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The Top 100 Rated Banks: The Consensus About Capital Is Unraveling

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The Top 100 Rated Banks: The Consensus About Capital Is Unraveling

Less than four years after the initial Basel III proposals were unveiled, Standard & Poor's sees growing signs that the global consensus about strengthening bank capitalization is coming to an end. For several years now, Standard & Poor's Ratings Services has built the underlying expectation that capital ratios would steadily strengthen into its ratings, in the belief that regulators around the world were all working toward this end.

Events in past six months illustrate that the consensus is starting to fray. Some national regulators are satisfied with Basel III targets, and believe that even tighter bank capitalization could backfire and cause economic damage. Others believe that banks can become more active in financing the economy once they are healthy enough to regain full access to the wholesale funding markets. In view of these worrisome cracks in the Basel III consensus, we expect differences about capital standards and stances to widen over the coming quarters. This is likely to make capital a greater source of differentiation for our ratings on banks that it has been over the past few years.

Overview

- Capital is likely to lead to greater ratings differentiation for banks worldwide over the coming quarters than in the past few years.
- Investors are increasingly skeptical about how indicative regulatory risk-adjusted ratios are regarding a bank's capitalization.
- Loan forbearance could spread as economies weaken, distorting capital ratios.

This fourth annual survey presents our risk-adjusted capital (RAC) ratios for the world's top 100 banks that we rate, based on end-2012 data (see table 1 below). The results generally indicate that more than half of the banks show steady or improved ratios compared with the end-2011 ratios. However, today's ratio trends are heavily influenced by credit growth and earnings, given banks' continued reluctance to raise equity. We see that some banks in emerging markets did not generate sufficient earnings organically in 2012 to self-finance rapid credit growth. Conversely, rises in capital metrics are more prevalent in mature markets that continued to show solid earnings. In more troubled markets, beside capital injections, governments sometimes helped banks to boost their regulatory ratios through weaker forms of capital, such as the conversion of deferred tax assets into current tax credits. Apart from capital levels, we expect the quality of total capital to decline, as banks are keen to build up a buffer of weaker hybrid regulatory capital above the minimum. Several of these trends lead us to the conclusion that we will see a steady decline in the number of banks whose projected RAC ratios will rise substantially higher than the end-2012 ratios.

Capital ratios are not meaningful in isolation, as the history of bank failures show. An adequate recognition and assessment of risk should be part of the equation. Investors have largely lost faith in the global consistency of regulatory risk-adjusted capital ratios and show increasing interest in alternative metrics, such as the leverage ratio. We continue to consider leverage ratios as useful complements to risk-adjusted capital metrics, but our preferred metric to analyze capitalization remains our RAC ratio. However, we recognize that the RAC ratio doesn't adequately capture some risks, such as significant litigation, business, and tail risks--which are particularly relevant for investment banks. We nevertheless consider this limitation in our broader capital and earnings assessment for investment banks.

Table 1

RAC Ratios: How The Top 100 Rated Banks Compare

Rank	Country	Institution	Operating company long-term ICR	SACP	Capital & earnings	Risk position	Combined impact (capital and earnings and risk position) (notches)	RAC ratio before diversification (%)	Tier 1 ratio (%)	Ratios as of date
1	China	Industrial and Commercial Bank of China Ltd.	A	bbb	Moderate	Adequate	-1	7.3	10.6	31/12/2012
2	U.S.	JPMorgan Chase & Co.	A+	a	Adequate	Adequate	0	6.3	12.6	31/12/2012
3	U.S.	Bank of America Corp.	A	bbb+	Adequate	Moderate	-1	8.3	12.9	31/12/2012
4	U.K.	HSBC Holdings PLC	AA-	a+	Adequate	Strong	1	8.0	13.4	31/12/2012
5	China	China Construction Bank Corp.	A	bbb-	Moderate	Moderate	-2	7.2	11.3	31/12/2012
6	U.S.	Citigroup Inc.	A	bbb	Adequate	Moderate	-1	7.3	14.1	31/12/2012
7	Japan	Mitsubishi UFJ Financial Group Inc.	A+	a+	Adequate	Adequate	0	7.0	12.6	30/09/2012
8	U.S.	Wells Fargo & Co.	AA-	a+	Adequate	Strong	1	8.1	11.8	31/12/2012
9	China	Bank of China Ltd.*	A	bbb-	Moderate	Moderate	-2	7.1	10.5	31/12/2012
10	China	Agricultural Bank of China Ltd.*	A	bbb-	Moderate	Adequate	-1	6.8	9.7	31/12/2012
11	France	BNP Paribas	A+	a	Adequate	Adequate	0	6.6	13.6	31/12/2012
12	U.K.	The Royal Bank of Scotland PLC	A	bbb	Adequate	Moderate	-1	7.6	12.4	31/12/2012
13	France	Crédit Agricole group §	A	a-	Adequate	Adequate	0	6.0	12.9	31/12/2012
14	Spain	Banco Santander S.A.	BBB	a-	Moderate	Very strong	1	5.1	10.3	31/12/2012
15	U.K.	Barclays Bank PLC	A	bbb+	Adequate	Adequate	0	7.3	13.3	31/12/2012
16	Japan	Sumitomo Mitsui Financial Group Inc.	A+	a	Moderate	Adequate	-1	6.2	13.2	30/09/2012
17	Japan	Mizuho Financial Group Inc.	A+	a	Moderate	Adequate	-1	5.5	12.7	30/09/2012
18	U.K.	Lloyds Bank PLC	A	bbb	Moderate	Moderate	-2	5.8	13.8	31/12/2012
19	U.S.	The Goldman Sachs Group Inc.	A	bbb+	Adequate	Moderate	-1	8.5	16.7	31/12/2012
20	Germany	Deutsche Bank AG	A	bbb+	Adequate	Moderate	-1	6.7	15.1	31/12/2012
21	Italy	UniCredit SpA	BBB	bbb	Moderate	Adequate	-1	6.3	11.4	31/12/2012
22	France	BPCE	A	a-	Adequate	Adequate	0	6.7	12.2	31/12/2012
23	China	Bank of Communications Co. Ltd.	A-	bbb-	Moderate	Adequate	-1	7.0	11.2	31/12/2012
24	U.S.	Morgan Stanley	A	bbb+	Adequate	Moderate	-1	10.3	17.7	31/12/2012
25	Japan	Norinchukin Bank	A+	a	Adequate	Adequate	0	13.0	19.9	30/09/2012
26	Netherlands	ING Bank N.V.	A+	a-	Adequate	Adequate	0	8.7	14.4	31/12/2012

Table 1

RAC Ratios: How The Top 100 Rated Banks Compare (cont.)

