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U.S. Banks: Back To Fundamentals

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U.S. Banks: Back To Fundamentals

The U.S. government announced yesterday that it has developed a three-pronged support plan to strengthen the balance sheets of U.S. banks and to restore confidence in the financial system. Standard & Poor's Ratings Services believes that this plan likely will mark the turning point in the crisis of confidence currently afflicting credit markets. Following on the heels of concerted moves by European central banks, as well as those of other countries around the world, the U.S. plan employs broadly similar measures aimed at increasing the financial institutions' access to funding as well as bolstering capital.

We believe the recent moves by the various governments will likely have a meaningful market stabilizing influence. Although, from a rating perspective, we view the potential effects of the plan as favorable to the credit quality of U.S. financial institutions, we do not anticipate an immediate impact on participating bank ratings. We are in the process of reassessing both industry risk and individual bank and bank holding company debt ratings in light of recent events. Specifically, there are eight issues that we will be addressing in this industry reassessment:

- How the business of banking may fundamentally change;
- Level of capitalization, asset quality, and estimated loss projections;
- Rating to fundamentals in irrational markets;
- Actual and potential government support or intervention;
- Operating company and holding company notching, including notching for hybrid securities and differences between senior and junior instruments;
- Appropriate leverage;
- Risk management issues such as risk appetite; and
- Funding/liquidity management and preparedness for dislocated markets.

We anticipate that our reassessment of the industry and rating actions, if any, will be completed within the next several weeks.

Tackling Systemic Risk

The U.S. Treasury, the Federal Reserve Board, and the Federal Deposit Insurance Corp. (FDIC) have announced yesterday a series of steps intended to restore confidence in the financial system and prop up capital in financial institutions.

Temporary liquidity guarantee program from the FDIC

The U.S. Secretary of the Treasury has signed the systemic risk exception to the FDIC Act. Under this Act, the FDIC is permitted to temporarily guarantee the senior debt of all FDIC-insured institutions and their holding companies (banks and thrifts, but not credit unions), as well as deposits in non-interest-bearing deposit transaction accounts. The plan allows participating institutions to have senior unsecured debt issued on or before June 30, 2009, to be guaranteed by the U.S. government for no longer than three years, whether or not the debt has matured. For debt scheduled to mature before June 30, 2009, the total amount guaranteed should not exceed 125% of outstanding debt as of Sept. 30, 2008. For this guarantee, the bank would pay a premium of 75 basis points (bps), resulting in a still-attractive cost of funds on an all-in basis compared with current market rates. Non-interest-bearing transaction deposit accounts held by FDIC-insured banks will be guaranteed until Dec. 31, 2009 (including promissory notes,

commercial paper (CP), interbank funding, and any unsecured portion of secured debt); a 10 bps surcharge will be applied beyond the \$250,000 deposit insurance limit. The premium is intended to compensate taxpayers for any costs to the government. If the costs are not covered by the premiums, the FDIC could collect special assessments from the banks.

The concept is in the mid-range of programs instituted by other nations—between those that issued blanket guarantees like Australia, and those that charged higher rates for the debt, tying it to bank creditworthiness, as in the U.K. This should allow U.S. banks to compete for funds in the global markets on an equal footing. It is, in our opinion, the most powerful aspect of the program because it speaks to the most immediate issue confronting the financial system: an almost total freeze in the interbank and other funding markets. We anticipate that investors will come off the sidelines and be far more willing to take up the debt of nine of the largest U.S. financial institutions, which could jumpstart the flow of funds in the financial system. Nine of the largest financial institutions have agreed to participate in this program.

A capital purchase program by the Treasury

The Treasury will set aside \$250 billion of the \$700 billion of funds approved by the Congress under the Emergency Economic Stabilization Act (EESA) for recapitalizing banks. Under the program, during the next 30 days (before November 15), healthy institutions will be able to issue nonvoting cumulative senior preferred stock to the government for a minimum of 1% of risk-weighted assets and a maximum of 3% of risk-weighted assets, or \$25 billion. These senior preferred shares qualify as Tier 1 capital and will carry a relatively favorable dividend rate of 5% for the first five years; if not called at the end of that period, the rate would step up to 9%. Dividends paid on these shares will be *pari passu* with other senior preferred dividends, and no junior securities or common shares can pay dividends if dividends are not paid on the senior preferred shares. The shares will be callable at par after three years, or before that, only if these are replaced by retained earnings or an issue of either common or preferred stock, or Tier 1-qualified capital if approved by the regulator.

