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What The New Administration Means For U.S. Banks And Ratings

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What The New Administration Means For U.S. Banks And Ratings

The new administration of President Barack Obama is bringing change, and perhaps no place will feel it more than Wall Street. What the ultimate impact will be on U.S. financial institutions and how it will affect their creditworthiness is still being worked out, but Standard & Poor's Ratings Services believes government support will be a net positive. In the wake of a damaging sequence of events that has led to the most profound changes in the banking industry since the Great Depression, government intervention has the potential to both reinvigorate and reinvent banking, albeit with increased regulation, stronger enforcement of existing rules, and overhauled supervision.

President Barack Obama's effort to stabilize the capital markets, revitalize the economy, and get banks lending again is still a work in progress, of course. Questions remain in the market as to whether or not the government will have to nationalize banks to keep them solvent, particularly after the U.K. expanded its bank rescue program with majority ownership of a bank in late January and U.S. banks reported huge losses for the fourth quarter. Other market concerns include how the new administration will handle bank restructurings, and loan modifications, and how sweeping new regulation will be. The lines of government control are already becoming visible, however. We believe that the favorable effect federal liquidity and capital support programs could have on the industry's performance, if successful, will eclipse these concerns from a ratings perspective. Remaking America in general and Wall Street in particular likely will take time, but the new administration appears to be evaluating what we view as several workable solutions to the financial system's problems, weighing both opportunities and potential risks.

Although our ratings ordinarily don't hinge on a shift in political control, we believe that the government's potentially extraordinary support is a key ratings factor for the eight major banks the government has deemed to be systemically important (see table 1). Press reports state that President Obama is pushing for additional money to inject fresh capital into banks and at the same time facilitate loan modifications to stem foreclosures. The plan, which the remaining \$350 billion in Troubled Asset Relief Program (TARP) money might fund--should this be the objective--would also reportedly detail steps to address in some fashion the deteriorating assets that weigh on lenders' balance sheets. President Obama's complementary economic stimulus plan, which the House of Representatives valued at \$819 billion under its recently passed bill, is equally important because it could soften the impact of economic stress on bank losses.

How Far Would The Government Go?

So far the government has been trying to strike the difficult balance between leaving banks privately managed and providing sufficient capital to keep them afloat. It has avoided taking controlling equity stakes, opting instead for nonvoting stock in the form of preferred shares in return for the TARP funding. However, if the economy deteriorates to such a point that additional losses would materially erode common equity, the U.S. government may be forced to take equity positions, or, at the very least, may have to provide more capital infusions to restore confidence in the banking system. Already, Citigroup's second tranche of \$20 billion in support is convertible at the company's discretion to common equity. The government also owns warrants that it issued alongside the TARP money, which give it small stakes in the banks – though nowhere near a controlling interest.

Whether or not the government will revive TARP's original intent -- to set valuations for hard-to-price assets -- remains an open issue. One way to do this might be to establish a "bad bank" under the FDIC that would pool the most toxic of assets from bank balance sheets, such as devalued mortgages or mortgage-related securities, to encourage renewed lending. Or Washington might achieve the same goal by guaranteeing losses above a certain level. A successful program to remove the risks of problem assets from bank balance sheets should help restore confidence that at the moment is sorely lacking in the banking system, we think. A mechanism to establish pricing of securities that encumber bank balance sheets could also help arrest the decline in the value of those assets.

A nationalization of the banking system, if it comes to that, would stabilize ratings in the near term but, we think, present longer-term concerns of stifling innovation and competitiveness. It could also make the banking system subject to policy initiatives, such as government directed lending to particular sectors, which we've seen in nationally owned banking systems including Mexico's in the 1980s.

Table 1

TARP Transactions Report For The Period Ended Jan. 23, 2009	
Par amounts for preferred stock with warrants	
	(Mil. \$)
Bank of America Corp.	45,000
Bank of New York Mellon Corp.	3,000
Citigroup Inc.	45,000
The Goldman Sachs Group Inc.	10,000
JPMorgan Chase & Co.	25,000
Morgan Stanley	10,000
State Street Corp.	2,000
Wells Fargo & Co.	25,000

Source: U.S. Treasury Department.