27	Netherlands	Cooperatieve Centrale Raiffeisen-Boerenleenbank B.A. (Rabobank Nederland)	AA-	a+	Adequate	Strong	1	7.4	17.2	31/12/2012
28	France	Societe Generale	A	a-	Adequate	Adequate	0	6.7	12.5	31/12/2012
29	Italy	Intesa Sanpaolo SpA	BBB	bbb	Moderate	Strong	0	6.0	12.1	31/12/2012
30	Switzerland	Credit Suisse AG	A	bbb+	Adequate	Moderate	-1	9.3	19.4	31/12/2012
31	Spain	Banco Bilbao Vizcaya Argentaria S.A.	BBB-	bbb+	Moderate	Very strong	1	5.1	10.8	31/12/2012
32	Switzerland	UBS AG	A	bbb+	Adequate	Moderate	-1	8.7	21.3	31/12/2012
33	U.K.	Standard Chartered Bank	AA-	a+	Adequate	Strong	1	8.8	13.4	31/12/2012
34	France	Crédit Mutuel group	A	a-	Adequate	Adequate	0	7.2	14.5	31/12/2012
35	Brazil	Banco do Brasil S.A	BBB	bbb+	Moderate	Adequate	-1	5.5	10.6	31/12/2012
36	Germany	Commerzbank AG	A-	bbb-	Adequate	Weak	-2	8.6	13.1	31/12/2012
37	Australia	National Australia Bank Ltd.	AA-	a	Adequate	Adequate	0	8.1	10.3	30/09/2012
38	Brazil	Itau Unibanco Holding S.A.	BBB	bbb+	Moderate	Adequate	-1	6.6	11.0	31/12/2012
39	Australia	Australia and New Zealand Banking Group Ltd.	AA-	a	Adequate	Adequate	0	8.8	10.8	30/09/2012
40	Canada	Royal Bank of Canada	AA-	a+	Adequate	Strong	1	7.3	13.1	31/10/2012
41	Brazil	Banco Bradesco S.A.	BBB	bbb+	Moderate	Adequate	-1	5.4	11.0	31/12/2012
42	Australia	Westpac Banking Corp.	AA-	a	Adequate	Adequate	0	8.8	10.3	30/09/2012
43	Sweden	Nordea Bank AB	AA-	a+	Adequate	Strong	1	8.5	11.2	31/12/2012
44	Australia	Commonwealth Bank of Australia	AA-	a	Adequate	Adequate	0	8.4	10.5	31/12/2012
45	U.S.	U.S. Bancorp	AA-	a+	Adequate	Strong	1	8.8	10.9	31/12/2012
46	U.S.	PNC Financial Services Group	A	a	Adequate	Strong	1	7.4	11.6	31/12/2012
47	Canada	The Bank of Nova Scotia	A+	a	Adequate	Strong	1	7.7	13.6	31/10/2012
48	China	China Merchants Bank Co. Ltd.	BBB+	bbb	Moderate	Strong	0	5.5	8.5	31/12/2012
49	Canada	Toronto-Dominion Bank	AA-	a+	Adequate	Strong	1	7.3	12.6	31/10/2012
50	Denmark	Danske Bank A/S	A-	bbb+	Adequate	Moderate	-1	8.1	18.9	31/12/2012
51	China	Shanghai Pudong Development Bank Co. Ltd.	BBB+	bbb-	Moderate	Strong	0	5.5	9.0	31/12/2012
52	Canada	Bank of Montreal	A+	a-	Adequate	Adequate	0	7.4	12.6	31/10/2012
53	U.S.	Capital One Financial Corp.	BBB+	bbb+	Adequate	Adequate	0	6.6	11.0	31/12/2012
54	Singapore	DBS Bank Ltd.	AA-	a	Adequate	Adequate	0	8.2	14.0	31/12/2012
55	Japan	Nomura Holdings Inc.	A-	bbb	Adequate	Moderate	-1	10.6	15.1	30/09/2012
56	Spain	CaixaBank S.A.	BBB-	bbb-	Weak	Strong	0	6.4	13.5	31/12/2011
57	India	State Bank of India	BBB-	bbb-	Moderate	Moderate	-2	6.2	9.7	31/03/2012
58	Japan	Sumitomo Mitsui Trust Bank Ltd.	A+	a	Moderate	Strong	0	N.A.	11.9	30/09/2012

Table 1

RAC Ratios: How The Top 100 Rated Banks Compare (cont.)

59	Japan	Resona Bank Ltd. †	A	a-	Moderate	Adequate	-1	6.5	10.3	30/09/2012
60	Norway	DNB Bank ASA	A+	a	Adequate	Adequate	0	8.8	10.9	31/12/2012
61	Netherlands	ABN AMRO Bank N.V.	A	bbb+	Adequate	Adequate	0	7.1	12.9	31/12/2012
62	Korea	Kookmin Bank	A	a-	Adequate	Adequate	0	7.5	10.9	31/12/2012
63	Korea	Korea Development Bank	A	bb+	Adequate	Moderate	-1	7.8	13.6	31/12/2012
64	Russia	JSC VTB Bank	BBB	bb	Moderate	Moderate	-1	4.7	10.3	31/12/2012
65	Belgium	KBC Bank N.V. ‡	A-	bbb+	Moderate	Adequate	-1	6.3	13.8	31/12/2012
66	Korea	Woori Bank	A-	bbb	Moderate	Moderate	-2	6.3	11.4	31/12/2012
67	Korea	Shinhan Bank	A	bbb+	Moderate	Adequate	-1	7.0	12.6	31/12/2012
68	Singapore	Oversea-Chinese Banking Corp. Ltd.	AA-	a	Adequate	Adequate	0	9.4	16.6	31/12/2012
69	U.S.	Bank of New York Mellon Corp.	AA-	a	Moderate	Strong	0	5.4	15.0	31/12/2012
70	Austria	Erste Group Bank AG	A	bbb+	Moderate	Adequate	-1	6.3	11.6	31/12/2012
71	Germany	Cooperative Banking Sector Germany	AA-	aa-	Strong	Adequate	1	10.0	12.1	31/12/2011
72	Singapore	United Overseas Bank Ltd.	AA-	a-	Adequate	Adequate	0	8.6	14.7	31/12/2012
73	Korea	Hana Bank	A	bbb+	Moderate	Adequate	-1	6.3	9.6	31/12/2012
74	Sweden	Skandinaviska Enskilda Banken AB (publ)	A+	a-	Adequate	Adequate	0	7.8	11.7	31/12/2012
75	Korea	Nonghyup Bank	A	bbb	Moderate	Moderate	-2	7.5	11.3	31/12/2012
76	Sweden	Svenska Handelsbanken AB	AA-	a+	Adequate	Strong	1	8.2	21.0	31/12/2012
77	U.S.	SunTrust Banks Inc.	BBB+	bbb+	Adequate	Moderate	-1	8.9	11.1	31/12/2012
78	France	Dexia Credit Local ‡	BBB	b+	Moderate	Weak	-3	7.5	22.2	31/12/2012
79	U.S.	BB&T Corp.	A	a	Adequate	Strong	1	7.6	10.7	31/12/2012
80	Canada	Canadian Imperial Bank of Commerce	A+	a-	Adequate	Adequate	0	8.0	13.8	31/10/2012
81	Ireland	Allied Irish Banks (AIB)	BB	b+	Weak	Adequate	-1	3.0	15.1	31/12/2012
82	U.S.	State Street Corp.	AA-	a+	Adequate	Strong	1	6.9	19.1	31/12/2012
83	Sweden	Swedbank AB	A+	a-	Adequate	Adequate	0	9.4	11.4	31/12/2012
84	Canada	Caisse centrale Desjardins	A+	a	Strong	Adequate	1	11.7	16.8	31/12/2012
85	Malaysia	Malayan Banking Bhd.	A-	a-	Adequate	Adequate	0	8.3	13.7	31/12/2012
86	Austria	Raiffeisen Zentralbank Oesterreich	A	bbb+	Moderate	Adequate	-1	4.8	11.4	31/12/2012
87	U.K.	Nationwide Building Society	A+	a-	Adequate	Adequate	0	6.1	15.5	04/04/2013
88	Spain	Banco Popular Espanol S.A.	BB-	b	Weak	Weak	-3	3.6	10.3	31/12/2012
89	U.S.	Fifth Third Bancorp	A-	a-	Adequate	Adequate	0	8.3	11.3	31/12/2012
90	Germany	Norddeutsche Landesbank Girozentrale (Unsolicited Ratings)	BBB+	bbb-	Adequate	Weak	-2	8.1	10.9	31/12/2012
91	U.S.	Regions Financial Corp.	BBB	bbb	Adequate	Moderate	-1	9.8	12.0	31/12/2012
92	Denmark	Nykredit Realkredit A/S	A+	a-	Adequate	Strong	1	9.3	19.1	31/12/2012

