Introduction

By Gregory Bauer, Group Managing Director, Global Banking

In more normal times, we try to host calls following rating actions for major banks to explain the rationale for our actions. In this crisis environment, the pace of activity has been too rapid to maintain this discipline. So, instead, today we pause to take the time to provide a broader perspective of our approach to managing ratings as we have now entered this latest, and most severe stage of the credit crisis.

Our current bank rating methodology was put into place in the first half of 2007. At the time, we had limited recent experience with bank failures, let alone defaults, particularly in the developed markets.
Special Comment

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Our methodology was based on historical behavior from prior crises, with the further consideration of legislative actions and regulatory constructs developed in the intervening years to inform our methodology. Now, suddenly, we have an extraordinary abundance of data coming from various banking systems around the world. It will take time to fully assimilate this data and embed it into the methodologies by which we manage our ratings. But, this does not negate the need for us to respond to what we are witnessing nor to consider institutional and regulatory behavior and performance which are clearly visible. In doing this, we will be actively adjusting the application of our methodology to fit the developing situation.

So in this report, we will concentrate on issues of ratings management. First, we will briefly discuss the implications of this crisis on the risks to European governments which are utilizing wide ranging and expanding approaches of nationalizations, capital injections, declarations of support, and formal guarantees to bolster their banking systems in response to the crisis.

We’ll then move from this discussion of sovereign actions, and resulting risks to the governments, directly to the issue of bank ratings management during this crisis period. We will discuss our ratings approach to banks that are receiving the forms of support addressed above, in Europe and elsewhere. This crisis is presenting unprecedented challenges to the application of our rating methodology for banks, particularly in relation to how we rate banks that have received some form of official support, ranging from a declaration of support to a formal guarantee. Our responses have and will vary, depending on the circumstances, but we are committed to providing a consistent and transparent approach to assessing risk and assigning ratings under these conditions. A description of our framework for responding to these situations will be provided, both in terms of assessing banks’ intrinsic financial strength and also long and short term debt ratings.

Lastly, we will conclude by focusing on the topic of hybrid capital instruments, for which we now have witnessed numerous approaches by regulatory authorities in the resolution of troubled or failed banks. These situations are informing our ratings approach very quickly in ways that require us to consider changes to our assessment of the risk to investors of these instruments, distinct from the risk to other classes of creditors. We have always notched these instruments consistent with their placement in the capital structure. However, we are witnessing a pattern of behavior that clearly indicates that these instruments often do not benefit from systemic support in the same way as more senior obligations. Further, loss severity, either through principal losses or missed interest payments, often exceeds our previously anticipated performance. We will be following up soon with more extensive public commentary on this subject, but today will be sharing some of the basis for the development of our thinking on this issue.

Implications of this Crisis on the Risks to European Governments

Pierre Cailleteau, Managing Director, Head of Global Sovereign and Supranational Ratings & Chief International Economist

In such frantic circumstances, we have indeed decided to take a step back and try to provide a composed perspective on what is happening.

For those interested, on Thursday we will have a conference call for our clients whose title is “Sovereign Ratings in the crisis: Anchors in the Storm?” where we will cover a lot of ground and talk about the transfer of risk to the balance sheet of governments all over the world.

About two weeks ago, I spoke about the US government Aaa rating and said its foundations remained unshaken. This remains our judgment. In the current environment, as it will be reiterated again in this report, we aim at protecting the ordinal value of our ratings and making sure our anchors are solid. This is true of the US government, despite the considerable challenges that lay ahead.

Today, I will speak about European governments, and for many if not most of them the judgment is similar. Our main opinion, to be fleshed out in a special comment that will be published on Thursday is that the spread of banking crisis has prompted EU governments to take calculated risks with public finances. By this we mean...
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risks – such as raising public debt – that do not really endanger creditworthiness in the short run and may rather consolidate them in the medium term.

The unprecedented seizing-up of the US and global credit markets has led to a severe liquidity stress in Europe, affecting many banks and banking systems and prompting a broad range of bold policy responses all over the continent.

To date the responses to the crisis have included full nationalizations, capital injections, firm declarations of support and formal full-blanket guarantees for banks' liabilities. Other initiatives are possible as the situation remains very fluid.

In addition, a reshaping of EU-wide financial stability arrangements is now being considered as a matter of urgency, and a relaxation of the Maastricht budget rules is increasingly probable.

The swiftness of the reactions, as illustrated by this weekend’s summit of heads of state, has so far confounded claims that a crisis management response in the European Union would be found lacking.

In terms of credit rating implications for banks, Moody's has taken rating actions in cases where we concluded that a bank's capital adequacy, funding model or long-term business franchise is no longer consistent with its current rating level.

