

Methodology

*Rating Banks and Bank Holding  
Companies Operating in the United States*

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*Insight beyond the rating.*

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## CONTACT INFORMATION

**Alan G. Reid**

Managing Director  
U.S. Financial Institutions  
Tel. +1 212 806 3232  
areid@dbrs.com

**Roger Lister**

Chief Credit Officer  
U.S. Financial Institutions  
Tel. +1 212 806 3231  
rlister@dbrs.com

**Peter Bethlenfalvy**

Group Managing Director  
Global Corporate Finance  
Tel. +1 416 597 3622  
pbethlenfalvy@dbrs.com

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All DBRS ratings and research are available in hard-copy format and electronically on Bloomberg and at DBRS.com, our lead delivery tool for organized, Web-based, up-to-the-minute information. We remain committed to continuously refining our expertise in the analysis of credit quality and are dedicated to maintaining objective and credible opinions within the global financial marketplace.



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# Rating Banks and Bank Holding Companies Operating in the United States

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## The U.S. Banking Sector in Perspective

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The U.S. banking sector is unique among modern banking systems in being vast in scale and concentrated by asset, yet highly fragmented by number of banks. As of mid-year 2007 there were approximately 7,350 FDIC-insured banks, either nationally or state chartered, holding about \$10.1 trillion in total balance sheet assets and some \$3.3 trillion in FDIC-insured deposits. Approximately 500 banks with assets in excess of \$1 billion, or less than seven percent of all banks, held about 88% of all banking assets as of March 31, 2007. The vast majority of these banks are small community-centered banks with assets aggregating to less than \$1 billion. DBRS is primarily focused on larger banks that issue publicly held debt.

Consolidation, driven by fierce competition, a search for more attractive markets, shareholder expectations and a variety of other reasons is shrinking the banking universe, even as assets and earnings continue to grow. Since 2001, the number of banks has declined by nearly nine percent. At the same time, the 128 new bank formations announced in the first quarter of 2007 are a testament to the attractiveness, relatively low barriers to entry and competitiveness of banking. Consolidation is also being driven by the growing focus at many banks on fee-based financial services as a means to higher profitability, better earnings stability and lower risk profiles, as banks seek to leverage their customer relationships across a broader array of products. Increasingly, banks, particularly the largest banking institutions, are involved in several financial services sectors besides banking – investment banking, wealth management, retail brokerage, insurance and fiduciary services such as trust administration and payment services.

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## Rating Methodology Overview

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Ratings assigned to a U.S. bank reflect the opinion of DBRS on the bank's credit quality. Reflecting a detailed analysis of a bank's strengths and the challenges it faces, these ratings are provided as a forward-looking measure of a bank's ability to meet its financial obligations in a timely manner. The long-term ratings express DBRS's view on a bank's remoteness from defaulting or otherwise being unable to pay as agreed on its obligations. Differences in the strengths of banks relative to each other are also reflected in their ratings. DBRS does not employ a formulaic approach in determining ratings, but rather seeks to combine the inextricably linked elements into an overall assessment of a bank's strength.

Ratings for U.S. bank holding companies (BHCs) reflect the consolidated strength of its banking and other operating subsidiaries, as well as its strength as a parent company. Ratings of federally insured U.S. banks within a BHC are generally equalized to take into account the regulatory environment in the United States. Ratings for other subsidiaries reflect their intrinsic strength and an assessment of parent support. For banks and BHCs owned by foreign parents, the ratings take into account an assessment of the likelihood of support provided by such parents. In general, this methodology also applies to other deposit-gathering financial institutions in the United States, including thrifts, non-bank banks, credit card banks and industrial loan companies. The regulatory environment, system support and parent support are discussed in greater detail below.

Long-term senior ratings cover deposits, including interbank facilities, senior unsecured debt and other similar senior obligations, as well as a bank's ability to meet its full payment obligations on financial contracts on a senior basis. DBRS rates various debt securities issued by a bank individually and these ratings are adjusted for the seniority of the securities versus the senior unsecured debt rating. Short-term ratings indicate the capacity of an issuer or borrower to fulfill in full its short-term repayment obligations in a timely manner with a one-year horizon.



## MONITORING

Once issued, DBRS regularly monitors ratings for appropriateness and makes changes when deemed necessary. A wide range of indicators of a bank's health are followed: Earnings are evaluated and events are assessed to determine any impact on a bank's fundamentals. Bank ratings are an intermediate-term assessment of strength across economic and credit cycles. Lower earnings that are driven by a deteriorating economy or weakness in specific sectors are not a cause to downgrade, unless the deterioration reveals inherent weaknesses in a bank's franchise, its earnings power, its risk management processes or its exposure to risk.

## RATINGS BASED PRIMARILY ON INTRINSIC STRENGTH

For U.S. banks, ratings are based primarily on the intrinsic strength of the bank and its BHC. Each rating is the product of a detailed analysis that leverages qualitative and quantitative analysis. The analysis utilizes publicly available information, as well as non-public information that the bank may share with DBRS as an "insider" under Regulation Fair Disclosure. Bank ratings by DBRS based solely on public information are rare, and arise only in response to sufficient investor demand for DBRS's analysis.