Table 1

RAC Ratios: How The Top 100 Rated Banks Compare (cont.)										
93	Italy	Unione di Banche Italiane Scpa	BBB-	bbb-	Moderate	Adequate	-1	6.4	10.8	31/12/2012
94	South Africa	Standard Bank of South Africa Ltd.	BBB	bbb	Moderate	Adequate	-1	6.9	11.3	31/12/2012
95	Turkey	Turkiye Garanti Bankasi AS	BB+	bbb-	Adequate	Adequate	0	9.1	15.5	31/12/2012
96	Korea	Industrial Bank of Korea	A	bbb	Adequate	Adequate	0	6.7	8.9	31/12/2012
97	Ireland	Bank of Ireland	BB+	bb	Weak	Adequate	-1	3.7	14.5	31/12/2012
98	Spain	Banco de Sabadell S.A.	BB	b+	Weak	Moderate	-2	3.5	10.4	31/12/2012
99	India	ICICI Bank Ltd.	BBB-	bbb	Adequate	Adequate	0	9.8	12.8	31/03/2012
100	Saudi Arabia	The National Commercial Bank	A+	a	Strong	Moderate	0	11.2	16.5	31/12/2012

Note: The ranking is based on Tier 1 capital as published in The Banker in July 2013. *Estimated RAC ratio. §Without the removal of Emporiki's exposures, which was formally recorded on a regulatory basis after the end of 2012, the RAC ratio was 5.8%. † RAC ratio based on consolidated holding company basis even if we do not rate the holding company (we only rate the operational compagny). ‡RAC ratio calculated at the group level. ICR--Issuer credit rating. SACP--Stand-alone credit profile.

Generally Speaking, More Than Half Of RAC Ratios Have Held Steady Or Improved In The Year To 2012

This is the fourth year in a row that we've published our RAC ratios for the world's top 100 world banks, to provide the marketplace with further insights into their capital strength. Given major variations in data among banks, it is simplistic to draw a single view about the industry from these numbers. Generally speaking, however, more than half have maintained or improved capital ratios since we last published this report. Based on our analysis of year-end 2012 ratios and from recent trends, we have identified a few patterns:

- About 40% of the banks had RAC ratios at year-end 2012 below 7%, which is our minimum threshold for assessing capital and earnings as "adequate," under our criteria. Furthermore, the average RAC ratios for the third, fourth, fifth, and sixth deciles are 6.4%, 6.7%, 7.2%, and 7.5%, which shows that a high concentration of banks have borderline capital metrics (see chart 1).
- The dispersion in capital metrics is relatively contained, with 15% of the banks having RAC ratios below 6% and the same proportion above 9% (see chart 2).
- The lowest capital ratios are concentrated in troubled markets, such as in Spain and Ireland, where banks made massive provisions that they did not offset with recapitalization by year-end 2012 (see chart 3).
- Aside from these cases, a number of banks in other markets have maintained comparatively mediocre RAC ratios in the three years that we have been compiling these data, such as VTB Bank, Raiffeisen Zentralbank Oesterreich, and the Mizuho group.
- The number of banks with the highest capital ratios, that is, above 10%, has fallen in the past two years. We counted six at year-end 2012, down from 10 at year-end 2010. If we leave aside Saudi Arabia-based The National Commercial Bank (NCB), banks in emerging markets no longer maintain RAC ratios above 10%, due to fast business growth in recent years. Only one bank had a ratio above 12% at year-end 2012, compared with three at year-end 2010.
- Three of the six banks with RAC ratios above 10% at year-end 2012 were cooperative or mutual banking groups in mature economies. These banks are subject to fewer investor demands and, to a varying extent, some restrictions to

the fungibility of capital within the group. Most mutual banking groups routinely maintain higher capital ratios because of their lack of or more limited access to equity markets, which are therefore not a viable option for raising large amounts of fresh common equity capital in the event of stress.

- RAC ratios for several major brokers and investment banks have steadily improved and are higher than for commercial banks. However, we believe their businesses carry significant litigation, business, and tail (statistically greater) risks, which economic capital models or regulatory capital requirements do not adequately capture.
- Divergences in earnings performance heavily influence differences in capital trends. For instance, lackluster earnings trends in the eurozone (European Monetary and Economic Union) or in Brazil, which constrain the ability to generate capital organically or to raise new equity, contrasts with the solid earnings trends in the U.S. or in China that are supportive to capital metrics.
- Some banks in emerging markets, like most major Brazilian or Indian banks, did not generate sufficient earnings organically in 2012 to self-finance rapid credit growth. For that reason, we revised our assessment of capital and earnings for Banco do Brasil to moderate from adequate in 2012.
- Conversely, increases in capital metrics are more prevalent in some mature markets that continued to show solid earnings, such as in Canada or the Nordics, or in countries where capital ratios historically have been moderate, such as in Japan, China, Korea, and France.

