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The Evolving Landscape For Banks Requires A Robust Analytical Framework

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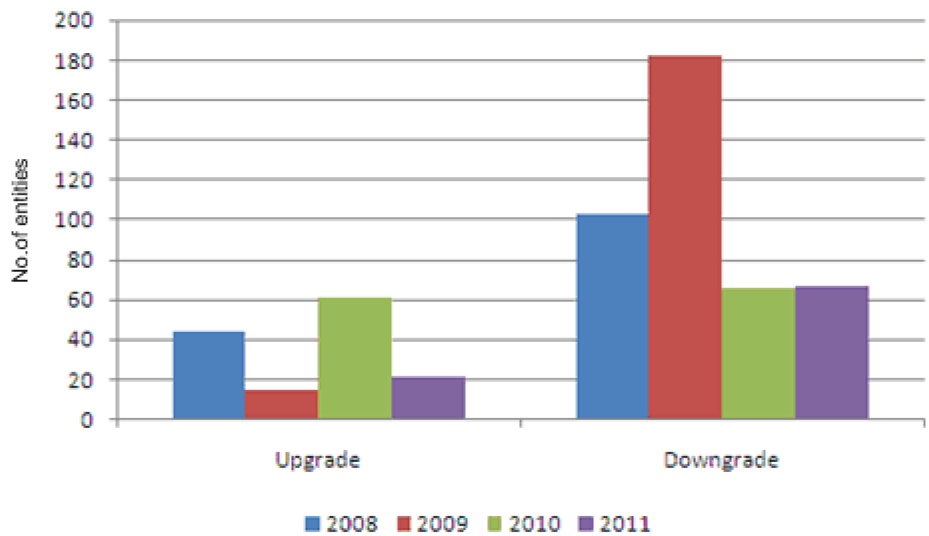
The global banking sector is reinventing itself after the 2007-2009 financial crisis--a process that Standard & Poor's Ratings Services believes will take at least a decade to complete. Today, four years into this transition, the industry has reached several critical inflection points:

- A potential shift in the power balance of global banking between banks in the developed markets of Western Europe and the U.S. on one side and the larger emerging countries in Asia and Latin America on the other;
- A developing regulatory backdrop, which may set the scene for a decline in revenues for traditional regulated banking and growth in volumes for shadow banking and disintermediation; and
- A change in the nature of government support for banks, which may lead governments to seek to reduce their contingent liabilities to the bank sector without undermining market confidence in the short term.

How each of these themes will play out and how they will affect the creditworthiness of banks remains unclear. In this evolving landscape, Standard & Poor's is finalizing its criteria for analyzing banks. This is a large endeavor that will impact our ratings on approximately 1000 banks across 86 banking systems around the world. We believe the new criteria will help us to explain our bank ratings with greater transparency and consistency for all market participants.

After peaking in 2009, the pace of bank downgrades had begun to slow globally (see chart 1). However, since the start of this year, this trend has reversed for banks in Western Europe. The intervention of governments and central banks around the world has succeeded in creating an interim period of stabilization for many of the Western European and the U.S. banking systems. But, as the events of the last few months have shown, it is a fragile peace.

Chart 1
Global Rating Migration



A Potential Shift In The Power Balance of Global Banking

The developed banking markets in the U.S. and Western Europe are under pressure and a recovery is still not assured. At the same time, banks in China, India, Brazil, Hong Kong, and Singapore are growing.

These trends are illustrated in chart 2 below, which shows a time series of Banking Industry Country Risk Assessment (BICRA) scores for banking systems that we evaluate, from June 2006 until June 2011. Overall, there is a clear negative trend in the BICRA scores for Western Europe and the U.S. As expected, the BICRA scores of the GIIPS (Greece, Ireland, Italy, Portugal, and Spain) countries have shown the most deterioration. The averages for BRIC (Brazil, Russia, India, and China) countries and developed Asian countries are more stable.

