

Commentary

*The Potential Impact of Evolving  
Legislation on U.S. Bank Ratings*

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*Insight beyond the rating.*

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## CONTACT INFORMATION

Roger Lister  
Chief Credit Officer – Financial Institutions Group  
+1 212 806 3231  
rlister@dbrs.com

William Schwartz  
Senior Vice President – U.S. Financial Institutions Group  
+1 212 806 3233  
wschwartz@dbrs.com

Steven Picarillo  
Senior Vice President – Financial Institutions Group  
+1 212 806 3238  
spicarillo@dbrs.com

Alan G. Reid  
Managing Director – Financial Institutions Group  
+1 212 806 3232  
areid@dbrs.com

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# The Potential Impact of Evolving Legislation on U.S. Bank Ratings

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## SUMMARY

This commentary was written as the proposed Senate and House of Representative Financial Reform Bills are being reconciled. Many of the details remain to be determined in the final legislation. Nevertheless, the scope of evolving U.S. legislation on financial reform is raising concerns about its potential impact on banks and their ratings.

One concern is with the potential constraints on the ability of U.S. government entities and regulatory agencies to provide support to the financial sector in the event of another crisis. The proposed legislation is expected to add greater clarity to the roles and responsibilities of the regulators, but may also constrain their ability to act, especially to provide timely support to individual institutions. If these constraints excessively limit the ability of the government to act quickly and effectively in a crisis, our concern is that systemic risk in the financial system could increase. DBRS does not ascribe any government support to individual ratings for the majority of its ratings of U.S. banks. However, the ratings of certain institutions, which DBRS has designated as critically important banking organizations (CIBs), incorporate support via floor ratings. Currently, just two CIBs are rated at the floor: Bank of America and Citigroup.

A second area of concern is the impact that this legislation may have on the health of U.S. banking organizations. While the legislation may well enhance banking organizations' risk profiles and strengthen the soundness of the financial system, it is also likely to increase regulatory costs and constrain business activities. A potential result is that banks will become less profitable and will, therefore, have less of an ability to absorb the impact of future negative events through recurring earnings.

With the final details of the legislation still to be worked out, its impact on U.S. bank ratings remains unclear. As more clarity emerges and likely outcomes are more discernable, DBRS will be better positioned to determine whether any rating actions are warranted. For the 61 bank holding companies currently rated by DBRS, at this point, we do not anticipate significant changes in our ratings as a result of the legislation.

## FLOOR RATINGS AND U.S. GOVERNMENT SUPPORT FOR CRITICALLY IMPORTANT BANKING ORGANIZATIONS (CIBs)

Until the 2008 crisis, DBRS did not incorporate any lift to U.S. bank ratings resulting from implicit support from the U.S. government, the regulators or other official entities. Prior to the crisis, we anticipated that some form of support was likely to be forthcoming in a crisis, but the timelines and extent of such support was not sufficiently reliable or predictable to warrant any lift to our bank ratings above our intrinsic assessment, which is based upon a bank's fundamentals.

This view changed in 2008-2009 with the escalation of the actions taken by the U.S. government and the various regulatory authorities to support the banking industry, and the financial sector generally, with the deepening impact of the crisis. In particular, much more comprehensive policies were put



in place in the U.S. that could be relied on to provide systemic support. To incorporate this elevated level of support, in February 2009, DBRS introduced the concept of a floor rating applicable to critically important banking organizations. This concept was subsequently applied to other countries, where banking sectors were under significant stress and government support was forthcoming.

Our interpretation of the increased level of support was that the U.S. government was seeking to ensure that U.S. financial markets were fully functioning with these CIBs as active participants. The level we established for the floor reflects the level of creditworthiness that market participants demand. As essential counterparties, the markets need to perceive the CIBs to be reliable partners in undertaking a wide range of financial transactions during a period of disrupted financial markets. In the U.S., the floor for the short-term rating was established at R-1 (middle) to reflect the importance of the full participation of these CIBs in the money markets. Comparable floors for long-term ratings were established for CIBs at “A” for bank holding companies and at A (high) for banks. Given the nature of the floors, all ratings have Stable trends.

From this perspective, CIBs are usually banking organizations that have extensive involvement in a country’s financial markets and perform critical roles in the flow of financial transactions. The loss of the market’s confidence in a CIB’s ability to perform as a reliable counterparty could infect the market’s perception of other participants and lead to a degradation of the functioning of the financial markets.

In the U.S., the CIBs are: Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup Inc., Goldman Sachs Group, Inc., J.P. Morgan Chase & Co., Morgan Stanley, State Street Corporation and Wells Fargo & Company. DBRS’s support assessment for these institutions is SA2, reflecting this stronger level of implicit support. For other U.S. banks, the support assessment is generally SA3 reflecting our lower level of confidence in the reliability of support; some banks are SA1 due to parent or other similar support. No additional support is imputed for banks whose ratings are above the floor.