Accepting Support Has Its Costs

It's unclear how the new administration will view the broadly worded TARP policy. Regulators could become increasingly prescriptive, for instance, about who banks lend to and how they restructure loans to borrowers that run into trouble. We would be concerned that aggressive regulatory intervention could not only skew capital allocation but also undermine the competitiveness of the banking system. We do not expect this, but it would be a negative rating factor if it were to occur. Our analysis of industry risk identifies quality of regulation as an important factor.

Accepting government help likely will have other ramifications for banks. TARP requirements already have forced them to cut executive pay, which eventually could hamper their ability to attract management talent. Other aspects of the TARP still require interpretation, particularly language barring banks from giving incentives for senior executive officers to take "excessive risks" that threaten the value of the financial institution during the period that the government holds an equity or debt position in it.

Loan Modification Can Get Complicated

Even as several banks have started their own loan modification programs that help restructure delinquent or past-due mortgages to affordable levels for homeowners, the government has signaled its own goal of helping to stem the rising rate of foreclosures. We've read in the press that the new administration is considering subsidizing loan modifications, allocating a portion of the TARP money or creating a new program. In our opinion, this move would effectively allow people to stay in their homes, could relieve banks of the steep losses associated with foreclosures, and probably would help prevent further erosions in bank loan losses.

From a ratings perspective, we believe loan modifications benefit the industry indirectly, but implementation of a broader government program likely won't be easy. We are concerned about legal issues that still surround the issue of whether or not banks can modify loans that have been securitized because the institutions don't own the securitizations. Could the institutions be sued if they tried to modify the loans as servicers? We would also be watchful of whether or not the terms to modify the loans, for example debt forgiveness, would be such that they could lead to large losses for the banks. In our opinion, these practices could create a moral hazard: If consumers see that it is easy to get their loans modified, for example, more borrowers may try to take advantage of the program and stop making payments. Lastly, questions remain in the marketplace that surround the efficacy of existing loan modifications, which in our view can serve as a band-aid rather than a cure for preventing foreclosures and helping arrest the erosion in house prices. If the government's new loan modification program proves successful, however, we believe it could limit further house price declines, which directly influence foreclosure rates and bank losses.

Regulatory Oversight Could Take Many Forms

The loudest calls for more regulation arise from a desire to prevent banks from returning to loose lending practices that might precipitate another credit market downturn. The question is whether or not the government could provide limits on certain business activities, or prohibit them, to keep banks in line, while motivating them to continue lending. Another alternative would be for the government to break up big banks and/or prevent new behemoths from forming so that they no longer pose a systemic risk. The markets may also put pressure on large, unwieldy institutions to break themselves up, as we believe is happening at Citigroup.

The rating implications of increased federal regulation of banks largely depend on whether or not such oversight will stymie bank growth as a result. The issue at the end of the day is if a stronger hand from the U.S. government could result in institutions being less responsive and innovative.

Moreover, we believe that national regulators eventually may reevaluate the Basel II approach to assessing how much capital banks need to keep on hand to underpin credit risk amid extreme stress scenarios, plus risk in their trading and investment books. Regulators and investors may also require higher cash buffers, especially for wholesale-funded banks, as opposed to those that have substantial funding from retail deposits. And they may encourage less risk-taking, especially in banks' proprietary trading.

We also expect more types of previously unregulated financial institutions to come under bank regulatory oversight. In the U.S., for example, authorities are incorporating the large securities firms into the bank regulatory framework, and the Federal Reserve has approved other finance companies, such as American Express Co., CIT Group Inc., and GMAC LLC, for bank holding company status. In our view, this would be a positive factor in our industry risk

assessments because the current two-tier system of regulated and unregulated institutions can create different sets of market rules and fuel irrational competition. Still, although a positive for the institutions themselves, this is a neutral factor in the ratings assessment.

How Government Support Factors Into Our Ratings

Beyond its role in regulation, the U.S. government's involvement in the banking industry as a whole has become a central theme in our credit analysis, especially with regard to systemically important financial institutions. Washington's willingness to take extraordinary measures to support the sector is no surprise, given the U.S. banking industry's vital importance to the health of the world economy. As of December 2008, we started recognizing the government's potential for extraordinary support for certain banks in the U.S., though we had done this in Europe and Asia already. At some point, we believe the U.S. will seek to wean the sector off of these support mechanisms and search for ways to contain systemic risk to avert another crisis. But that will be difficult to do until the financial markets have stabilized. In the meantime, we will monitor the new administration's programs as they unfold.

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