Chart 2

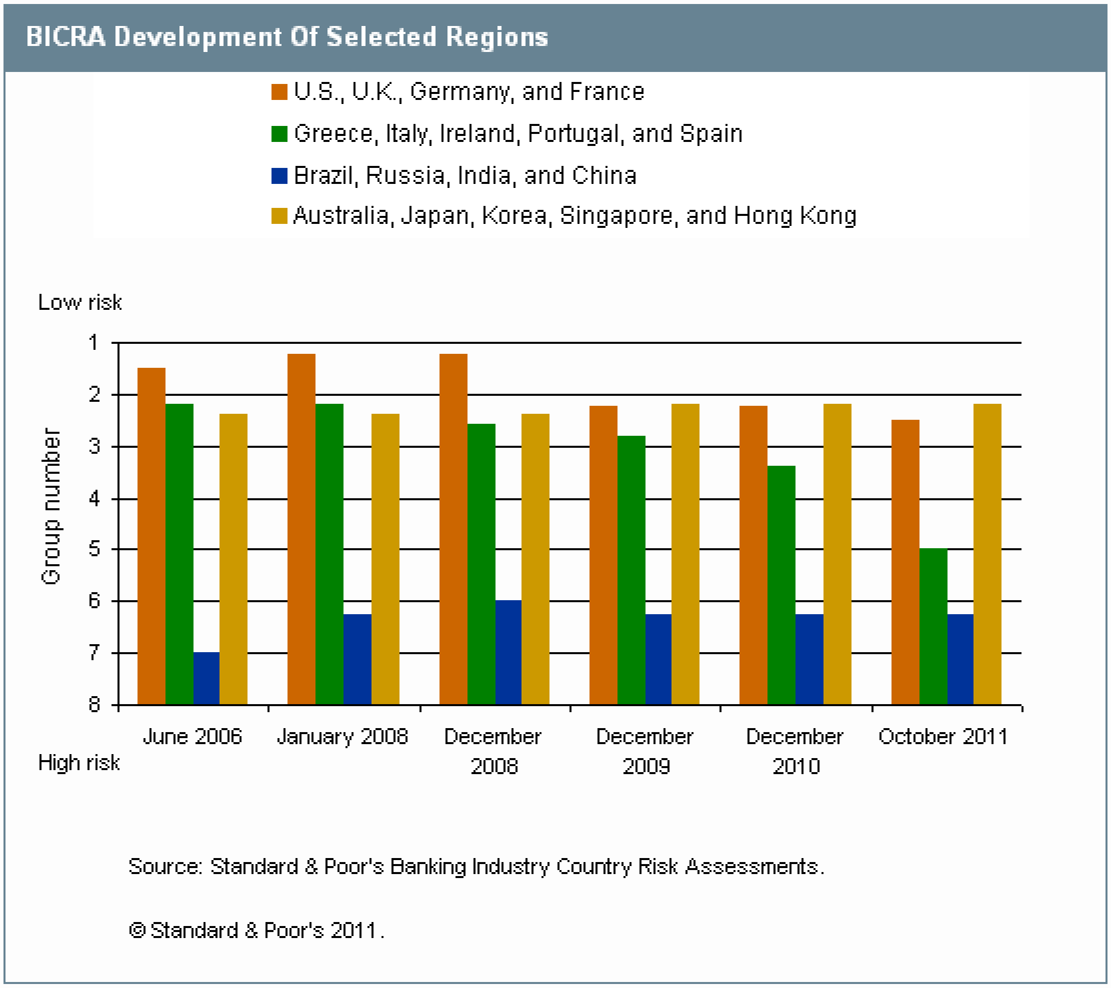
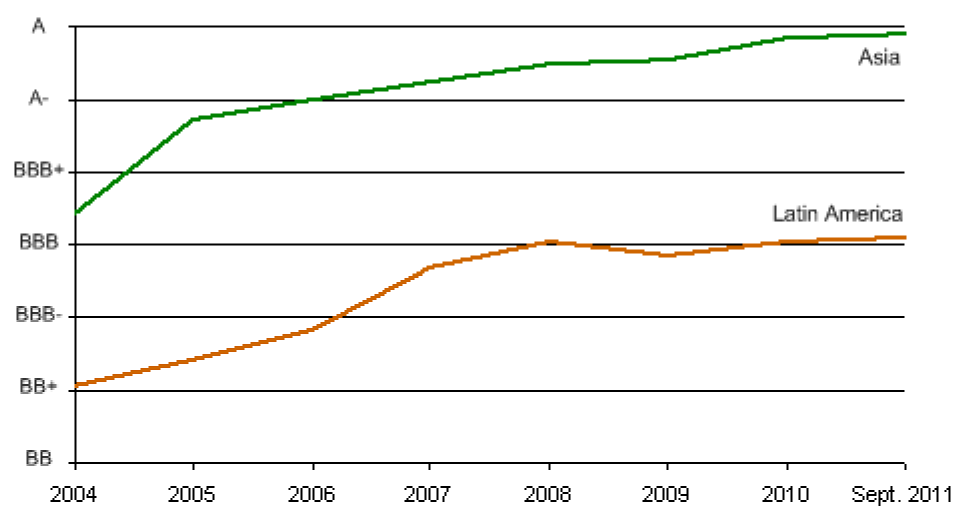