Chart 1

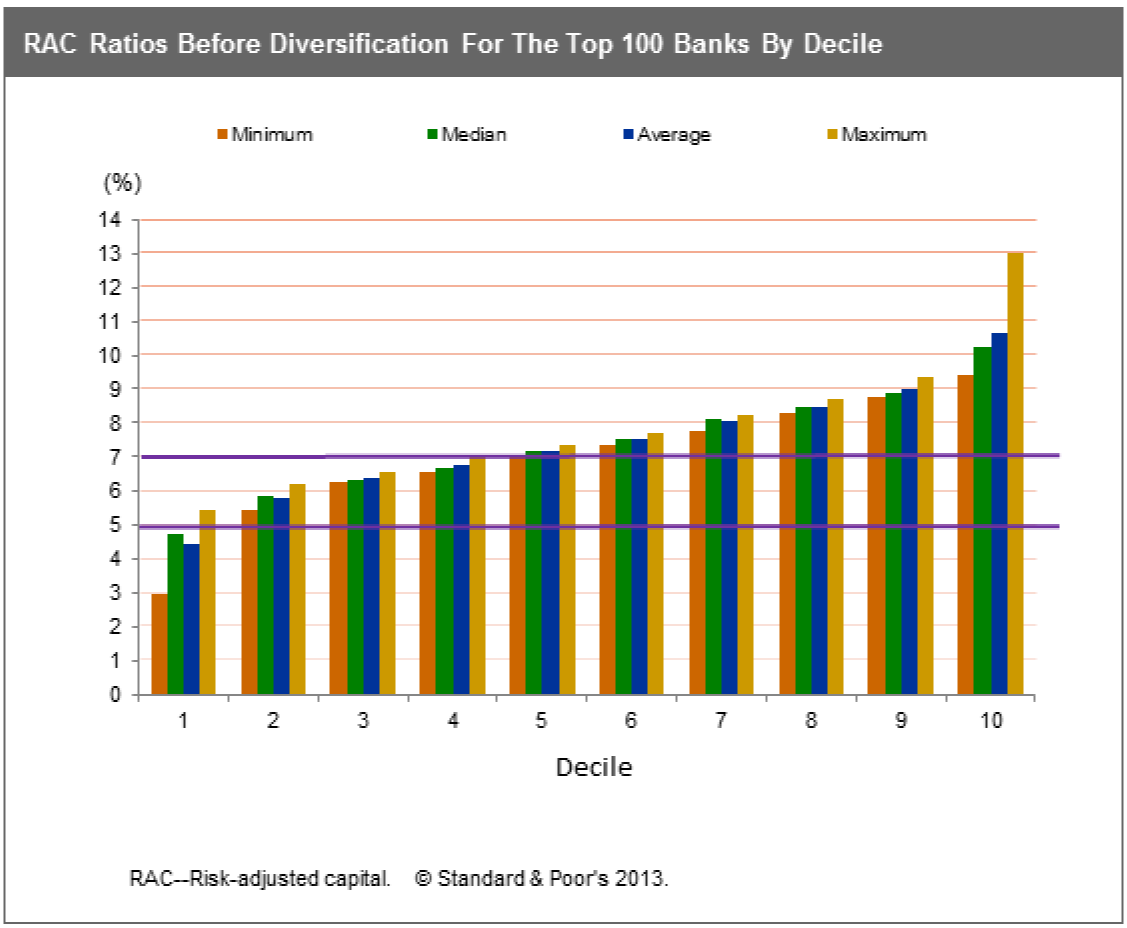
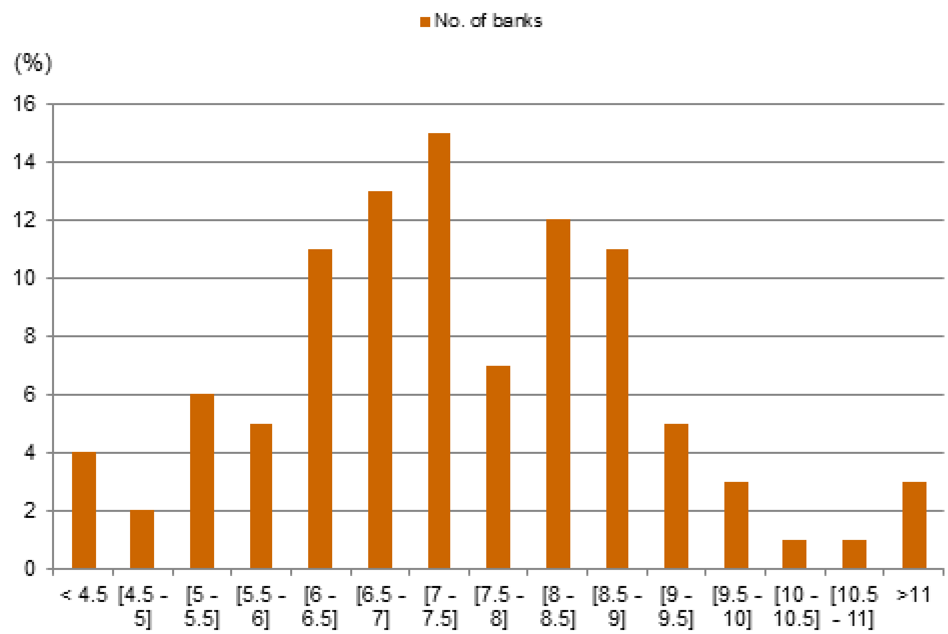


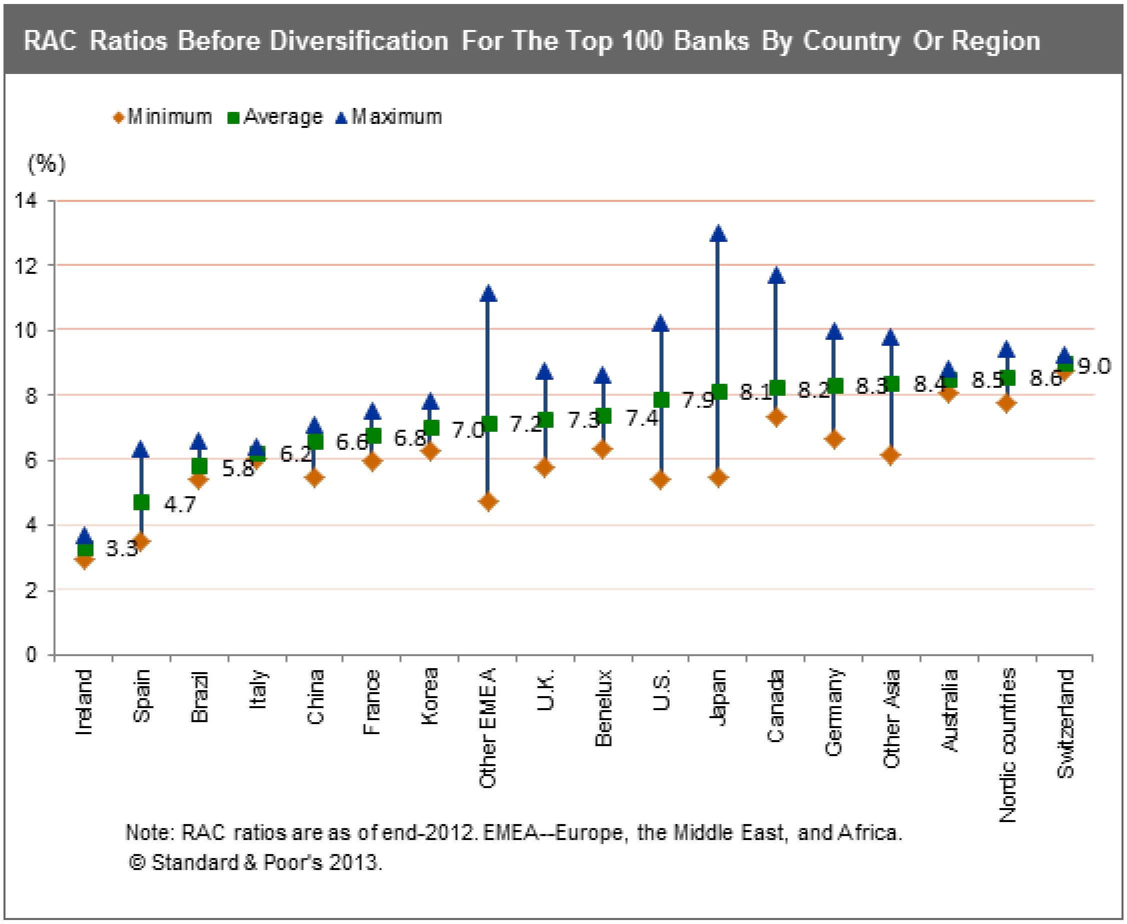
Chart 2

RAC Ratios Before Diversification By Bucket For The Top 100 Banks



Note: RAC ratios are as of end-2012. RAC--Risk-adjusted capital.

