

features

special report



It's A Tough New World For Global Banking

Midway through 2009, global banks can expect to experience further losses, which are now emanating from the more predictable loan portfolios. To date, most losses have been concentrated in the larger banks' securities portfolios, specifically as these relate to trading assets. Financial institutions face a barrage of challenges to their business and financial profiles: widespread asset quality deterioration, greater capital demands, lower earnings, increased regulation, extreme market volatility, and recessionary conditions. Structural changes are also transforming the industry on a fundamental level. Standard & Poor's Ratings Services has recently adjusted many of its bank ratings and outlooks across North America, Europe, and Asia to reflect this new era of risk and reward.

Proposed financial regulatory reforms could lead to a permanent shift in competitive dynamics...

Since mid-2007, our counterparty credit ratings on U.S. banks (at the operating subsidiary level) have fallen by an average of two notches, to 'BBB+' from 'A'. Where ratings go from here depends on how deep the economic downturn proves to be. If it is deeper than we currently expect, we could revise ratings downward. Our June baseline forecast in the U.S. is for the recession to be the deepest and the longest downturn since the Great Depression, with a sluggish recovery beginning in fourth-quarter 2009.

Longer term, we believe President Obama's proposed financial regulatory reforms could lead to a permanent shift in competitive dynamics, depending on the specifics of the legislation that Congress ultimately enacts. In particular, greater capital requirements—although generally favorable from a bondholder's perspective—may put large banks at a competitive disadvantage versus smaller institutions if rules for them turn out to be more punitive than for smaller banks (see *"Regulatory Reform Raises Competition Issues For U.S. Financial Institutions,"* on p. 16). There are open questions from a credit ratings standpoint about the proposed financial system reform, including how a proposed level playing field among banks and non-banks shapes up, how new methods for resolving bank holding company failures may affect our notching criteria between operating company and holding company, what the new regulatory regime structure means for the likelihood of default, and shifts in our assumptions of government support.

Like the U.S. market, European banks are navigating a deep recession

that comes on the heels of unprecedented losses at several of the sector's largest banking groups in 2008. European banks' credit loss provisions more than doubled in 2008 from 2007, and we believe significantly higher credit losses are on the horizon (see *"European Banks Face Higher Credit Losses As The Downturn Enters Its Second Phase,"* on p. 19).

Likewise, the deepening recession in Russia is leading to an increase in problem loans and credit losses in the country's financial system—a trend we expect is severe enough to lead to a restructuring and recapitalization of the banking sector (see *"High Credit Losses Likely To Trigger Recapitalization Of Russian Banks,"* on p. 31). We broadly estimate under our base scenario that the industry-wide need for additional capital for Russian banks could reach \$40 billion through 2011 (see *"Assumptions: Credit Stress Testing Financial Institutions In The Russian Federation,"* on p. 38).

The banking industry has its bright spots, too. Although U.S. banks in virtually every major market are feeling the severe effects of both the weak economy and their own mounting credit losses, we believe global banks' and brokers' securities-related businesses have already seen the worst (see *"Global Banks' And Brokers' Securities-Related Business: The Worst May Be Over, But Improvement Will Be Gradual,"* on p. 41). As a result, we recently revised our 2009-2010 revenue assumptions for asset-backed securities, collateralized debt obligations, residential mortgage-backed securities, and monoline-related and leveraged finance positions, which serve as starting

points in our analysis of the related businesses of the global banks.

We view government financial support for systemically important institutions and successful capital-raising campaigns in the equity and credit markets as positive factors from a credit quality perspective for certain banks in the U.S. and Europe. We feel these have bolstered investor confidence.

In addition, our revised Bank Industry Country Risk Assessment score for Japan reflects our assessment that during the past five to six years (i.e., since the "lost decade" for Japan's economy, so called because economic growth was more or less flat), structural risks facing the banking industry have moderated to an extent that the Japanese banking industry is likely reasonably to withstand cyclical economic and credit downturns (see *"Banking Industry Country Risk Assessment On Japan Revised Upward To Group 2,"* on p. 29).

Despite our recent slate of rating actions on banks worldwide, we believe institutions face ongoing pressures and structural transformations that will keep ratings trends negative for the next year or two. The downturn still has the potential to surprise many institutions, particularly those with material credit exposures to higher-risk products and/or the most depressed economies. **CW**

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