Chart 3 shows the ratings development of the largest rated banks in Asia and Latin America.

Chart 3
Rating Development Of Leading Banks



Asia includes the largest 20 banks by assets in China, Hong Kong, India, Singapore, and Taiwan.
Latin America includes the largest 20 banks by assets in Brazil, Mexico, Chile and Peru.

In Western Europe, holdings of sovereign debt continue to stoke fears over the capital adequacy of banks with the greatest exposures, which has led governments to extend unprecedented levels of support to restore confidence and prop up the euro. In the U.S., the mortgage market remains out of commission and continues to afflict many of the larger banks that are significant players in that market. Despite record low interest rates and numerous government programs aimed at helping underwater borrowers, home prices are not expected to recover over the next 2-3 years because the problems of Fannie and Freddie have not yet been fixed.

In contrast, for Asian and Latin American banks, the story seems to be different. Leading banks in these regions have benefited from strong economic growth which has supported household and corporate credit quality. However, as growth prospects start to weaken, we think these banking systems could be more susceptible to asset quality issues. The stronger systems have strong and stable funding profiles and they have spent the last few years strengthening and re-enforcing their regulatory infrastructures focusing on monitoring loan quality, demanding higher capital levels, and controlling high risk lending.

How our updated criteria will help monitor developments

We have been assessing industry and country risks using our Banking Industry Country Risk Assessment (BICRA) methodology for several years. The proposals in our new methodology will give more weight to the risks associated with growing economic imbalances, the resilience of the economy, and the importance of system-wide funding and the role of governments and central banks in this funding. We are also proposing a change in how this macroanalysis is applied to bank ratings. Specifically, we are proposing that this analysis will set the starting point, or the anchor, for all bank ratings in a country.

The BICRA methodology allows us to create a consistent framework to evaluate the relative strengths of banking systems and recognize how these trends affect our bank ratings. The goal of this analysis is to build a global lens through which we can examine both the economic and industry risks that determine the relative creditworthiness of the banks in a country.

Recent rating actions show how the emerging issues can be assessed using the BICRA. In each of the cases, described below, the BICRA revisions have been accompanied by bank ratings changes. After the proposed methodology is adopted, we believe market participants will have much greater clarity as to how these changes in BICRA scores and the links with our sovereign ratings affect bank ratings.

In our outlook for European Economies, "The Specter Of A Double Dip In Europe Looms Larger" published Oct. 4, 2011, we stated that the outlook for European economies has been declining and we noted that financial market pressures on European banks have intensified. We also lowered our economic growth forecasts for Europe's four largest economies (Germany, the U.K., France, and Italy) from our previously published predictions. These economic concerns were cited as a contributor to our lowering of the BICRA for France to group 2 from group 1 on Oct. 14, 2011. Other reasons were tightening funding constraints and rising housing prices. Under our current criteria, we directly linked this BICRA revision to the concurrent rating changes on French banks. Under our proposed criteria, this linkage will be more direct and transparent.

Similar economic concerns affected the BICRA for Spain, which we dropped to group 4 from group 3 on Oct. 13, 2011. Our revision was based on Spain's lower growth prospects, still-depressed activity in the real estate market, and rising turbulence in capital markets. For similar economic reasons we revised the BICRA for Portugal to group 5 from group 3 on March 31, 2011. Our revision was based on a weakened macroeconomic outlook, limited government policy flexibility, and significant vulnerability to external shocks.

Some BICRA scores are likely to change again based on our proposed updated BICRA criteria, which we indicated in the "Request for Comment: Methodology For Determining Banking Industry Country Risk Assessments," published May 13, 2010 and updated in the "Request for Comment: Banks: Rating Methodology," published Jan. 6, 2011. We expect fewer banking systems will meet the criteria for the BICRA group 1 designation. Moreover, some Western European banking systems will likely see a negative adjustment in BICRAs, while some of the Asian and Latin American BICRAs are likely to see an improvement from their current levels.

