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Criteria | Financial Institutions | Banks:

Franchise Stability, Confidence Sensitivity, And The Treatment Of Hybrid Securities In A Downturn

Primary Credit Analyst:
Scott Bugie, Paris (33)1-4420-6680; scott_bugie@standardandpoors.com

Secondary Credit Analyst:
Tanya Azarchs, New York (1) 212-438-7365; tanya_azarchs@standardandpoors.com

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Standard & Poor's Ratings Services is updating the following aspects of its methodology for rating financial institutions:

- Franchise stability and confidence sensitivity;
- Payment deferral risk of financial institutions' hybrid securities.

In addition, we are updating certain related assumptions concerning the following:

- Assessment of bank industry risk;
- Volatility of funding markets;
- Projections of bank losses;
- Relative emphasis on capital.

This article amends and partially supersedes the criteria set forth in the "Financial Institutions Criteria" and "The Hybrid Capital Handbook," published on RatingsDirect.

Criteria Summary

We are introducing specific methodology regarding the analysis of confidence-sensitive business lines in evaluating financial institutions' funding, liquidity and overall business risk. In addition, in the context of the downturn of the financial sector, we are articulating the factors that lead to a wider notching for hybrid capital securities relative to our counterparty credit rating (CCR) on an issuer. We are also:

- Adjusting our assumptions to reflect a higher overall level of industry risk for financial institutions;
- Adjusting our assumptions to reflect higher volatility of funding markets and the associated likelihood of systemic risk;
- Adjusting our projections to reflect higher losses for financial institutions; and
- Increasing the emphasis in our analysis on capital relative to other indicia of creditworthiness.

Methodology

Importance of franchise stability (confidence sensitivity)

We believe the face of the banking industry will change as a result of the market upheaval and governments' extensive supportive actions. Analysis of the franchise stability and relative confidence sensitivity of a financial institution goes beyond the funding profile to the fundamental nature of the financial institution's business model.

In our view, stability of franchise and maintenance of market confidence are crucial to a financial institution's credit profile. Although most financial institutions are vulnerable to erosion of confidence (because they are typically highly levered and fund most of their assets with debt), some wholesale banks and nonbank finance companies are more vulnerable than others given their business models and funding mix. For instance, specialist lenders that depend on short-term wholesale funding and financial institutions with large trading operations--particularly in derivatives--are particularly sensitive to an erosion of confidence.

We focus on franchise stability and the relative proportion of confidence-sensitive business lines in an institutions' business mix. Our assessment of this factor forms part of our overall view of a financial institution's business profile. Factors that indicate the relative degree of confidence sensitivity are:

- Degree of the business model's dependence on a perception of strong creditworthiness (the higher the dependence, the more confidence sensitive an institution is likely to be);
- Simplicity/transparency versus complexity/opacity of accounts (simple and transparent institutions are less confidence sensitive than are complex and opaque institutions);
- Significance of explicit credit triggers in derivatives contracts and borrowing agreements (e.g., when collateral requirements increase in the event of a downgrade);
- Wholesale versus retail funding (the higher the proportion of wholesale funding to total funding, the more confidence sensitive an institution).

Financial institutions most exposed to volatile markets and loss of investor and counterparty confidence will likely continue to be vulnerable to loss of market access. Consequently, "sudden default" risk is, in our view, a characteristic of many financial institutions, particularly during periods of extreme market turbulence, although government measures to shore up funding markets, such as those taken around the world in the second half of 2008, reduce this risk.

The investment-banking business lines of securities trading and prime brokerages are particularly confidence sensitive because they require a high volume of daily cash, securities, and derivative transactions with counterparties to maintain inventory positions. Counterparties of these business lines generally expect to have confidence that trades will be settled in accordance with industry norms and that obligations under derivative contracts, including those to post collateral, will be met. A particularly damaging development for investment banks, in our view, is a loss of access to daily cash and derivative transactions at any price or collateral haircut.

Payment deferral risk of financial institutions' hybrid securities

The current downturn in the banking industry leads us to review criteria regarding issue credit ratings on financial institutions' hybrid capital securities. We typically rate the hybrid capital securities of investment-grade financial institutions two notches below our CCR on the issuing institution. The lower issue rating reflects the payment deferral risk and the hybrid's deep subordination under liquidation.