Public information includes financial reports, regulatory disclosures and presentations issued or otherwise made available to the public. Non-public financial information shared with DBRS could include budgeted revenue and capital targets, loan granularity and asset quality trends. Face-to-face meetings provide further input and an opportunity to assess the quality of the bank's executives – among other things – to manage the franchise and adjust to a changing environment.

The analysis takes advantage of the analytical framework that DBRS's U.S. financial institutions group (U.S. FIG) has developed to quantify or evaluate various elements underpinning a bank's intrinsic strength. By using various ratios and other metrics, as well as taking into account qualitative characteristics, this framework helps determine the strength of different aspects of a bank's intrinsic strength. By integrating the interconnected elements of a bank's strength, the framework facilitates the evaluation of a bank's overall financial profile. Trends over time provide a useful perspective on whether a bank is gaining or losing strength. Trends over time combined with metrics and stress tests also help identify strengths and weaknesses.

Peer group comparisons are a particularly valuable tool for identifying relative strength and understanding trends over time. In determining the appropriate peers, DBRS considers not only banks that are rated similarly by DBRS irrespective of size and business model, but also banks that are of similar size, business model and operating footprint. This framework continues to evolve as U.S. FIG enhances these analytical tools.

For some banks and BHCs, external factors and parent support can play a role in determining ratings. When a bank or BHC is the subsidiary of a foreign entity or has significant foreign ownership, the rating can be affected. Except for some form of parent support, DBRS does not see any lift for U.S. bank ratings from external support based on the U.S. regulatory environment. These topics are discussed in more detail below.



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## Analytical Elements – Interconnected Building Blocks

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DBRS's ratio analysis focuses on five interconnected aspects of a bank's financial health: The following exhibit lists the five building blocks and provides illustrations of their application:

<b>Interconnected Building Blocks</b>	<b>Illustrative Elements</b>
Franchise Strengths	Business mix, market positions, branch franchise and other distribution channels, management quality
Earnings Power	Diversification, net interest margin, efficiency, capacity to absorb adverse events
Risk Profile, Asset Quality and Risk Management Processes	Credit, interest rate, market, operational, legal, regulatory risk, loan portfolio composition/concentration
Liquidity	Funding profile, composition of deposits, securities portfolio, credit lines, emergency liquidity plans
Capital Structure and Adequacy	Capital levels, mix, quality and composition, cushion over regulatory requirements

### **DETERMINING THE RATING FROM THE BUILDING BLOCKS**

DBRS considers these building blocks to be significantly interrelated and considers each building block an essential element in the overall assessment. Accordingly, ratings reflect the interdependent nature of a bank's ability to meet its obligations in a timely manner, rather than a simple additive weighting scheme.

Nevertheless, there is a sequence of the assessment that provides a perspective on the relative importance of the building blocks. Franchise strength is the key driver of the rating. The stronger a bank's franchise, the higher a bank's rating is likely to be. It is unusual for a bank to be well rated if it has a weak franchise, absent some form of parent or structural support mechanism. Equally important is the earnings power that the bank generates from its franchise. Strong, resilient earnings provide the best protection for creditors. Earnings provide the bank with the ability to generate capital and grow. Additionally, earnings provide the capability to withstand adverse events without invading capital. Resilient earnings provide resources to rebuild capital after adverse events.

A strong franchise does not guarantee strong earnings power, although usually one is derived from the other. Banks can have franchises with a number of strengths, such as leading market positions, which the bank is nevertheless not translating into comparably strong earnings power due to below-peer margins or high expense ratios. Better-rated banks tend to have stronger, more diversified franchises and hence more resilient earnings power. In assessing earnings power, DBRS takes into account a bank's risk profile that reflects, among other things, its business mix, concentrations and exposure to stress scenarios.

Liquidity is another critical, but interrelated building block that should not be assessed in isolation, but rather in the context of the entire institution. A highly rated bank is less likely to have weak liquidity than a lower rated bank, but high liquidity by itself would not necessarily result in a high rating if a bank's franchise and earnings power were weak. On the other hand, highly specialized niche banks with strong liquidity may be rated highly although their franchises and earnings power are less strong.

Similarly with capital adequacy, high capital ratios are unlikely to drive a high rating in isolation, if a bank has a weak franchise and poor earnings power relative to its risk profile. In evaluating capital adequacy, the analysis seeks to identify how well the bank is capitalized relative to its risk profile, earnings power and regulatory requirements. It is important for well-rated banks to have a comfortable capital cushion above well-capitalized levels to ensure that their businesses are not constrained by adverse events and/or regulatory actions.