A Developing Regulatory Backdrop

Alongside this shift in the balance of power, the sustainability of some banking business models are under threat from the myriad of regional regulatory jurisdictions. While many attempts at regulation on a global basis have been tried, devising a universal system promises to be a thorny and potentially elusive quest. We think shadow banking may be well positioned to take on a greater share of lending from the traditional banking sector, as changing regulations make some lines of business less attractive. It will take years before we see the full effects of regulatory changes. However, as we assess the impact of each development, we believe our proposed bank rating methodology will help us to communicate our views on the changes and their impact on ratings in a very transparent and predictable fashion.

Regulatory uncertainty continues to be pervasive, and the list of new and proposed rules is long. For example, Basel III calls for stronger standalone capital, funding, and liquidity. Legislation in the U.S. prevents banks from proprietary trading under the "Volcker Rule". Governments, like that of the U.K., are considering segregating retail and business banking from wholesale and investment banking under the Vickers Report.

As a result of some of these changes, we believe that banks will reassess the profitability of corporate lending, high-risk or complex loans, and financial contracts such as derivatives under the evolving capital, liquidity, and transparency standards before deciding whether to continue these business lines, and any exit by regulated banks is likely to see these activities move into the shadow banking system. For example, in the U.S., the shadow banking sector may be about to seize emerging opportunities to finance more assets that banks either can't or won't fund because of the impact of new regulations, including the Dodd-Frank Act, the Basel III capital and liquidity guidelines, and the yet-to-emerge solution for the government-sponsored entities (GSEs) Fannie Mae and Freddie Mac.

Thus, we believe disintermediation of the banking system, which began decades ago, is likely to resume as resurgent shadow banking firms bolster their balance sheets to take on business that the banks discontinue. Under these conditions, what the new "normal" returns for traditional banks will be is difficult to predict, but they are likely to be lower than in the past.

We have noted since early 2010 that banks would need to start rethinking some of their activities (see "Back To The Future For The U.S. Banking System?" published Jan. 27, 2010, "For Universal Banks, The Recent Dominance Of Investment Banking Is Giving Way To More Balanced Earnings").

How our updated criteria will help monitor developments

Our proposed criteria will help us to reflect developments in the industry risk analysis of the BICRA, in banks' standalone credit profiles (SACPs) and in the issue ratings on specific debt issues. Our country-focused industry risk analysis includes our assessments of the regulatory framework in which banks operate and the competitive dynamics of a sector, including how banks compete with other non bank financial institutions. Changes that impact a whole sector will be assessed in the BICRA. Changes that are specific to selected banks are more likely to be assessed in the SACP as part of the business position and risk position. Of course, the impact of business decisions about keeping or exiting certain business lines and associated risks will also have an impact on the capital, funding, and liquidity needs of banks, the other key components of the SACP.

"Bank Resolution Regimes: Potential Rating Implications As Sovereign Support Frameworks Evolve" published on March 16, 2011 explains how emerging regulations on winding up failed banks may impact issue ratings.

The Balance Between Stand-Alone Bank Creditworthiness And The Potential For Government Support

We believe that governments are looking for ways to reduce their contingent risk to the banking sector, but not at the expense of undermining the financial system. Consequently, we expect many governments to continue supporting banks until they are strong enough to stand without support, which could take years for some to achieve, if ever. Our proposed criteria will allow us to clearly separate the SACP and the impact of government support in our ratings. This means that any change in the likelihood of future government support for banks will be clearly identified and articulated in our ratings.

Standard & Poor's proposed criteria framework is built on our knowledge that banks are inherently leveraged and, with a core mismatch in the maturities of their assets and liabilities, and highly sensitive to shifts in confidence. Government support for, and regulation of, the financial system as a whole, and some highly systemic institutions in particular, plays a critical role in offsetting these fundamental challenges.

The level of government support extended to banks after the onset of the financial crisis has heightened political sensitivities about this issue. We believe that governments continue to have significant economic incentives to support banks, because the economic costs of banking failures could be more damaging for a country. Nevertheless, politicians are under pressure to reduce the potential future costs of rescuing banks and at the same time need to foster confidence in their financial systems by offering to underwrite risks in banks' balance sheets and backstop funding needs where investors have withdrawn.