At the time the floor was introduced, the turmoil in the financial markets meant that it was very difficult to accurately ascertain the intrinsic strength of certain banks, particularly the two CIBs most under pressure. As a result, DBRS monitored the health of Bank of America and Citigroup, but did not finalize the intrinsic assessments. Actions taken by the banks themselves and by the U.S. government in dealing with the crisis, along with the recovery in the economy, have resulted in the underlying health of these institutions improving. This improvement has narrowed the likely gap between the floor ratings and their intrinsic assessment. In light of the potential for the evolving legislation to affect the floor ratings, DBRS will shortly finalize and subsequently publicize the intrinsic assessments for these two CIBs.

Within the legislative proposals being considered, some avenues for support would remain, but others would be curtailed. The U.S. authorities will likely retain considerable scope to provide support to U.S. financial institutions on a system-wide basis in the event of a crisis. This is necessary to keep the country’s financial markets functioning and protect its economy from the consequences of a financial market collapse. At this time, DBRS does not see the changes as prohibiting all support, but only constraining how support might be provided. With the details still to be reconciled and subsequent regulations to be finalized, DBRS has not changed its approach to incorporating government support into its ratings for CIBs.



In European countries, DBRS's current approach to support is generally to add one notch to the intrinsic assessment for banks that are designated as systemically important banks (SIBs) with SA2 support assessments. Within this broader group, CIBs are a subset that are supported at a higher level. By factoring in support, DBRS is relying on the likelihood and predictability of timely explicit or implicit external support for SIBs because of their scale and importance, as well as the consequences of bank failures in many countries. For SA2 banks outside of the U.S. that are rated by DBRS, support above any floor is believed to be more predictable than in the United States.

DBRS believes that this difference is warranted for these countries because of their more concentrated banking industries, greater inter-connections between the state and financial institutions, a history of more predictable government intervention to support their SIBs, as well as the recognition that bank failures have historically been very unusual. In view of the impact of the crisis on the regulation of financial institutions globally, DBRS is also monitoring evolving legislation and regulation in those countries where it rates banks to determine if adjustments need to be made to its approach to support.

## SUMMARY OF MAJOR ISSUES IN PROPOSED LEGISLATION ON U.S. FINANCIAL REGULATION

What is apparent at this point is that operating costs for many U.S. financial institutions are likely to rise due to additional regulation and increased FDIC fees and assessments. Less clear is the final form of legislation on the limitation of certain business activities that may require banks to significantly restructure the affected businesses or exit them entirely. In combination, these impacts may well result in banks having lower margins and higher capital requirements. At the same time, the legislation may also result in U.S. financial institutions having stronger risk profiles. Even without the legislation, banks are lowering their risk profiles after the crisis. Basel III is also likely to bring additional capital requirements and other constraints. Improved risk profiles may positively impact ratings and reduce funding costs.

DBRS is concerned about the unintended consequences of the proposed regulation. Some possibilities include contraction in certain lending categories, significant product changes, increased product costs for customers (particularly depository accounts and credit card programs), increased flow of financial activity outside banks and other extensively regulated financial institutions, and the migration of more constrained financial activities to more non-banks or other domiciles.

### Key Issues

#### 1) Regulatory Authority

Changes in regulatory authority and responsibility for managing systemic risk could impact the level of systemic risk and might affect DBRS's floor rating concept:

- Orderly mandated institution liquidations
- Form of regulatory resolution; FDIC receivership
- Increased capital requirements, which may be positive from a risk prospective, but could also raise the cost of capital and constrain lending.
- Treasury oversight and approval of emergency financial stabilization programs, which may reduce predictability and timeliness
- Clarified and defined roles of the Federal Reserve System (systemic regulator) and FDIC (institutional regulator)



## 2) Regulatory Controls / Business Constraints /Risk Limitations

DBRS perceives that there are various proposals which, if included in the final legislation, could drive changes in corporate structure, constrain business activity and increase operating expense and capital costs, but could also improve risk profiles:

- Increased capital requirements
- Volcker Rule – elimination or limits on proprietary trading, hedge fund and private equity investing
- Institution concentration limits, which could limit expansion of larger banks
- Derivative reforms (Lincoln Amendment)
- Securitization reforms, including required retention of a portion of securitizations
- Regulation of non-bank companies and subsidiaries
- BHC excessive compensation limits

## 3) Regulatory Costs

DBRS sees the following changes, if included in the final legislation, as potentially increasing costs or reducing revenues for financial institutions:

- FDIC deposit insurance assessments; especially if less core deposit driven
- FDIC fees to pay for projected losses and expenses
- FDIC authorization to impose special assessments
- Consumer Protection Agency restrictions on federal pre-emption (this could impact banks operating in multiple states, particularly super-regional banks)
- Disallowance of hybrid capital in Tier 1 capital (Collins Amendment)
- Interchange fee reduction (Durbin Amendment)

## CONCLUSION

DBRS anticipates that the final legislation will be passed in the next few months. In assessing the implications of the final legislation, DBRS will endeavor to evaluate the impact of the legislation on banks and the financial system. Where necessary, ratings action may be taken. Given the extent of the changes that might occur and the time that may be required to put the legislation into practice, however, DBRS sees this process of legislative implementation as likely to result in a lengthy period of evaluation that could last into 2011. DBRS will publish further commentaries as the consequences of the legislation become clearer.

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**Corporate Headquarters**

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