Chart 3



We Base Our Ratings On Our Projected RAC Ratio

While the RAC ratios in this report are as of year-end 2012, to be forward-looking, our capital and earnings assessment relies on our projected RAC ratio for a bank for the current and subsequent calendar years (see table 2). For close to 80% of the 100 banks, our capital and earnings assessment is in line with what the RAC ratio at year-end 2012 would suggest, based on the ranges in our criteria. For about 13% of the top 100 banks, our assessment reflects a higher projected RAC than the year-end 2012 ratio. However, 18 months ago we found a higher proportion of banks whose RAC ratios we believed would improve. At that time, one-third of the banks with an adequate capital and earnings assessment had current RAC ratios below the 7% threshold.

Table 2

Capital And Earnings Assessments Compared With RAC Ratio Ranges

	RAC ratio before diversification				
Capital and earnings	**Less than 5%**	**5%-7%**	**7%-10%**	**10%-15%**	**Total**
Strong	0	0	1	2	3
Adequate	0	10	47	3	60
Moderate	2	24	5	0	31

Table 2

Capital And Earnings Assessments Compared With RAC Ratio Ranges (cont.)					
Weak	4	1	0	0	5
Very weak	0	0	0	0	0
Total	6	35	53	5	99

Note: RAC ratios as of end-2012. RAC--Risk-adjusted capital.

For instance, we assess Nationwide Building Society's capital and earnings as adequate, despite our calculation that its RAC ratio on April 4, 2013, was a relatively low 6.0%. We believe that regulatory requirements for Nationwide to improve its leverage ratio will bolster our view of capital and earnings over the next one to two years, mainly because of improving underlying profit. We assume that Nationwide would be able to raise capital, which will be Basel III-compliant and eligible for our capital assessment. (If that is not the case, we could lower the ratings.) Even so, we now believe that Nationwide's loss experience is no longer materially superior to peers' and that its balance sheet leverage is high. In sum, we see that Nationwide's capital and earnings and risk position, combined, is now a neutral factor for the rating, compared with positive previously.

Another example is Crédit Agricole, whose capital and earnings we assess as "adequate," reflecting our expectations that the group's RAC ratio before diversification will reach 7.0% by the end of 2014, up from 6.0% at end-2012. The 6.0% RAC ratio in table 1 excludes the exposures of former subsidiary Emporiki Bank of Greece, which the parent formally sold in 2013. Including the exposures, the RAC ratio was 5.8%.

We believe that the declining ranks of banks with substantially higher projected RAC ratios (i.e. improving ratios) is resulting from somewhat improved capital metrics achieved over the past two years and our increasing doubts about whether they can continue to improve in the coming years. For several years, we have considered that capital was a rating weakness for the large global banks, as illustrated by the Top 100 rated banks, but that capital positions were on an improving trend and would be for a number of years, based on their need to meet more stringent Basel III capital requirements. A growing number of banks have indicated since mid-2012 that they were compliant with the core equity Tier 1 requirements under Basel III or will be by year-end 2013. In the six months to December 2012, the average common equity Tier 1 (CET1) capital ratio of large, internationally active banks rose to approximately 9% of risk-weighted assets from 8.5% (source: Basel Committee on Banking Supervision, August 2013). As a consequence, minimum regulatory requirements are exerting less pressure on banks to accumulate more capital.

Differences Of Opinion About Bank Capital Are Likely To Lead To Greater Ratings Differentiation

After the financial crisis, a consensus had emerged about the need to boost capital ratios, but we believe that it has been weakening over the past six months. Authorities in some jurisdictions consider that the roll-out of Basel III was the end of the journey, while others see that the current stability in capital markets is an opportunity for a second capital-raising push. Furthermore, adoption of Basel III was delayed in some jurisdictions, notably the EU and the U.S., while Australia, Canada, Singapore, and Switzerland, for instance, had moved ahead with implementation as of Jan. 1, 2013.

For example, The EU's Capital Requirements Directive IV (CRD IV), approved in April 2013 by the European Parliament after lengthy debate, provides a common framework that largely replicates Basel III, with some exceptions. Because of differences of opinion among EU member countries about capital requirement minimums, CRD IV leaves, in our view, significant flexibility for member countries to introduce higher requirements at the national level. In another example, U.S. authorities approved the final rules for implementing Basel III in July 2013, with a phase-in period for larger institutions beginning in January 2014.

U.S. authorities issued a proposal for a new supplementary leverage ratio for the eight large complex U.S. banks, with a ratio of 5% for bank holding companies and a leverage ratio of 6% for operating companies, effective in January 2018. Authorities also contemplate minimum levels for long-term debt and equity to facilitate single point-of-entry resolution, capital surcharges for global systemically important banks, and higher capital requirements if reliance on short-term wholesale funding is high.

We see worrying cracks in the Basel III consensus among major national banking supervisors about the extent and pace of the capital strengthening. While some banks and supervisors are almost equally convinced that increasingly demanding capital requirements may backfire and lead to a reduction in lending to the real economy, a growing number of supervisors elsewhere appear to believe that banks need to first address investors' concerns regarding their financial soundness. According to this line of thinking, they should therefore recapitalize before they can fully return to the wholesale funding markets. Furthermore, facilitating their access to funding would allow them to become more active in financing the economy. We expect the cracks in the consensus to widen over the coming quarters. We are likely to integrate these views to a greater degree into our assessment of capital and earnings, leading to greater rating differentiation than in the past few years.

To Avoid Rights Issues, Banks Have Been Turning To Weaker Forms Of Capital

Banks have been reluctant to resort to rights issues to recapitalize, which would dilute the equity of existing shareholders--unless forced to turn to government recapitalization. Instead, they've opted for various other forms of deleveraging to reduce the need for capital, such as asset sales, run-off, earnings retention (aided by dividend cuts), or one-time gains from disposals and liability management exercises. Furthermore, there was no need for most banks to raise equity given the long Basel III transition period.