As regards sovereign ratings, only the Icelandic government has so far seen its rating placed on review for possible downgrade -- the key issue being how it intends to maintain financial stability and extend some support to banks, including in foreign currency, without jeopardizing its own credit standing. The Prime Minister of Iceland has framed the debate exactly like this yesterday, and the government tries to ring-fence its balance sheet from the fall-out of the banking and economic crisis. It is increasingly clear that such a ring-fencing will not be totally effective.

Moody's overall subdued response regarding European sovereign bond ratings reflects our view that, in most cases, the rescue does not involve outsized and/or immediate debt increases, and remains manageable within the respective government's current rating category. Government balance sheets are not yet materially affected, while a less prompt reaction to protect banking systems might have durably weakened the countries' economic strength, upon which the governments' taxing power is based.

More specifically, for those governments that announced capital injections (such as the Netherlands, the United Kingdom, France, Belgium and Luxembourg), we consider the net impact on the government's balance sheet to be muted. Gross debt may increase, but the governments acquire assets that they plan to transfer back onto the market in the near future. This is consistent with our analysis of the US’s recent actions, detailed in its recent Special Comment entitled “The Unshaken Foundations of the US Government’s Aaa Rating”.

For the many governments -- i.e. Germany, Denmark, Italy, Greece, France, the UK -- that have announced their strong resolution to support their banking systems in case of need, the actual impact on public finances remains hypothetical. What is happening is that governments are now making explicit contingent liabilities that were so far only implicit -- although arguably the size of the commitment is larger than had been generally expected.

Where the guarantee is legally binding, as in the case of Ireland, Moody’s believes that it is too early to judge the extent to which the government’s financial strength would be impaired should the guarantee be called. It is our view that, in light of the solid cushions that Ireland has built over the years -- solidifying its Aaa position -- only widespread bank insolvencies would be likely to undermine the strength of the government’s balance sheet to a point of exerting downward pressure on its rating. Moreover, in the absence of any concerns over refinancing risk for the Irish government, such a scenario would be unlikely to strain Irish public finances so abruptly that a quick repositioning of the rating would be justified.

That is why it is Moody’s view at this stage that European governments are taking calculated risks with public finances with the ultimate aim of protecting the vitality of their respective economies.
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The nature of the rescue operations poses a number of complicated questions that Moody's will discuss in its forthcoming Special Comment this week. Three considerations require heightened vigilance. Firstly, the crystallization of contingent liabilities on the current scale is a process that is difficult to control. Secondly, the deleveraging that will probably result from the current dislocations will deepen the downturn in many countries. Finally, the relaxation of budgetary rules will add uncertainty with regard to the medium-term orientation of public finances, although Maastricht ceilings have never played a critical role in Moody’s assessment of governments’ creditworthiness.

Governmental Interventions and Rating Implications for Banks of the Current Market Turmoil

Richard Cantor, Group Managing Director and Chief Credit Officer, Credit Policy

I plan to discuss two aspects of Moody's rating actions within the banking sector:

1. Our broad rating response to the systemic crisis, the funding pressures, and the governmental support we have observed across the globe; and

2. Our rating actions on the individual banks that have recently received targeted governmental assistance.

With regard to our bank ratings in the aggregate, I suppose it is possible to construct arguments both in favor of systematic downgrades and in favor of systematic upgrades at this point in time. That is:

- On the one hand, one could argue that the current market turmoil implies a heightened risk of default for all banks, and that should be reflected in downgrades across the sector.

- On the other hand, one might equally argue that the global demonstration of official support for the banking system argues in favor of systematic upgrades for deposit and senior debt ratings in many countries.

Both of these views are, we believe, short-sighted, particularly in the context of Moody's long-term credit ratings.

Despite the extraordinary liquidity strains that we have see as a result of the current market turmoil, we continue to view most bank debt in advanced economies to be solidly investment-grade -- and most is rated single-A or above. Moreover, Moody's does not anticipate taking systematic rating actions -- positive or negative -- across the banking sector for the following four reasons:

1. The current crisis is systemic in nature, affecting many banks to a similar degree in many regions, often with a similar intensity that appears independent of their relative intrinsic financial strengths.

2. The intrinsic financial strengths of many banks remain strong, and, once the crisis passes, their franchises will be even stronger than before.

3. Governmental authorities are providing an extraordinary level of support to the banking industry, even in countries where governmental support may be less certain during more normal periods.

4. At the same time, we expect that the level of governmental support we have observed of late to be reduced over time, as the systemic nature of the crisis recedes. At that point, the risk of default for individual banks will again be determined by a combination of their own intrinsic financial strengths and the (uncertain) likelihood of governmental support in times of stress.