### **1. Franchise Strength**

In assessing a bank's franchise strength, DBRS considers:

- Business mix
- Strength of individual businesses
- Customer segments and strength or "stickiness" of customer relationships
- Customer product penetration and length of customer relationships
- Customer service, employee capabilities
- Competitive advantages/disadvantages
- Distribution channels (strength, diversification, adaptability)
- Strength of branch network
- Attractiveness of footprint (economic growth, demographics etc.)
- Special skill sets, technology
- Product range, product innovation
- Systems and technology (reliability, up to date versus antiquated, flexibility)
- Operational capabilities across geographies and businesses
- Integration of different businesses and product lines across the bank
- Management's skills in marshalling bank's capabilities
- Management of business risk
- Strategy for sustaining growth, potential for growth with current model

The strength of the bank's market presence in its key product lines directly impacts its capacity to attract new business and compete effectively. In this respect, market penetration is a key consideration, as measured by the size and breadth of the branch network, deposit market shares in various markets, and the scale of a bank's businesses. Scale can be particularly relevant in providing commoditized services profitably, such as custody and other fiduciary services, so as to spread the typically high overhead cost associated with these businesses over a larger revenue stream.

#### **Branch Banking Franchise**

DBRS considers the strength of a bank's branch-based franchise as an important factor in its ratings. Branch-based banking competition is mostly local in nature. Franchise strength is an important element of any financial institution's ratings and branch networks remain a critical component of a bank's overall franchise.

DBRS's fundamental premise is that banks with larger market shares at the local level generally have better market positions and stronger franchises. Higher market shares mean greater convenience for retail and business customers, with a lower attrition rate when customers move residences or jobs. Cost efficiencies can be achieved in marketing, advertising, infrastructure and technology. Revenue potential increases with the ability to provide a broader range of products, to offer access to specialists, customize products to the local market and to increase visibility and acceptance among customers. Internal float increases. Importantly, the ability to withstand competition improves with greater market share, as the potential impact of competitors opening new branches is reduced. These benefits may be partially offset by diseconomies of scale such as the added cost of controlling a larger organization, and by the difficulty larger banks tend to have in being responsive to local customers.

An important tool in evaluating local franchise strength – particularly for larger banks – is to look at a bank's shares of branches by city. Based on conversations with banks and other industry participants, a branch share of at least 20% is considered to represent a dominant position, as this means the bank reaches at least one in five customers, which provides substantial visibility and allows the capture of scale advantages. A branch share of at least 10% is considered robust, as a bank can leverage some scale advantages and withstand competitive pressure from rivals by reaching one in ten customers.

A branch share of at least 5% is necessary to be well established in DBRS's analysis, as many banks view this threshold as critical to be able to operate efficiently, gain recognition and achieve revenue opportunities in a local market. To evaluate the strength of a bank's overall franchise, these positions are aggregated



to show the share of a bank's branches or deposits that are located in markets where its share exceeds each critical level of 20%, 10% and 5%. This analysis is also conducted for deposit shares, while taking into account the distortions that headquarters and other special purpose branches can introduce into a bank's overall position in specific markets.

DBRS also looks at other aspects of a bank's franchise such as non-branch distribution channels, including consumer finance offices, mortgage banking and retail brokerages. Despite the growth in online banking and other alternatives, branches remain the key channel for banks to serve their retail, small business and many middle-market customers, making a strong branch network a key part of a bank's overall franchise.

For smaller banks that lack a substantial branch network a useful tool for assessing franchise strength is their ability to attract and retain low-cost core deposits in relation to the size of their loan portfolio. Unlike larger regional banks, community banks often originate a higher percentage of their deposits from small business and municipal customers rather than from branch-based retail customers. Small corporate and institutional deposits tend to be at least as stable – or sticky – as retail deposits. Consequently, many community banks are able to maintain relatively high core funding levels in addition to having strong liquidity profiles, above-average loan yields and lower earnings volatility.

### **Management's Contribution to the Franchise**

Management's acumen in the creation and maintenance of an optimal business mix, together with the viability and achievability of strategic initiatives for entering new markets, building out the current footprint, and broadening the product mix are considered. In this context, the experience and depth of the management team to run an institution, along with the capacity of operating systems and the robustness of administrative policies and practices – such as credit administration – to safely manage business volumes are taken into account. DBRS also considers management's ability to direct the institution as it grows. The effectiveness and efficiency of management's use of the bank's resources is evidenced by the bank's profitability relative to the level of risk taken. While success in delivering strong earnings and franchise growth is viewed positively, the risk profile that is generating this growth and the ability of management to cope with an adverse environment are also analyzed.

### **Quality and Role of the Board of Directors**

The independence, experience and diversity of the Board members are also evaluated. An active Board meeting several times a year that consists of predominantly independent members bringing together a broad range of experience in business and finance is preferred. The composition and independence of the audit committee, as well as the frequency of its meetings, are particularly relevant. Board members from different geographic locations are preferred for larger banks operating in multiple states. A board with heavy insider representation and with members whose companies are being financed by the bank is viewed less favorably. Ownership influence on an institution and multiple class voting structures are also taken into account. With respect to the chairman and other senior executives, an orderly succession plan and aggregate compensation relative to those of similar banks are relevant issues.

