary opinion to banks' internal estimates. The case studies we've been performing globally for the past year confirm to us that, in a number of cases, we have a difference of opinion with respect to the internal risk weights that banks compute and our own risk assessment. Furthermore, we've observed that internal ratings-based (IRB) figures aren't always consistent among banks within the same market and suggest relativities among markets that aren't always in line with our own risk assessment.

Basel II is more detailed and issuer-specific than our benchmark risk weights, but its sensitivity to assumptions, model calibrations, and national discretions can in our view significantly distort relativities and make comparisons potentially misleading. For example, current Basel II IRB risk weights that local banks compute tend to indicate that Japanese and German retail mortgages are on average several times more risky than those in Spain or the U.K. By contrast, our final benchmark risk weights indicate different and sometime opposite relativities between these mortgage markets. Equity portfolios constitute another example, where even Basel II's standardized approach can lead to a risk weight that is 50% higher in some countries than in others. For more examples of differences in risk weights under Basel II see, "Transition To Basel II Creates A Need For A Consistent, Comparable Measure Of Bank Capital," published Feb. 21, 2008.

A limitation of our approach is that we don't quantitatively differentiate risks within the same asset class in a country except for credit risk mitigation. However, under our RACF we will continue to do that qualitatively in the rating process.

How can you ensure that the RAC ratio is transparent and replicable if you adjust for the specificities of each institution?

The replies to our Request For Comment expressed concern that our proposed quantitative specific case adjustments (SCA) may make our framework complex and opaque, so we decided against performing them. However, we expect to continue to use our qualitative judgment about an institution's specific features. When we launch the RACF, we anticipate using that qualitative judgment to complement RAC ratio output and other existing measures like

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regulatory ratios. As originally planned, we expect to make our RACF methodology and parameters publicly available. Since Standard & Poor's does not propose to factor qualitative adjustments into the calculation of the RAC ratio, any market constituent, provided that all the information we've used has been publicly disclosed by individual institutions, should be able to fully replicate our RAC results. With this high level of transparency, we look forward to a better dialogue with investors and issuers about our opinions about capital adequacy.

Standard & Poor's regularly incorporates confidential information in our rating process. In calculating the RAC ratio, however, we expect that most of the information we'll use will be in Pillar 3 or in other public disclosures, and we'll need little confidential information.

Is the RAC ratio less procyclical than Basel II?

We expect the RAC ratio to be less "procyclical" than Basel II IRB ratios. No one has an exact idea of how much risk-weighted assets would rise as calculated under Basel II in an economic downturn. Estimates vary from low to relatively high double-digit volatility between the peak and trough in the credit cycle.

We continue to estimate that, under Basel II, risk-weighted assets would rise 10% to 20% in an economic downturn. That's despite some of the changes regulators have adopted in recent years to limit the procyclicality of Basel II, specifically to the main formula for determining capital requirements. (See "Assessment Of The Basel II Framework: Where Do The Key Formulas Come From?" published Feb. 15, 2007.) For institutions highly concentrated on one single asset class in a given country, we should not rule out 50% or greater volatility in extreme scenarios. For example, if estimates of loss given default (LGD) for retail mortgages rise in a specific market to 18% from 12% as a consequence of a sharper-than-currently-expected drop in real estate prices, risk-weighted mortgage assets would need to rise by 50%.

The fact that IRB retail mortgage risk weights are on average two to three times lower in countries like Spain and the U.K. than in Germany or Japan illustrates, in our opinion, how much past credit cycles can affect calibrations and the lagging impact on banks' capital ratios before realized losses result in higher or lower risk weights.

In comparison, our RACF relies on benchmark risk weights that we've calibrated to what we view as the low point in an exceptionally difficult credit cycle and in our opinion should be much less volatile over time. Although a country's structural economic risk may change and therefore require a change in our benchmark risk weights, these changes we anticipate should be the exception rather than the norm. Our benchmark charges aren't based on one-year probability of defaults (PDs) stressed in a model to a high confidence interval, but are our top-down estimates of what could be the impact of what we consider to be a three-year worst-case scenario. Therefore, normal swings in one year PD and LGD estimates over the credit cycle, we believe, should not challenge the adequacy of our benchmark charges.

How are we modifying the RACF in light of the responses we've received to the Request For Comment?

The Request For Comment has been extremely useful to help us identify some potential shortfalls of our original proposal, while confirming the fundamental value of our RACF approach. The most important changes that we're currently finalizing are:

We're changing how we factor in a country's economic risk.

We'll move away from the Banking Industry Country Risk Assessment (BICRA) in favor of an economic risk score as a scaling factor to compute our country charges for corporate and retail asset classes. (For further information about our BICRA methodology, see "Banking Industry Country Risk: These Are the Good Old Days," published

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June 6, 2006, and "S&P's Banking Industry Country Risk Assessments: Global Annual Roundup," published Aug. 9, 2007.)

We acknowledge that the BICRA, which reflects both economic risk and banking system industry risk, is in some cases heavily influenced by the latter and not always well correlated to domestic corporate and retail credit risk. We're developing a new scoring system for country economic risk that we believe should address this distortion issue and which we expect to make public when we introduce the RACF. We anticipate that rating committees at Standard & Poor's will assign and monitor these scores, following a process similar to that for our ratings. We plan on publishing and updating the scores and supporting analyses.

We don't anticipate using specific case adjustments.
We don't anticipate performing quantitative specific case adjustments (SCA), as explained above, to ensure that our approach is transparent and replicable.

We're dropping the idea of a benchmark floor.
Consistent with not performing specific charge adjustments (SCAs), we decided to drop the "benchmark floor" concept. Instead, we intend to apply our benchmark risk weights to a bank's exposure at default, which would be independent of the risk weights that it calculates under Basel II.