Moody's will, of course, continue to take selective rating actions on individual banks if and when we conclude they have experienced enduring impairments, such that their asset quality, capital, franchise value or funding stability is materially weaker than those of other banks that carry the same ratings. Moreover, in some cases, downward rating transitions could be severe if we determine that the risk that a bank might not survive the current cycle, and the risk of default, becomes material.
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In summary, we do not expect to materially change the overall distribution of our bank ratings, but we will as always take individual rating actions to improve our rank ordering of risk within the sector and to make sharp rating distinctions for those banks with the weakest intrinsic financial strength.

The other topic I want to address relates to our ratings on specific banks that have received extraordinary levels of governmental support. In these cases, Moody’s has generally not upgraded, and has at times downgraded, the affected banks' long-term ratings. These actions, which may have run contrary to the expectations of some market participants, have reflected some or all of the following six considerations:

1. A high expectation of governmental support may have already been factored into our ratings;
2. The circumstances that led to the governmental intervention may have revealed fundamental weaknesses in the bank's asset quality, capital, or business model that are inconsistent with a higher rating;
3. The reactions of the bank's customers to its new circumstances may be negative and may impair its long-term franchise;
4. The amount of governmental support may be insufficient to deal permanently with the current crisis;
5. The current provision of support is likely to be temporary and hence not a major consideration for the bank's long-term ratings; and
6. The ultimate resolution of the bank may involve significant restructuring that could impair its long-term franchise value.

I have one final comment on short-term ratings. Although upgrades of long-term ratings are unlikely following governmental intervention, the likelihood of an upgrade of a bank's short-term rating to the level of the government's short-term rating may be considered in some circumstances, as the temporary nature of the governmental support may be less of a concern over the short-run.

Performance of Bank Hybrid Securities

Ifigenia Palimeri, Managing Director & Chief Credit Officer, Banking

My remarks will focus on the performance of bank hybrid securities during the current crisis and refinements that Moody’s is currently considering for our methodology. I would like to clarify that when I refer to hybrid instruments this includes primarily junior subordinated debt and preferred securities.

In the current financial crisis a number of hybrid securities have either defaulted or faced payment difficulties. In addition, in many jurisdictions the measures that regulators put in place to protect depositors and senior debt holders at a time of financial distress did not extend to the hybrids, leading in some cases to significant loss of principal. Some recent examples include:

- The subordinated debt and capital securities of Roskilde Bank in Denmark, where the good bank/bad bank structure that was put in place is anticipated to reduce the amount available to repay those securities.
- The preferred securities for Fannie Mae and Freddie Mac in the United States, where dividends are not anticipated to be paid for a number of years.
- The subordinated debt and preferred securities for Bradford and Bigley in the United Kingdom which were excluded from the rescue package.
- And all debt instruments for Washington Mutual Inc. and Washington Mutual Bank in the USA which were not assumed by another institution which acquired substantially all assets of the bank subsidiaries and assumed all deposit liabilities.

Our current framework recognizes that these instruments have a higher risk profile and therefore have been rated lower than senior obligations. Hybrids have features that may lead to increased probability of interest non payment, and/or increased severity of loss upon default, and therefore higher expected loss. Our current methodology notches these instruments from the bank’s senior rating because, until now, our assumption was...
that at a time of financial distress, the same support extended to senior creditors would also extend to hybrid investors. Recent events have shown that this is not always the case. At the same time the principal loss we have observed and the increased loss from non payment of interest have exceeded in most cases our original expectations.

So the current crisis has highlighted two primary issues: First that systemic support often does not extend to these instruments and second that the ratings transition risk and severity of loss are higher than originally assumed. Let me provide some more clarity on these two points.

In the past, banks with deteriorating financial performance were able to continue to operate and had access to the capital markets for an extended period of time. However in the current environment a bank that faces or is perceived to face capital or liquidity constraints is driven to default as market confidence evaporates and extreme operating pressure occurs. Therefore, we do not see a gradual deterioration of performance, but rather a severe shock that has lead in most cases to a government instigated rescue package. These rescue packages often do not extend support to these junior instruments, which are sometimes viewed as loss absorbing capital by regulators. Additionally by removing assets from the banks, these rescue packages negatively affect the recovery potential of the hybrids. In some cases the rescue packages have been structured as an equity injection and in those instances usually all debt holders have benefited. However, if the financial crisis persists, it is unclear whether equity injections will still be available to assist banks in financial distress.

To incorporate these new observations in our ratings, we are considering the following two main changes in our methodology: First, to remove systemic support from the rating of junior subordinate debt and preferred securities, and second, to widen the notching, especially for lower ratings, to reflect the increased transition and severity risk that these instruments face.

We are planning to release to the market next week a report in which our views and observations for hybrid securities will be discussed in detail. At the same time, we will be conducting a country-by-country review where we will examine whether these instruments have received systemic support in the past and whether the regulators have made public statements that they will support junior instruments.

Once we conclude our country-by-country analysis, we will inform the market about our final views and we expect to implement the revised methodology over the following months.
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