In a downturn of the banking sector and the broader economy, the financial condition of a greater number (than during other parts of the business cycle) of regulated financial institutions may erode to the point where regulators intervene and force suspension of hybrid coupon payments. Or the institution itself may opt to suspend payment to preserve cash and capital. In a more stressed operating environment, we analyze issuers' hybrid securities to assess if the issuer's stand-alone credit profile, the structure of the hybrids, and the regulatory practices concerning hybrid securities in the applicable jurisdiction combine to increase the risk of payment deferral. When we perceive increased risk of payment deferral, we assign a hybrid issue rating three or more notches below the CCR on the issuer.

In identifying cases that warrant a wider gap between the CCR on the issuer and the issue rating on the hybrid securities, we assess the following indicators of heightened risk of deferral:

- The issuer has incurred material net losses recently, and its near-term financial prospects are poor.
- The issuer is at risk of breaching minimum regulatory capital requirements or other performance tests that would require special regulatory approval to continue payments on its hybrid securities.
- The issuer's creditworthiness erodes to a level that could materially affect its access to and cost of capital. In mature economies, this is often when the CCR falls below the 'A' category.
- The company has substantially cut or eliminated its common dividend. This means the issuer has already crossed a certain line as far as market perception is concerned.

Importantly, we view the issuer's stand-alone financial profile as the key indicator of potential pressure to defer payments on hybrid securities. In cases where our CCR on a financial institution is higher than the institution's stand-alone credit due to expectations of specific government intervention, we typically will widen the gap between the hybrid rating and the CCR. We generally believe that governments in mature market economies are less willing to support hybrid capital issues to the same extent as more senior obligations, as the 2008 nationalizations of Fannie Mae and Freddie Mac in the U.S. attest.

Governments in developing markets generally appear to take a more interventionist approach with respect to their banking systems and may be more inclined to continue the payments of hybrid capital securities of banks under difficulty. In these cases we may not widen the gap between the hybrid issue rating and the CCR on the issuer, even when the stand-alone rating on the hybrid issuer is lower than the CCR.

As financial performance recovers after a downturn, we may raise the issue ratings and narrow the gap between the hybrid issue rating and our CCR on the issuer. From this perspective, the issue ratings on hybrid capital securities are potentially more volatile than issue ratings on conventional debt issues. This pattern of widening and then narrowing of the gap between issue ratings on hybrid capital securities and the CCRs on the hybrid issuers was evident in the ratings of Japanese financial institutions during the "lost decade" of the mid-1990s to the mid-2000s.

Assumptions

1. We are raising our assessment of bank industry risk. This will likely depress our stand-alone ratings on the banks. We believe more volatility in funding markets is likely, and with it an increase in the probability of systemic risk.

2. In light of our assessment that capital markets will be more prone to volatility in the future, we will have less tolerance in the ratings for reliance on short-term wholesale funding, and for relative confidence sensitivity of financial institutions' business models.

3. The protracted nature of the market dislocation and the rapidity and severity of asset deterioration have stressed financial institutions' earnings capacity and levels of capitalization. As a longer global recession becomes more probable, we expect higher levels of stress than those experienced during a typical business-cycle trough. This has the potential to change our ratings significantly. To assess this critical element, we are projecting the losses we envision for financial institutions in mature market economies. We expect higher-than-typical losses for certain loans in U.S. institution portfolios (see "Rated U.S. Banks Likely To Weather Market Difficulties," published May 6, 2008, on RatingsDirect), and more ordinary peak-of-cycle losses elsewhere. Financial institutions with greater proportional exposures to riskier assets will likely suffer proportionally greater loan losses. Applying our loss

projections of individual bank asset exposures will be important in differentiating bank creditworthiness.

4. In light of the massive capital infusions and possible failings in regulatory measures of capital sufficiency (Basle I, II), we are placing more emphasis on risk-adjusted capital (RAC) measures. We are developing our own framework for assessing RAC that is more risk-sensitive than Basel I and more conservative in most cases than Basel II as it currently stands, particularly with regard to market risk capital and private equity risk (see "S&P Requests Comments On Its Global Risk-Adjusted Capital Framework For Financial Institutions," published April 15, 2008, on RatingsDirect).