## ***2. Earnings Power***

In assessing a bank's earnings power, the analysis looks at the components underlying a bank's earnings and their ability to withstand stress. These include asset yields, funding costs, net interest margin and efficiency. The revenue contribution of fees and commissions, the efficiency of the operating platform, and the amount of loan loss provisions recognized by the bank also influence profitability. Effective use of the balance sheet is reflected in returns on assets. Ultimate profitability reflects the combination of earnings and capital strength relative to the bank's risk profile. Trends over time and peer comparisons provide opportunities to gauge the strength and trajectory of earnings power.

### **Revenue Diversification**

The analysis of revenue diversification starts by examining the contribution of various components that contribute to earnings. The analysis takes into account the breadth of industry sectors represented in



the loan portfolio, the geographic dispersion of loans, as well as the diversity of fee-based products and their relative contribution to net revenues. The broader the industry coverage and geographic dispersion in the loan portfolio, the more resistant net interest income is to economic dislocations in a specific market or industry. The analysis also takes into consideration the competency of the financial institution in originating and underwriting the risk in those industries and geographic areas, as well as its ability to appropriately price the risk inherent in those transactions.

### **Loan Yield, Cost of Funding and Net Interest Margin**

An important indicator of earnings power is the loan yield, which reflects the bank's business mix and the risks inherent in its loan portfolios. A lower-than-peer group average yield on loans can be mitigated by a lower risk profile in the loan portfolio. Held predominantly for liquidity, yields on securities play a more modest role in overall yields on earning assets for most banks.

Typically driven by deposit costs, the cost of funding liabilities is a critical component of earnings power. Generally, a greater share of core deposits drives lower deposit costs. While non-interest-bearing and other checking accounts typically have lower interest costs, they also generate non-interest expenses that need to be taken into account in looking at overall earnings strength. A greater reliance on wholesale funding often leads to above-average funding costs. Moreover, an undue reliance on less stable wholesale funding may make an institution more susceptible to market-funding disruption. Higher aggregate funding costs can be mitigated by minimal reliance on volatile funding sources.

Net interest margin (NIM) is an important gauge of a bank's ability to generate a spread between its funding costs and the yield on its assets. A stable NIM for a sustained period indicates both a balanced loan portfolio with a stable funding base and prudent management of the impact of interest rate volatility, and is therefore a positive rating consideration.

### **Non-Interest Income**

An important element in analyzing earnings is the contribution of non-interest income sources. Relatively high non-interest income as a percentage of net revenues is generally considered favorably, because such businesses typically involve limited amounts of assets, capital and credit risk. Thus, non-interest income boosts profitability and, at the same time, lowers the bank's exposure to credit and interest rate risk.

Fiduciary services such as trust administration and custody services, although influenced by market factors, tend to produce relatively stable fees and commissions. Cash management and some treasury operations also produce stable fees. By contrast, brokerage commissions, investment banking fees, trading revenues and residential mortgage-related fees are more heavily influenced by market conditions and changes in interest rates, and therefore tend to be more volatile sources of non-interest income.

### **Efficiency**

An important consideration for earnings power is the efficiency of a bank's operations and how well management manages operating expenses. One useful measure is the ratio of operating expenses to operating revenues, which shows both trends over time and the performance of a bank relative to its peers.

While expense ratios can indicate differences in efficiency, especially over time, they are also impacted by a bank's mix of business. In evaluating how well a bank manages its expenses, account is taken of its business mix. Typically, fee-based businesses have higher expense ratios than lending businesses that also have to absorb the cost of credit.

DBRS reviews other indicators of performance and productivity to ascertain trends in efficiency. DBRS also looks at the extent to which a bank is generating positive operating leverage by keeping expense growth below revenue growth. The challenge for banks is that much of their investment is made via current expenditures that can drive up the prevailing expense ratio. Well-run banks tend to manage their investment efforts in line with their revenue growth.



### **Profitability Measures**

In gauging the strength of a bank's earnings, the analysis looks at various profitability measures. An important measure is income before provisions and taxes (IBPT) which assesses a bank's resources to absorb the impact of deteriorating loan portfolios and other adverse events out of current income. Besides the standard measures, such as the return on assets and the return on equity, the analysis also considers IBPT to risk-weighted assets (RWA), which is the regulatory measure of risk-adjusted assets.

Earnings strength is assessed by the extent to which earnings can simultaneously cover large unanticipated losses and non-recurring expenses, accommodate balance sheet growth, and pay dividends expected by shareholders – all without weakening stockholders' equity. One of the key measures of a bank's financial health is the amount of loan loss coverage, defined as pre-provision income relative to loan loss provisions. This measure helps indicate the extent to which earnings can decline and losses simultaneously increase without invading capital.

A steady dividend stream is expected by most shareholders, and the average payout rate by banks has risen to about 50% in recent years. A reduction in the expected dividend rate could result in a material adverse change in the bank's stock price and market capitalization; hence, banks are under pressure to maintain a steady dividend rate and therefore sufficient and stable earnings.