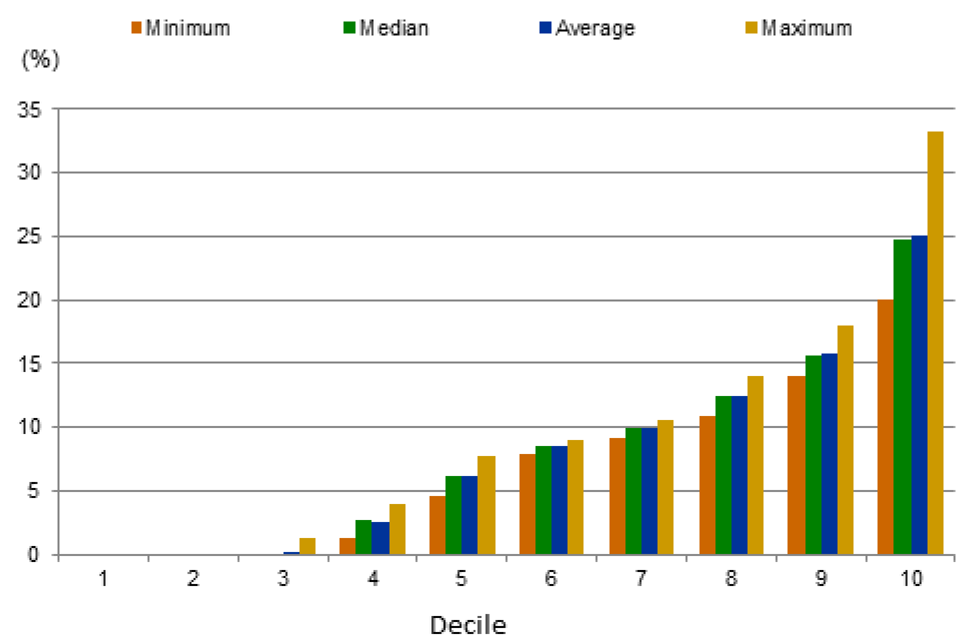
One of the main exceptions was Barclays, which was forced into a £5.8 billion fully underwritten rights issue (net of expenses), announced in July 2013. This followed the Prudential Regulation Authority's capital adequacy review of major U.K. banks, which relied on the Bank of England's adjusted leverage ratio approach. We now see lower downside risk to our assessment of Barclays' capital and earnings, thanks to a capital increase-equivalent of just under 100 basis points of Standard & Poor's risk-weighted assets and subsequent capital initiatives--including plans to raise up to £2 billion of CRD IV-qualifying additional Tier 1 securities and a reduction in CRD IV leverage exposure by £65 billion-£80 billion. We now project that our RAC ratio for Barclays may comfortably exceed 8.0% by year-end 2014. This is higher than our previous expectation of between 7.0% and 7.5% by year-end 2014, which was close to our 7% threshold for an adequate capital and earnings assessment.

In Europe, most of the other capital increases over the past 12 months, for instance by Commerzbank, Erste Bank, or KBC, came about because banks wanted to exit government recapitalization or hybrid capital schemes, which came with too many strings attached.

To minimize equity issuance, some banks increasingly rely on weaker forms of capital, such as hybrid capital, minority interests, or deferred tax assets. To raise capital under Basel III, a number of banks in the past few months have shown a growing interest in issuing hybrid capital instruments because the more costly alternative to issuing Additional Tier 1 capital is holding equity. While half of the top 100 world banks have on average less than 8% of total adjusted capital (TAC, our measure of capital) in the form of hybrids, this proportion reaches an average of 10% in the seventh decile, 15% in the ninth decile, and 25% in the highest decile (excluding RBS, whose hybrids account for 57% of TAC, due to £25 billion of 'B' shares) (see chart 4).

Chart 4

Hybrid And Admissible Preferred In TAC Per Decile For The Top 100 Banks

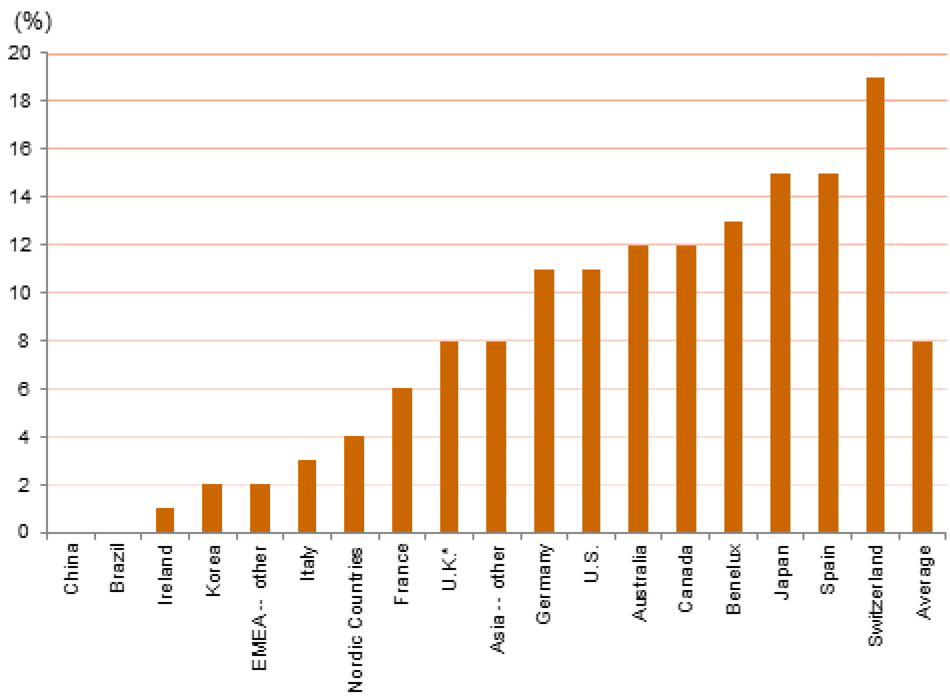


*Excluding RBS PLC. TAC--Standard & Poor's total adjusted capital.

Countries with hybrids accounting for more than 10% of TAC on average notably include Japan, Spain, the Benelux countries, Canada, the U.S., and Australia (see chart 5). The comparatively high average in Switzerland is not representative because it is distorted by the high level at Credit Suisse (32%). Many European banks delayed hybrid issuance until regulators clarified requirements in June 2013. But we expect the proportion of hybrids to continue to grow over the coming months, now that banks have sufficient clarity about the features that regulators require for eligibility for Additional Tier 1 capital. Standard & Poor's recognizes the stronger equity characteristics of this new generation of hybrids, particularly given their greater flexibility to suspend coupon payments and the greater magnitude of loss absorption allowed by principal reduction or equity conversion. However, we will remain attentive to what we consider is a growing reliance on a weaker form of capital.

Chart 5

Hybrid And Admissible Preferred As A Share Of TAC For The Top 100 Banks



*Excluding RBS. EMEA--Europe, the Middle East, and Africa. TAC--Total adjusted capital.

We note that a few banks have a high share of minority interest in TAC. Among the top 100, close to 90% have a contribution of minority interest to TAC of 10% or less. However, a few banks have such a high proportion that it may raise questions regarding the fungibility of capital within the group. The two biggest outliers are the two Austrian banks, RZB group and Erste group, with minority interests at 37% and 31% of TAC.

The banks that display the highest contribution of deferred tax assets (DTA) to TAC are in Italy (22% on average for the top three Italian banks in the study), and Brazil (44%), primarily due to the specifics of tax laws in those countries.