While banks have started to delever, the global standards for capital levels are increasing. Without strong retained earnings, banks will have to raise significant amounts of additional capital. At the same time, while liquidity has improved for many, funding markets have become more skittish.

The recent bail-out of Dexia, alongside the extension of new liquidity measures and the expected €108 billion bank capital raising for eurozone banks, demonstrates the economic realities that governments face and the real support they need to provide, despite any longer term political will to reduce it.

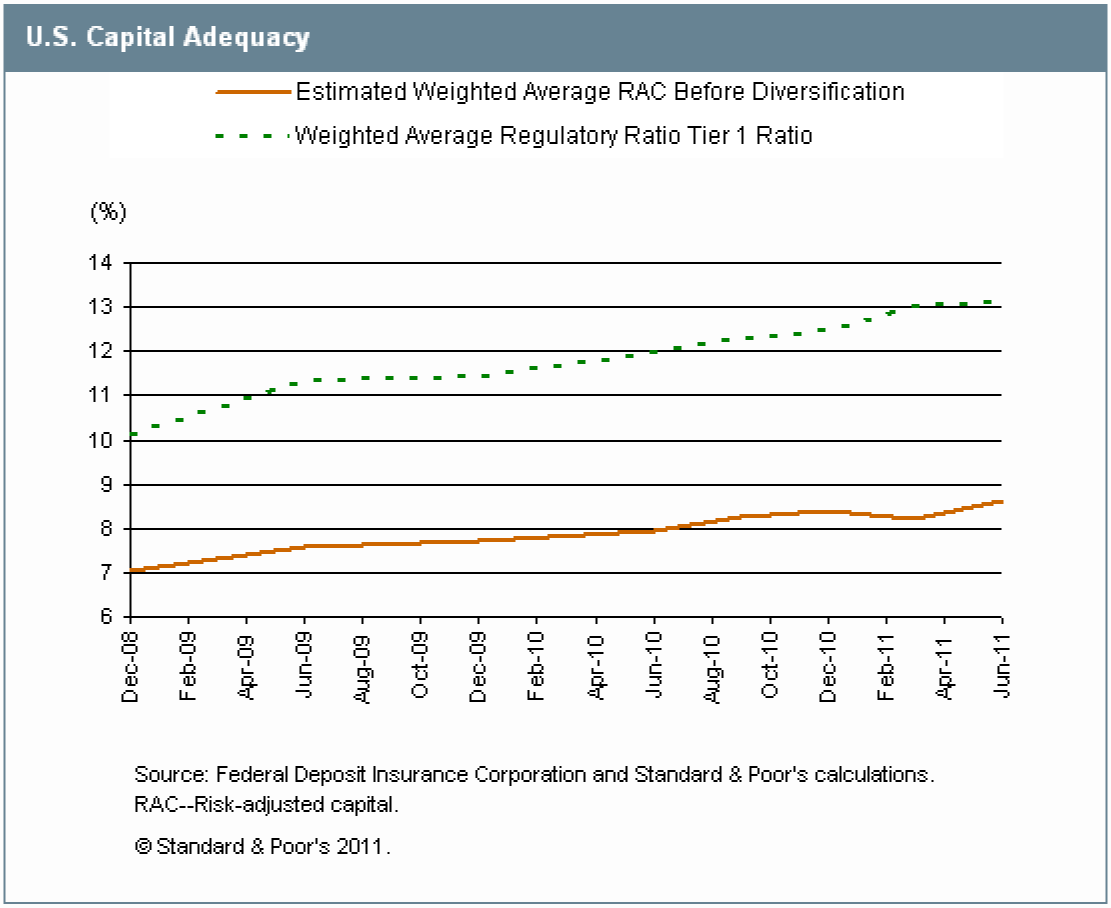
How we view capital

In our view, capital is not a rating strength for most banks. Despite significant deleveraging in the U.S. and Western Europe over the past two years, we expect most banks to maintain only an "adequate" amount of capital in the next few years. In Asia and Latin America, we see rapid growth that has prevented any meaningful build up of capital.

