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

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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.

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