The benchmark floor was to serve as a conservative starting point for an SCA, whereby Standard & Poor's analytical committees would have discussed the differences between IRB figures and our benchmarks in order to form our opinion. As part of that process, we would have quantified a specific charge adjustment, which we would have factored into the final RAC ratio.

However, the benchmark floor concept would have introduced asymmetries in the treatment of institutions under the standardized approach compared with those under the IRB approach, and in capturing only the most conservative part of the higher sensitivity of the Basel II formula.

We propose lowering our risk weights for certain unrated securitizations.
We'll continue to base our benchmark risk weights for securitization exposures on our structured finance ratings, in an approach similar to the Basel II standardized approach. Concerning unrated exposures, we'll continue to deduct unrated first-loss pieces and mezzanine tranches, but we propose to apply a lower capital risk weight to unrated senior exposures and unrated liquidity facilities associated with asset-backed commercial paper (ABCP) programs.

We're going to use the information that institutions care to give us for assessing their capital needs to develop more granular asset class definitions.
In order to improve the risk sensitivity of our approach, we intend to use more granular asset class definitions and define new benchmark risk weights at the outset of the RACF rollout. We'll also seek to better recognize credit risk mitigation factors. For example, we expect the RACF to be able to differentiate for portfolios such as commodities finance, funds, Lombard loans, leasing, or those hedged with credit derivatives. However, we'll aim to stick as much as possible to Basel II sub-asset-class definitions, in order to maintain consistency in definition and minimize any extra workload for credit institutions.

We'll take into consideration the granularity of listed and unlisted equity portfolios.
As stated in the Request For Comment, we believe that "both model computation and historical track records clearly show that stock market fluctuations of 30% to 50% over a one-year period can take place." However, Standard & Poor's acknowledges that a simple unique benchmark would likely fail to capture the diverse

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composition of the world's stock markets, as well as the differences in diversification and concentration of portfolios that institutions hold. All other things being equal, we consider that a portfolio composed of one single line of €100 million is riskier than a portfolio composed of 100 lines of €1 million each.

Standard & Poor's intends to differentiate equity risk weights according to the volatility of each market, granularity of the portfolio, and geographic diversification.

We're changing the way we adjust for asset diversification.

Instead of adjusting for diversification across asset classes and risk types, we intend to adjust for concentration and diversification across business lines (e.g. corporate, retail, trading, insurance). This is more in line with our analytical reasoning. We plan to publish full details about these adjustments in the 2009 criteria article.

To what extent does the RACF incorporate observations from the current credit crisis?

Our calibrations of the RACF, in our view, look on average more conservative than banks' own estimates under IRB and their economic capital model computations. However, given the current market dislocation and prospects for deep recessions in a number of markets, we're reassessing the adequacy of our stresses. For now, we still believe that the vast majority of our benchmark stress scenarios are robust enough, but we've decided to extend our backtesting exercise a few months to factor in as many as possible data points from the current credit crisis.

When are you going to introduce the RACF?

In light of the current market dislocations, Standard & Poor's decided to extend the backtesting exercise that feeds into RACF's benchmarks and postpone publication of our detailed methodology to the first quarter of 2009. In the meantime, we'll continue to exchange views with market participants about our approach to analyzing capital, collecting further feedback and communicating our opinions.

We'll likely start referring to our new RAC ratio in our reports on individual banks that we rate in the second quarter of 2009. However, we expect this will be a gradual transition throughout the year depending on the availability of Pillar 3 data. We intend to include the detailed RAC results in a table that we'll include when we update each institution's Full Analysis (see table below for an example of how we might present the RAC results).

Note also that due to the delayed implementation of Basel II in the U.S., we intend to employ an interim framework based on the financial statements for U.S. banks, as described in the Request for Comment.

Table 1

Illustrative Example Of Standard & Poor's Detailed RAC Results

	Exposure*	Basel II RWA	% of exposure	S&P's RWA	% of exposure
Credit risk					
Government and central banks	4,828	550	11	297	6
Institutions	9,706	2,053	21	2,155	22
Corporate	46,523	44,675	96	40,321	87
Retail	38,418	8,753	23	11,728	31
Of which mortgage	32,096	4,225	13	7,712	24
Securitization	0	0	0	0	0
Other assets	525	525	100	525	100
Credit risk total	100,000	56,555	57	55,026	55

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Table 1

Illustrative Example Of Standard & Poor's Detailed RAC Results (cont.)

Market risk					
Equity in the banking book	251	260	104	1,568	625
Trading book market risk	--	3,042	--	4,563	--
Interest rate risk in the banking book	--	--	--	0	--
Market risk total	--	3,302	--	6,131	--
Insurance risk					
Insurance risk RWA	--	--	--	7,377	--
Operational risk					
Operational risk RWA	--	3,114	--	3,325	--
Total before diversification					
RWA before diversification	--	62,972	--	71,859	--
		Basel II RWA	**% of RWA**	**S&P's RWA**	**% of RWA**
Diversification and concentration					
Single name (on corporate portfolio)		--	--	5,815	14.4
Sector (on corporate portfolio)		--	--	(1,569)	(3.9)
Geographic		--	--	6,223	11.3
Business and risk type		--	--	(5,236)	(4.8)
Total RWA adjustment		--	--	6,914	9.6
Total after diversification					
RWA after diversification		62,972	--	78,773	--
Capital ratio					
Tier 1		4,770	7.6	--	--
ATE (RAC ratio)		--	--	4,650	5.9

*In order to preserve anonymity, data has been rebased to US$100,000 total credit risk exposure. RAC--Risk-adjusted capital. RWA--Risk-weighted assets.

Additional Contact:
Financial Institutions Ratings Europe; FIG_Europe@standardandpoors.com

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