Our proposed criteria introduce clear guidance on how our Risk-Adjusted Capital (RAC) ratio influences our ratings. Our assessment is based upon how we expect the RAC ratio will develop, and via our risk position assessment, determine whether the RAC ratio is too conservative or aggressive compared to the specific risks taken by a bank.

In 2009, Standard & Poor's re-evaluated its assessment of capital. We proposed a risk-adjusted capital (RAC) framework that would allow us to have a globally consistent metric for all bank ratings. In many cases, our RAC ratios were significantly lower than the regulatory Tier 1 ratios. Since that time, the market has moved toward a common Tier 1 regulatory capital measure. While this is closer to our RAC ratio, it is still often higher. The explanation lies mainly in the calibration of our risk weights (see "Bank Capital Methodology And Assumptions," published Dec. 6, 2010). As chart 4 shows, capital adequacy has improved and the divergence between our RAC ratio and the Tier 1 capital ratios of the banks in the U.S. has increased, widening from about 3 percentage points to over 4. We see this same trend in capital adequacy across most regions.

Chart 4



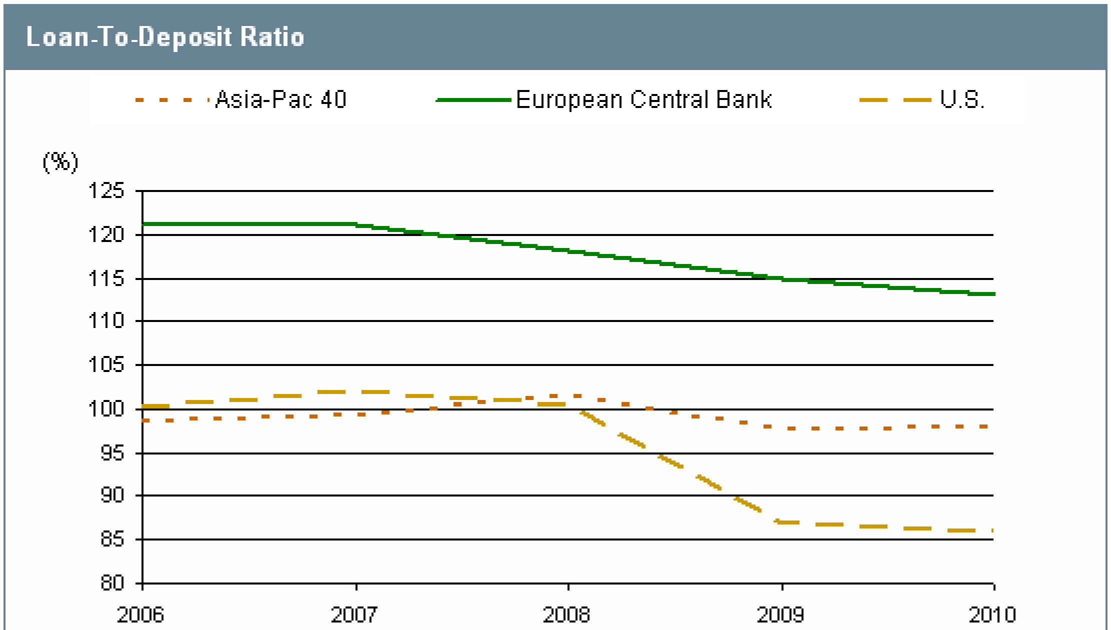
How we view liquidity and funding

Our proposed criteria seek to recognize that some banks are more sensitive to shifts in confidence than others based primarily on their dependence on short-term wholesale funding. First we look at system-wide funding in the BICRA, then, as part of the SACP, we assess how a specific bank compares to the system funding average and its standalone liquidity characteristics. In general, bank funding and liquidity has strengthened since 2007, but it is too early to tell whether this represents a structural improvement.

The sudden default of Lehman Brothers sent shockwaves through the financial system and forced governments to take unprecedented action to prevent the default of some of the largest financial institutions in the U.S. and Europe, and restore financial market stability. More recently, market concerns over eurozone sovereign contagion are driving up borrowing costs and dragging down share prices for banks around the world. The rapid increase in covered bond issuance over the last few years is evidence of a structural shift where investors are seeking greater collateral protection when lending to banks.