### ***3. Risk Profile, Asset Quality and Risk Management Processes***

Taking risk is an inherent function of banks as financial intermediaries. A critical element of the rating process is evaluating the nature and extent of the risks that a bank faces and how well the bank manages these risks. In this building block, the ratings process looks at a range of risks and risk management processes. Credit risk generally receives the most attention, given its importance for banks generally. Also addressed are interest rate risk, market risk, and operational risk. The bank's track record in managing risk generally and asset quality in particular through economic cycles, and its capacity to sustain a sound credit profile in the intermediate future are key rating considerations. In this context the robustness of the bank's policies and procedures, together with the depth and experience of its management team are key considerations. Meeting with management also enables DBRS to assess management's general risk appetite and approach to management of those risks.

#### **Asset Quality and Credit Risk Management**

The analysis focuses equally on the credit processes and the quality of the loan portfolio. The primary considerations in assessing the credit process typically include the level of authority delegated to credit risk management to ensure adequate controls, the robustness of the internal rating scale to properly identify riskier loans, and house exposure limits that minimize bulky relationship exposures. The bank's underwriting standards for different types of loans, as well as policies for avoiding excessive risk concentrations in volatile industries or regions are reviewed. The frequency of exceptions to house limits and underwriting criteria, and the circumstances under which they are approved help in assessing the bank's credit discipline.

Assessing the quality of the loan portfolio involves a review of the composition of loans by customer type, industry and geographic location. The type of collateral held against various loans and recourse to third parties are also considered, as are concentrations in potentially higher-risk industries or loan types, such as commercial real estate and sub-prime residential mortgages, along with any factors that tend to mitigate these risks. For instance, an elevated portfolio concentration in commercial real estate could be mitigated by the combination of conservative loan-to-value (LTV) ratios and debt service capacity requirements, a highly granular and diversified portfolio, and a strong track record in safely managing this business through various real estate and interest rate cycles. The securities portfolio is also scrutinized for its composition and credit quality.

In retail lending, DBRS's evaluation looks at the bank's processes, experience and track record in managing retail credit. The various loan portfolios are reviewed in terms of vintage analysis, target markets and product mix. The review also considers the customer segment risk profiles in terms of such parameters



as LTVs, FICO scores and other measures. The evaluation also looks at the bank's skills in being able to manage any businesses such as credit cards or automobile leasing that require specialized skills. Compliance with internal policies and external regulatory requirements is also an important consideration.

Asset quality performance is reviewed and the prevailing trends analyzed in a process that involves the use of various ratios, loan migration data based on the internal rating scale, and trends in customer creditworthiness and collateral coverage. Additional factors include the bank's capacity to cover loan losses from earnings and the adequacy of its capital cushion in case earnings should not be sufficient to offset losses.

While there is some flexibility in the timing of recognizing losses, such as those from asset sales and rebalancing the loan portfolio, a delay in taking these steps could potentially increase the amount of losses. How well management copes with deterioration in credit quality by recognizing and addressing the problems is part of the assessment. Additionally, management's ability to properly gauge and adjust its loan loss provisions is also qualitatively evaluated.

### **Managing Interest Rate Risk and Market Risk**

Given the importance of interest rate risk, considerable attention is paid in the rating process to evaluating the extent of a bank's interest rate risk and how well it is managed. In this respect, the analysis considers the maturity profile of the bank's assets and liabilities together with the risk limits approved by senior management under changing interest rate scenarios. Importantly, management's track record over time and under various interest rate environments in complying with these requirements and maintaining a relatively stable NIM are key considerations.

### **Operational Risk**

Given the operational complexity of banks, operational risk is an important consideration in evaluating a bank's soundness and the potential for losses that could impair earnings and capital. These risks include diverse elements such as minimizing human error, failures in systems and technology, and the inability to meet regulatory and compliance requirements. The bank's track record in managing operational risk over time and its disaster recovery plans also receive considerable attention.

## ***4. Liquidity***

The bank liquidity analysis focuses predominantly on the sources of funding and their stability under changing economic and interest rate environments. The maturity profile and cost of the various funding liabilities also have a material impact on the robustness of the bank's liquidity. Importantly, the bank's contingency liquidity plans to deal with potential funding dislocations are reviewed.

For BHCs with one or more operating bank subsidiary, the capability of the operating bank subsidiaries to fund their financial obligations through all foreseeable market conditions is a key requirement for their viability; hence, this capability receives much analytical attention. In the same context, the stand-alone liquidity position of the holding company is analyzed to determine how long it can meet its operating expenses and debt service obligations from its own resources without relying on dividends from regulated bank subsidiaries.

In the spectrum of funding sources, core deposits are the most attractive, because they tend to be both relatively stable and typically lower in cost than wholesale funding. Excessive reliance on wholesale funding contributes negatively to bank ratings, while modest reliance on wholesale funding is viewed positively, especially for smaller banks that have less access to the capital markets and alternative sources of funding. To the extent that a bank's business model is more focused on capital markets activities, a greater reliance on wholesale funding is to be expected.