The move should improve confidence in the financial system, which in turn has ripple effects for funding. However, we see that most institutions need common equity more than hybrid capital. To be sure, the larger institutions are already near maximum levels on hybrid securities within the capital structure in accordance with Standard & Poor's criteria. The step-up feature, in our opinion, also disqualifies the instrument for inclusion in our capital measures given the incentives it contains to exercise the call. Furthermore, if banks continue to experience bottom-line losses over the next year or two due to loan loss provisioning requirements, in our opinion, the headroom for preferred issuance (for which common equity is the base) will likely diminish. In addition, banks that issue this preferred stock will have to abide by the EESA provisions that place restrictions on executive pay, such as the use of golden parachutes, and that require the issuance of warrants to buy the bank's stock equal to 15% of the preferred stock issue. We will treat the warrant-related addition to paid-in-capital as a component of capital. This could put a damper on the appetite to issue such stock, although the same nine large banks have already signed on to do so.

Broader CP funding facility (CPFF) program from the Fed

The Federal Reserve will fund purchases of three-month CP from high-quality issuers, both industrial and/or financial, starting October 27. Under the program, there will be a special purpose subsidiary set up to issue the debt. We understand that it is intended to reach firms outside the financial sector given the broader concerns about the effects of the credit crunch on the real economy.

No Details Yet On Distressed Asset Pricing

The announcement provided no further information on the workings of EESA's main thrust, which was to purchase or guarantee troubled assets (at first mostly mortgage assets) in order to promote liquidity and pricing transparency to the markets. About \$450 billion of the EESA funds remain to be committed to this purpose (although their deployment above the first \$100 billion requires additional congressional approval), which is aimed at the root of the market turmoil—the valuation of mortgage-related assets. This aim has broader implications for the housing markets in our view. If implemented successfully, it could help put a floor under mortgage assets and, by extension, under house prices themselves.

Some large questions remain about the program, although we believe that markets should be able to again focus on fundamentals. The time constraints are one issue. What will the economy and the banking system look like after three years when the debt guarantees, and even possibly will the preferred stock investments expire? Will that be enough time for banks to have worked through their bad loan portfolios, and for the funding markets to have returned to normal? Will the plan effectively limit the downside effects of the credit crunch on the economy? An ordinary credit cycle may last three years, but could one of this magnitude last longer?

A Reassessment Of The Industry

Standard & Poor's continues to evaluate its ratings on financial institutions in light of recent events and regulatory developments. On a positive note, there now appears to be a consistent global response to restoring confidence to global financial markets; we view this as a favorable development. Still, the business of banking may be changing, as both Goldman Sachs and Morgan Stanley are now bank holding companies, and the deleveraging of balance sheets accelerates. In our opinion, banks as financial intermediaries likely will evolve differently as the industry consolidates further and the regulatory framework is overhauled. They are likely to be much better capitalized in future. This will affect the returns that banks can earn, but at the same time, perhaps, reduce the potential for the type of volatility we are witnessing now. We anticipate that the originate-to-distribute model will also likely be heavily scrutinized. At the end of the day, there seems to be two conflicting forces in the banking industry that banking regulators will need to reconcile: deleveraging, and re-intermediation of the "shadow banking system." We continue to focus our analysis on fundamentals and on the capital required to sustain ongoing operations and offset potential losses. If banks are permitted to recognize losses over the next few years, rather than having to accelerate lifetime losses on loan portfolios into the current period, capital requirements, at least current regulatory ones, should be manageable. However, fire-sale valuations could lead to widespread insolvencies not contemplated in ratings. We expect that the recent pronouncements by the Financial Accounting Standards Board and the SEC on mark-to-market valuations of illiquid securities should stabilize the markets even further, as will the confidence-boosting efforts of central banks and market regulators. We believe that the moves should help alleviate the potential for the confidence-driven erosion of credit (so-called "credit cliffs") for institutions that have their funding cut off because of market conditions rather than fundamentals.

Standard & Poor's will likely not change banks' ratings at this time as a result of the government's recent actions. However, while we believe these actions will help restore confidence in financial institutions and help stabilize funding markets, the very real issue of deteriorating asset quality as the economy slows, continues to pose risks to the banking system in our view. We expect earnings to suffer from continued write-downs on market-disrupted

securities and, more importantly going forward, from provisions for loan losses. Thus, there continues to be downward ratings pressure on the major banks, even though the risks of a credit cliff have receded.

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