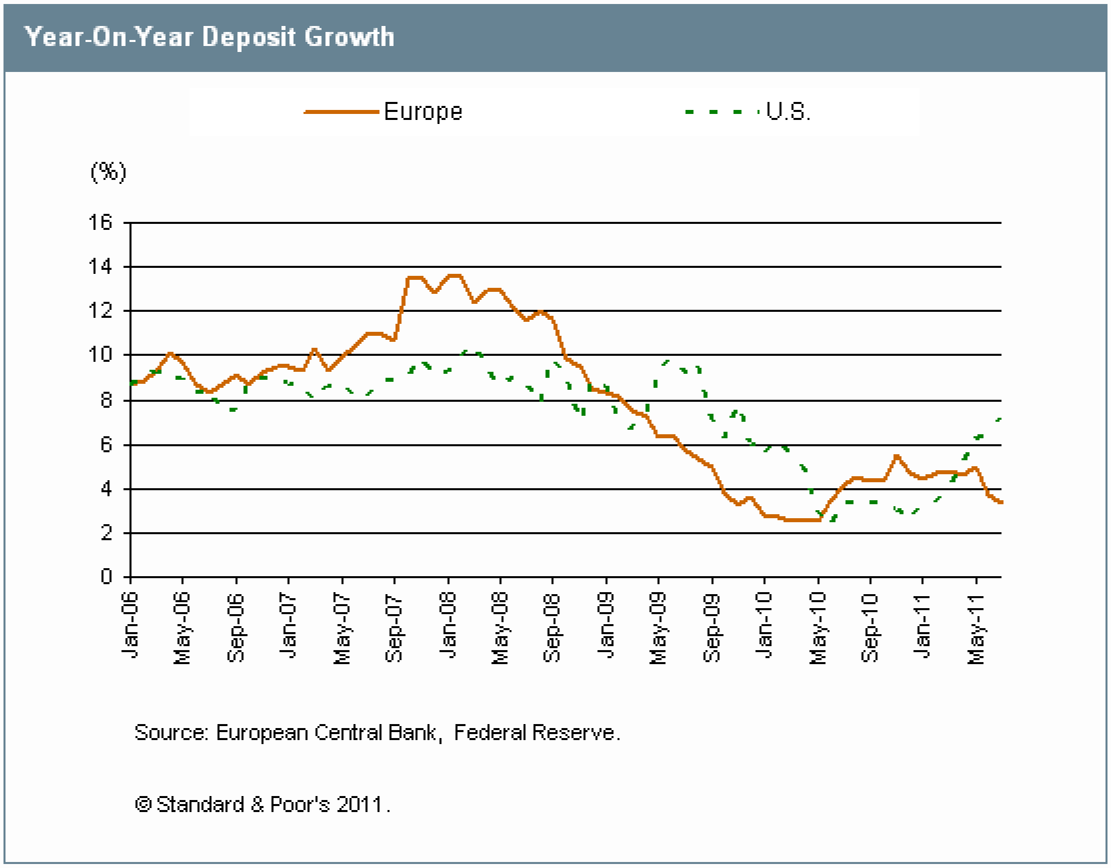
As chart 5 shows, the loan-to-deposit ratio by region has improved, reflecting growth in deposit funding. Given the continuing difficulties in wholesale funding markets, we think this trend could continue, although for how long remains to be seen. As seen in chart 6, deposit growth appears to be slowing in the eurozone.