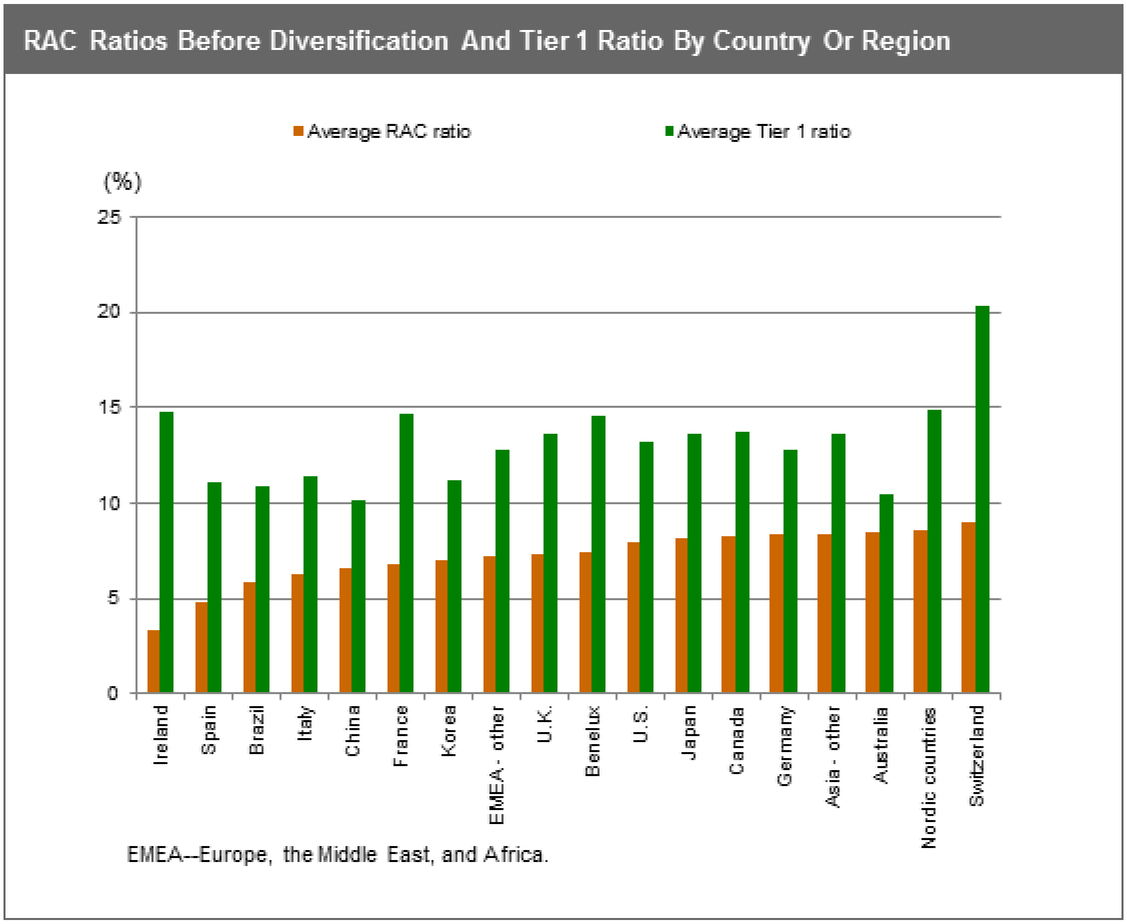
The relative proportion of DTA in TAC is one of the aspects that we consider in our assessment of the quality of a bank's capital. We deduct DTA related to tax loss carryforwards from TAC. We do not deduct other DTA that primarily reflect timing differences between tax accounting and the financial reporting periods. Nevertheless, even DTA arising from timing differences have the potential to exhibit a reduced capacity to absorb losses in circumstances of stress, in our view. That is why we think that where the proportion of DTA in TAC is high or increasing, it could be indicative of a weaker level of solvency than what would be otherwise indicated by either regulatory capital or our RAC measure.

National Regulatory Differences Are Showing Up In RAC And Tier 1 Ratios

A comparative analysis of RAC ratios and Tier 1 ratios for banks around the world illustrates the significant differences among countries' national regulatory frameworks (see chart 6). For example, the institutional framework in Australia, with supervisors adopting a conservative approach to regulatory capital adequacy, is very strong. Partly for this reason, our RAC ratios for the four major Australian banks have remained within a very narrow range around 8.5%. In contrast, other jurisdictions--such as Japan or the U.S.--show wide ranges in RAC ratios, with the strongest banks nearly twice as strong as the weakest banks (see chart 3). Several countries exhibit regulatory ratios that are comparatively stronger than the RAC ratios for their banks show. That's because our risk-adjusted capital framework applies higher capital charges for certain types of risks:

- Credit risks in countries with higher economic risks, such as in Ireland or Spain;
- Trading risk and operational risks, including for asset and wealth management businesses, such as in Switzerland; and
- Insurance risk, such as in Brazil or in France.

Chart 6



How Relevant Are Tier 1 Ratios?

Banks have been generally increasing their capital ratios according to regulatory rules, but investors and bank analysts are increasingly skeptical about how indicative these ratios are. There's a growing suspicion that regulatory ratios may give a biased picture of risk containment or capital raising, because, as the thinking goes, the Basel framework leaves a lot of room for "optimization" (a kind of minimization) of risk-weighted assets or other "window-dressing" initiatives.

Then there's the question of consistency, particularly in Europe. Successive studies by regulators have showed that when different banks were asked to risk weight the same portfolio they produced different outcomes. Such studies have confirmed long-standing doubts about the comparability of regulatory ratios and inconsistencies in bank and supervisory practices, and sparked proposals for change. These include calls for alternative metrics, such as the leverage ratio.