Liquidity is also about balancing the sources of funding with the characteristics of the bank's assets. Given the lower liquidity of loan products, particularly for smaller banks, core deposit funding that accounts for a large percentage of the loan portfolio is considered a rating strength. By contrast, large certificates of



deposit (those in excess of \$100,000), brokered deposits and unsecured borrowings are more confidence-sensitive and can become much more expensive when liquidity is needed. Consequently, excessive reliance on these typically more volatile funding sources weakens the bank's liquidity profile and may constrain its short- and long-term ratings.

DBRS seeks to understand a bank's preparedness for dealing with a liquidity crisis. The review process considers the unique characteristics of each banking company. Contingency liquidity plans for the operating bank that involves sufficient long-term funding and reliable additional borrowing capacity from various sources to continue operations without major disruptions are viewed favorably. DBRS also looks at a bank's access to a variety of liquidity sources beyond internal resources. Access to the Federal Reserve discount window and Federal Home Loan Banks (FHLB) advances, including the availability of necessary collateral, is also considered and the extent to which borrowing capacity is already utilized is taken into account. DBRS also looks at lines of credit and back-up facilities, especially at the BHC level, as well as correspondent banking relationships. Liquidity plans that involve the sale of assets are given more credence when a bank has demonstrated its ability and experience in selling such assets and the assets are relatively marketable. Securitization provides access to liquidity, but can pose challenges if access to the capital markets is curtailed. Such challenges need to be factored into the liquidity assessment.

In its quarterly liquidity study (the most recent edition of which is titled *First Quarter 2007 U.S. Bank and Bank Holding Company Liquidity Study*), DBRS generates five liquidity ratios – three at the bank level and two at the parent holding company level – to provide a comparative basis to help evaluate the adequacy of an individual bank's liquidity. These ratios have been found to be useful in identifying banks and BHCs that may have less than adequate liquidity. Leveraging the detailed data in the regulatory reports for about 215 BHCs with consolidated assets over \$2 billion, this study generates the wholesale funding reliance, the ratio of core deposits to net loans and the ratio of net liabilities to total assets that measure liquidity at the bank level. For parent companies, the analysis reports liquidity coverage both with and without dividends from regulated subsidiaries. By providing trends and a basis for comparison among banks, this analysis helps establish the adequacy of a bank's liquidity, especially by identifying outliers. Less robust ratios do not necessarily mean weak liquidity for any specific bank or BHC, as other factors may offset the weakness by providing liquidity in other forms. These ratios are discussed in the DBRS methodology titled *Lifting the Lid on Ratio Analysis for U.S. Banks*.

### ***5. Capital Structure and Adequacy***

The composition and adequacy of capital receives careful analytical attention as a measure of the bank's solvency and its capacity to absorb losses from operations and loan defaults in excess of its earnings. Factored into the analysis is the scale and diversity of the bank's franchise, the resiliency of its earnings power, the reliability of its operating processes and the soundness of the bank's risk management processes. An important consideration is the extent of losses that a bank could absorb out of income before provisions and taxes on a current basis as well as in a stressed environment. Also addressed is the ability of the bank to generate capital from operations to sustain balance sheet growth, make strategic acquisitions and accommodate required capital expenditures, as well as management's practice in prioritizing capital adequacy relative to meeting shareholder expectations regarding return on equity.

Management targets for various capital ratios and the cushions over the respective regulatory "well-capitalized" levels are important considerations. Also important is management's practice of paying dividends and buying back shares to support its share price. A high dividend pay-out rate could be constraining, because shareholders come to expect the same amount of dividends in the future irrespective of the bank's earnings. A high payout ratio could hinder healthy balance sheet growth and prudent investment into the bank's infrastructure and businesses.

Considerable attention is paid to the level of a bank's regulatory capital ratios, particularly Tier 1, and the extent to which these levels provide a cushion above the regulatory minimums. Having an adequate cushion is an important consideration, because the regulators are typically the ultimate deciders of whether



a bank has sufficient capital to remain solvent. The regulators may also place constraints on banks that they perceive to have inadequate capital, including limitations on acquisitions and dividend payments.

DBRS uses various capital ratios to illuminate different perspectives on the Company's capital position. No single measure, however, encapsulates all the factors determining capital adequacy.

### Capital Ratio Analysis

The simplest capital ratio utilized by DBRS is the ratio of equity to assets, which indicates how well a bank is protected from insolvency due to a decline in the value of its assets on a book value basis. A bank also benefits from a high equity ratio as it does not need to fund equity, but higher equity also reduces returns to shareholders on their equity.

To adjust for the greater risk that goodwill could be written down, DBRS also looks at the ratio of tangible common equity to tangible assets (TCE/TA) which assumes that goodwill is valued at zero. This measure tends to penalize banks that have made acquisitions. In evaluating capital adequacy, DBRS considers the extent to which a bank is generating earnings from the acquired assets and the extent to which the assets underpinning the goodwill still have value. Neither of these measures takes into account the different risk profiles across banks, a step that the regulatory ratios do address.