Chart 5



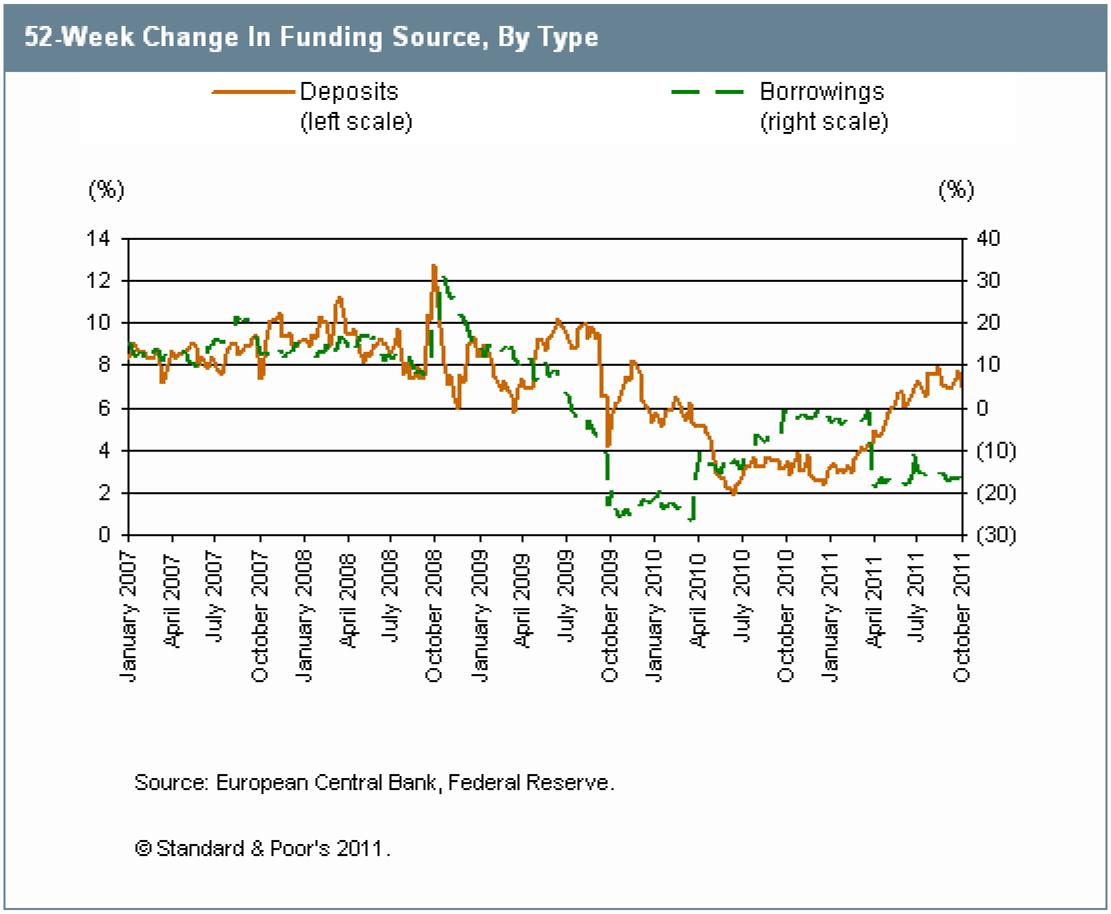
Source: European Central Bank monthly statistics, Federal Deposit Insurance Corporation, and Standard & Poor's calculations. The regional figure for Asia-Pacific was calculated by combining data from the top 40 regional banks.

Chart 6



Given the strong inflow of deposits, we have also seen a reduction in the use of wholesale funding (see chart 7). This trend has been evident in many banking systems. The appearance of a structural shift in funding may also be distorted by the lack of loan demand in many of the Western European and in the U.S. markets.

Chart 7



Ongoing concerns about funding and liquidity highlight the need for more transparency from banks via internationally consistent disclosures. The implementation of the new Basel III framework for liquidity risk measurement, standards, and monitoring could lead to improved disclosure and help us to further improve our metrics and analysis. In either case, our proposed criteria help us to clearly articulate our opinions on funding and liquidity and how these impact our ratings.

Where Next?

We believe that our revised criteria framework allows us to offer greater transparency into our ratings on banks at a time when the landscape for banking is evolving. The outlook for the global banking industry is clouded by the potential shift in the balance of power among banks, the emergence of a more significant shadow banking sector, and the potential for a different relationship between banks and governments. In our view, our new criteria provide a lens to understand these key themes, and their impact on banks.

Related Criteria And Research

- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- How Standard & Poor's Intends To Finalize Its Bank Criteria And Apply Them To Ratings In The Fourth Quarter Of 2011, Nov. 1, 2011
- Request for Comment: Methodology For Determining Banking Industry Country Risk Assessments May 13, 2010
- Bank Capital Methodology And Assumptions Dec. 6, 2010
- Request for Comment: Banks: Rating Methodology Jan. 6, 2011
- For Universal Banks, The Recent Dominance Of Investment Banking Is Giving Way To More Balanced Earnings June 30, 2011
- The Specter Of A Double Dip In Europe Looms Larger Oct. 4, 2010
- Back To The Future For The U.S. Banking System? Jan. 27, 2010
- Bank Resolution Regimes: Potential Rating Implications As Sovereign Support Frameworks Evolve, March 16, 2011