

# When Fear Overtakes Fundamentals In Credit Markets

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PARIS (Standard & Poor's) Oct. 1, 2008--Global capital markets currently face single-day movements of 30% or more in share prices of financial companies and volatility in borrowing rates and spreads on credit default swaps. When uncertainty of this magnitude dominates the markets, Standard & Poor's Ratings Services believes that the assessment of a financial institution's credit profile should take into account the interaction between fundamental credit elements and short-term factors shaped by market distress.

"This balance is essential for banks and broker-dealers, because confidence is a meaningful factor in the highly leveraged financial sector," said Standard & Poor's credit analyst Scott Bugie.

Investment banking business lines such as securities trading and prime brokerage can be particularly confidence sensitive, since they require a high volume of daily cash, securities, and derivative transactions with counterparties. Continual access to securities and derivatives markets is the lifeblood of these businesses.

"Volatility in share prices and credit spreads can quickly switch from reflecting temporary 'market noise' to inflicting more lasting commercial and financial damage to a financial institution's fundamental credit profile," added Mr. Bugie.

Sharp drops in share prices can rapidly erode ability to raise equity, while a sudden widening of spreads automatically increases the cost of funding (see our criteria article "How Stock Prices Can Affect An Issuer's Credit

Rating," published Sept. 26, 2008, on RatingsDirect). The most damaging developments for banks and brokers are a loss of access to daily cash and derivative transactions at any price or collateral haircut and an outflow of customer deposits (a bank run). Going from noise to material damage is a complex shift involving judgment of market psychology.

The speedy impact of negative market sentiment on fundamental creditworthiness contributed to the sudden bankruptcy of Lehman Brothers Holdings Inc., the rescue of American International Group Inc. via the U.S. Treasury's two-year, \$85 billion credit line, and the collapse--and subsequent bailout--of Bear Stearns Inc., among others. Negative market sentiment has not been confined to U.S. entities. In Europe, the Dexia and Fortis groups, HBOS PLC, and Bradford & Bingley PLC are recent prominent cases illustrating how downswings in market indicators can quickly weaken credit fundamentals and ultimately force either direct government support actions or hastily-negotiated--and government-brokered--mergers.

#### ACCESS TO MARKETS IS CRUCIAL

We assess a financial institution's relative vulnerability to periods of turbulence in the credit markets, among many factors that determine creditworthiness. A financial institution's fundamental credit profile includes characteristics specific to the entity--franchise strength, business diversification, management skills, earnings quality and stability, and asset risk profile--alongside systemic elements linked to the institutional and regulatory framework in which the institution operates.

"Liquidity is also a critical credit element, particularly in distressed markets. A financial institution's internal liquidity, access to markets, and alternative funding and liquidity support arrangements are important credit factors," said Mr. Bugie, "and an entity's contingency plans for liquidity under severe stress scenarios take on added analytical weight when market conditions are unfavorable and emergency preparations may be put into action. Clearly, institutions that depend highly on short-term wholesale funding are particularly vulnerable to volatile markets."

Negative signals from troubled capital markets not only impair the ability to raise funds, they can also restrict operational liquidity, meaning the ability to execute daily market transactions. Financial institutions need to continually buy and sell instruments and engage in derivative transactions during operating hours and settle accounts at the end of the day in the various markets in which they operate. Fortunately, daily operations are uneventful most of the time. But when the habitual operating environment breaks down, even over a short period, creditworthiness can deteriorate quickly. In these conditions, real or perceived variations in credit profiles can trigger significant shifts in investor and counterparty behavior, up to the most extreme step of a complete closeout on transactions with an institution under any terms.

#### OUR ROLE IS TO OPINE ON CREDITWORTHINESS, NOT DRIVE IT

At times like this, it is important to restate Standard & Poor's long-standing objective and role to opine on creditworthiness, but not to lead it directly. Credit ratings historically have provided ballast to the market because they take an intermediate- to long-term perspective and are based on analysis of

intermediate- to long-term factors. We believe that credit ratings that solely reflect prevailing market sentiment as expressed in prices and spreads would add little value to the marketplace, and in fact could contribute to increased credit price volatility.

In some circumstances, however, movements in share price and credit spreads contribute to a material change in an entity's scope to raise equity, cost of funding, asset values, earnings capacity, and, most basically, ability to operate. Consequently, in troubled capital markets, we are particularly vigilant to assess vulnerability to short-term operational and liquidity factors that influence the fundamental creditworthiness of a financial institution.

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