Regulatory capital ratios contain two kinds of adjustments that DBRS finds useful. To better reflect the regulators' assessment of capital as a protection for depositors, the regulators adjust the numerator, capital. While excluding most intangibles and other comprehensive income, Tier 1 regulatory capital includes trust preferred securities and other qualifying hybrids in Tier 1 capital. Moreover, the regulatory ratios adjust assets for risk. To adjust for risk posed by assets, a risk-weighted asset measure (RWA) is created that reflects the weighting of assets based on risk and includes asset equivalents for off-balance sheet exposures such as commitments. The resulting Tier 1 ratio provides a risk-adjusted measure of a bank's capital adequacy, albeit based on a fairly rudimentary risk adjustment process under Basel I.

DBRS also looks at the regulatory leverage ratio, Tier 1 capital to tangible assets, which is more constraining in that assets are not risk-adjusted. Extending the analysis, DBRS also considers the ratio of tangible capital to RWA, which takes advantage of the regulatory risk-weighting. Reflecting DBRS's preference for equity over hybrids as a cushion for bondholders and other senior creditors, this ratio excludes the hybrid securities that are given full equity value by the regulators up to certain limits.

For some banks, DBRS can also utilize a bank's own estimates of economic capital that reflect much more extensive assessments of risk than the rudimentary approach under Basel I. The extent to which the evaluation of capital adequacy can rely on these estimates depends upon the quality of the underlying analysis. Under Basel II, the regulatory risk assessment becomes more granular and more aligned with the actual risks embedded in the assets and other exposures across a BHC's activities. While the Basel II approach has not yet been adopted for BHCs, it is paralleled by the generally more extensive economic capital or risk capital assessment that is already employed by many larger banks in their risk management processes.

In broad terms, banks with a limited product range and a heavy dependence on net interest income tend to have more exposure to credit risk and higher earnings volatility, necessitating higher capital levels. This scenario is typical of most small community banks. By contrast, regional and super-regional banks tend to have more diversified franchises and derive a larger share of their revenues from fees and commissions that provide some insulation from adverse trends in credit risk and generally produce more stable earnings. Consequently, larger banks typically require less capital.



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## Rating Considerations Beyond the Five Building Blocks

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In addition to the five interconnected building blocks, DBRS takes a range of other considerations into account in its analysis. Some key considerations are described below.

### **BANK HOLDING COMPANY FUNDAMENTALS**

The ratings of U.S. BHC debt obligations take into account their structural subordination to those of the operating bank subsidiaries; therefore, they are typically rated one notch below the comparable instruments issued by banks. This notching practice recognizes that almost all assets and revenues are held or received by the bank subsidiaries of a typical BHC, while the BHC is dependent on its own, typically limited resources and on dividends from subsidiaries that could be curtailed if regulators perceive this action is needed to safeguard the viability of the bank under their supervisory control. No notching may be required for BHCs with an extensive array of strong subsidiaries across a range of regulatory environments which reduces the risk that the BHC cannot access the resources in its subsidiaries.

Assessing the adequacy of a holding company's financial fundamentals and liquidity takes into account the holding company's double-leverage and capacity to meet its financial obligations. Elevated or high double-leverage often signals excessive use of long-term debt by the holding company to capitalize its subsidiaries and, correspondingly, the holding company is likely to have high debt service obligations. The review focuses on the resources available to meet operating expenses and debt service obligations, including the repayment of maturing debt. Thus, only the holding company's unencumbered liquid assets and other assets readily available from non-regulated subsidiaries are considered as available funding sources to pay its debt obligations, expenses and stock dividends.

### **SUPPORT FROM PARENT OR OTHER OWNERS**

If a bank's ultimate parent company is domiciled in the United States, the ratings are based solely on the bank's intrinsic credit quality. For foreign-owned banks operating in the United States, varying degrees of expected parent company support are factored into the ratings. How the level of such expected support is reflected in DBRS's ratings is articulated in more detail in the methodology titled *Enhanced Methodology for Bank Ratings – Intrinsic and Support Assessments*.

DBRS equalizes its ratings of subsidiary banks of a U.S. BHC that are insured by the Federal Deposit Insurance Corporation (FDIC), based upon the FDIC's enforcement of cross-guaranty liability against commonly controlled depository institutions and the Federal Reserve's policy that a BHC should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity (also referred to as the "source of strength doctrine").

Considerations of parent support are more likely to arise for thrifts and other non-bank FDIC-insured institutions that can be owned by non-bank parents that could be stronger than their financial subsidiaries, rather than BHCs that are primarily dependent on the strength of their financial subsidiaries.

### **CONSIDERATION FOR REGULATORY ENVIRONMENT AND SYSTEMIC SUPPORT**

DBRS views the U.S. regulatory structure as providing a strong operating environment, but does not ascribe any "too big to fail" systemic support to elevate ratings beyond intrinsic strength. Ratings are not adjusted for any implicit support from the U.S. government or any of its agencies. DBRS believes that this approach is consistent with the current trend towards more effective regulation and supervision in the United States that has been accompanied by less rather than more government support for failing banks in the United States.



Ratings, however, do take into account the robust role of U.S. federal and state regulatory agencies in requiring adequate and timely public financial disclosure, in supervising banks' operating performance and credit quality, and in taking prompt corrective action to protect the federal deposit insurance funds, the safety and soundness of the banking system, and the integrity of the U.S. financial markets.

Under DBRS's current ratings process that is consistent across countries, U.S. banks without foreign ownership receive a Support Assessment (SA) of SA3 (for more detail, refer to methodology titled *Enhanced Methodology for Bank Ratings – Intrinsic and Support Assessments*). This SA3 designation means that external support is not expected to be forthcoming under most circumstances with enough certainty to warrant raising ratings above the rating based on a U.S. bank's intrinsic strengths. For comparison, an SA2 support assessment by DBRS reflects the expectation of some sort of systemic external support, ideally with a timeliness element in it. An SA1 support assessment by DBRS reflects a very strong to good likelihood of and predictability of timely external support.

DBRS ascribes substantial benefits to investors and uninsured depositors arising from the extensive examination, supervision and regulation in the United States that constrains the risks that banks might take. Banks, like other extensively regulated entities, generally benefit, because this regulation reduces the risk that actions by poorly managed banks can lead to disruptions in local or national markets. Particularly important in limiting such risky actions by banks is the strengthened ability of regulators to take prompt corrective action if a bank's condition is deteriorating or it is deviating from sound practices. The regulators may put pressure on management to sell the bank, divest some assets or find other solutions to recapitalize the bank and restore it to a sound financial basis. Such efforts are more likely to be successful where there is value in the franchise.

An element in DBRS's ratings assessment is evaluation of management's relationship with its regulators. Indications of adversarial relationships would cause DBRS to be concerned about the strength of the franchise and its prospects. Close supervision is also good for senior debt holders, because it reduces the risk that sustained deterioration passes unnoticed.

#### ***Banks That May Pose Greater Risks Not Guaranteed to Be Protected***

DBRS does not believe that any U.S. bank is "too big to fail" in the context of systemic support. DBRS does expect that banks that pose greater risks to the financial system or elevated threats to the FDIC insurance fund are likely to receive greater attention, but this does not imply a greater likelihood that their senior debt would be protected. To avoid problems arising in the first place, the regulators pay closer attention to such banks and have developed processes to handle problems that might arise if a bank's condition deteriorates. Given the size of the market and number of players, the U.S. regulators have a broad array of solutions that may not involve keeping the institution intact, thereby protecting senior debt holders.

If a bank with federally insured deposits has deteriorated to such a degree that the FDIC and other regulators need to intervene, the FDIC is charged with finding the least costly resolution. Under the current process, the outcome is uncertain. DBRS does anticipate that bank regulators would take action to avoid an abrupt, disorderly failure, but that may well mean that uninsured depositors or senior debt holders are exposed to potential loss: there are no explicit guarantees for investors or uninsured depositors.



## NOTCHING AND SENIORITY OF RATED DEBT CLASSES AND PREFERRED SHARES

In cases where the condition of a bank or BHC has deteriorated significantly, equity owners are highly likely to face losses, while senior creditors may well not receive payment in full. Reflecting the greater risk of loss for holders of subordinated debt, as this debt is viewed as part of total capital, this debt is typically rated one notch below senior debt issued by the same entity. Similarly, ratings of trust preferred securities and preferred shares also take into account the ranking of these securities in the issuer's capital structure and the issuer's credit strength. Depending on the specific structure of trust preferred securities, they are typically rated one or two notches below senior debt. DBRS typically rates preferred shares two notches below senior debt.

In addition, debt issued out of the bank holding company is also more at risk and structurally subordinate to senior debt issued by its subsidiary bank and is therefore typically rated one notch lower.

## RELATED RESEARCH AND METHODOLOGY LINKS

The DBRS reports referenced below include examples of frequently used financial ratios and comparative statistics used in U.S. bank rating analysis as well as additional detail on DBRS rating methodologies.

- [Lifting the Lid on Ratio Analysis for U.S. Banks](#)
- [U.S. Banking Peer Group Statistical Handbook](#)
- [U.S. Bank and Bank Holding Company Liquidity Study](#)
- [Example of DBRS stress test for commercial real estate concentration risk](#)
- [Big, But Not Dominating III: DBRS Assesses U.S. Super-Regional Banking Franchises](#)
- [Enhanced Methodology for Bank Ratings – Intrinsic and Support Assessments](#)
- [Bank and Bank Holding Company Trust Preferred Securities](#)

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**Corporate Headquarters**

DBRS Tower  
181 University Avenue  
Suite 700  
Toronto, ON M5H 3M7  
TEL +1 416 593 5577