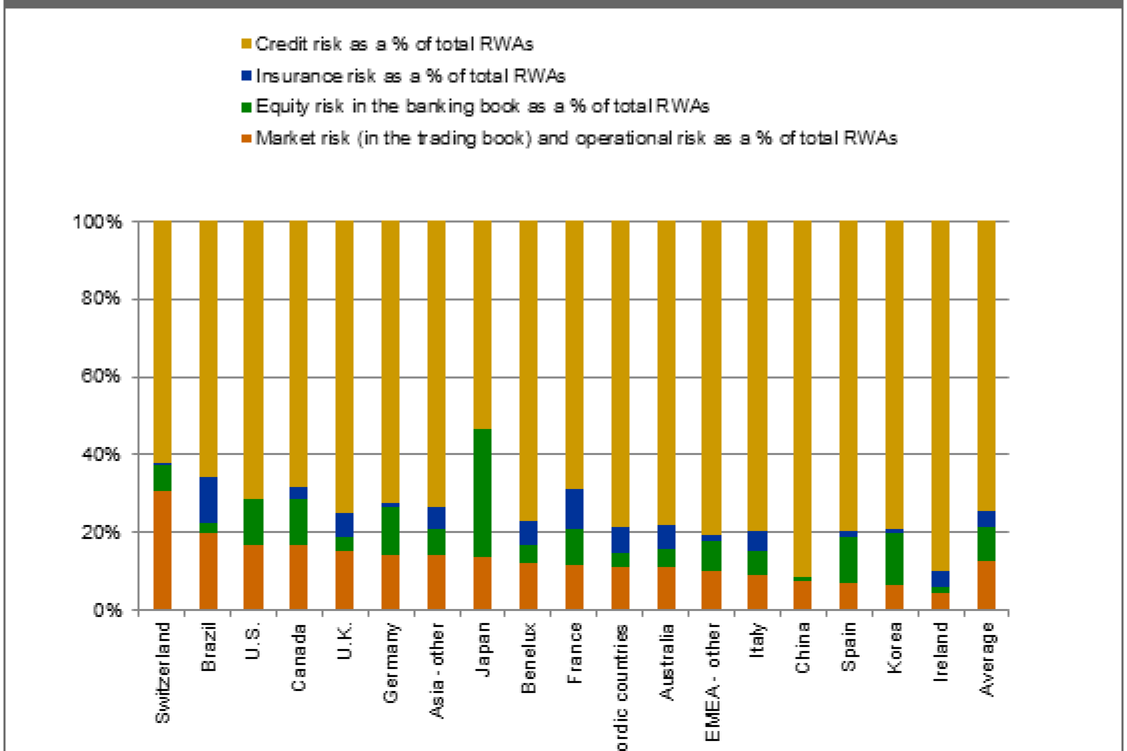
Standard & Poor's continues to focus on the RAC ratio, because we believe that its global comparability more than offsets the drawbacks of its lower risk sensitivity. Furthermore, our assessment of capital adequacy, which examines each bank's risk characteristics, goes beyond the RAC ratio. See "The Basel III Leverage Ratio Is A Welcome Addition, But Not A Substitute For Risk-Weighted Capital Metrics," published Sept. 20, 2013.

We Currently Assess Capital And Earnings As Adequate For Investment Banks

Although market risk represents a small fraction of risks that we capture under our risk-adjusted capital framework, we take a cautious approach toward this and other risks that investment banks take on (see chart 7). Market risk in the trading book and operational risk (related to all businesses) typically account for a small fraction of overall capital risk weights, including under Standard & Poor's risk-adjusted capital framework. For the group of investment banks in our study, it only accounts for about 30% of risk-weighted assets. The proportion these risks account for in Switzerland reflects the profile of Credit Suisse and UBS AG.

Chart 7

S&P's Risk-Weighted Assets Breakdown By Type Of Risk For The Top 100 Banks



RWAs--Standard & Poor's risk-weighted assets before diversification. EMEA--Europe, the Middle East, and Africa.

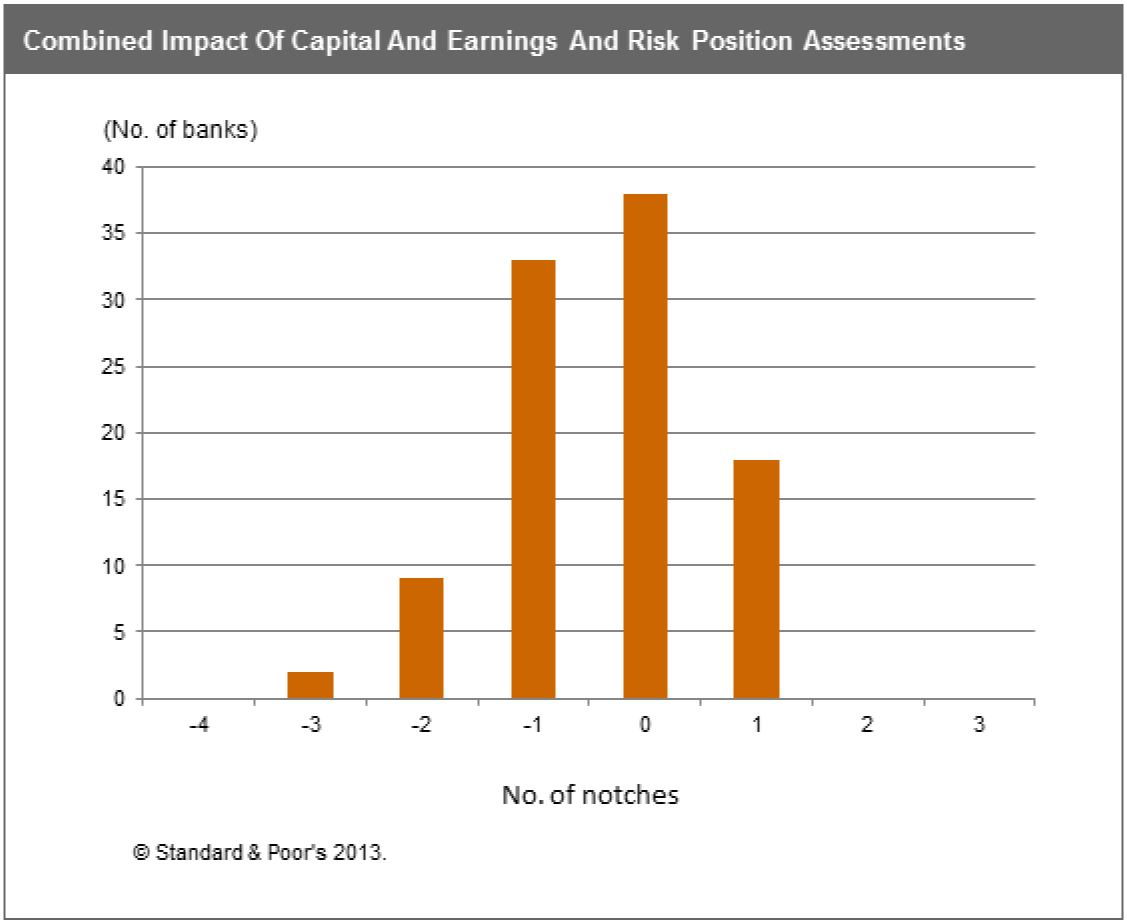
We believe that investment banks typically remain highly leveraged institutions with a risk profile that our risk-adjusted capital framework does not completely capture. We remain cautious in evaluating the risks of these banks and our ability to forecast what we expect to be volatile revenue and earnings streams, given uncertainty in the capital markets and about future litigation costs and regulatory fines. Major investment banks carry significant litigation, business, and tail risks, which their economic capital models or regulatory capital requirements do not adequately capture, in our view. For that reason, we reflect the inherent volatilities in their business and the complexity of the underlying risks in our overall assessment of capital and earnings. That's why RAC ratios that are close to our criteria-defined threshold of 10% continue to support an adequate assessment for several investment banks. As a result, it is unlikely that we will revise our assessment of capital and earnings for these banks to strong from adequate in the short term.

The Added Impact Of Risk Darkens The Picture

The history of bank failures shows that high capital ratios are not meaningful in isolation. Any assessment of capital should also adequately recognize and measure the risk. There are growing concerns in the market that some banks--especially in some European countries--have been slow to recognize nonperforming loans (NPLs), revalue collateral, and book impairments to protect capital and profitability by spreading losses over an extended period. At Standard & Poor's, we take into account underprovisioning in our assessment of risk position in our ratings criteria for banks.

In this study of 100 large global institutions, the combined impact of our capital and earnings and risk position assessments on the ratings ranges from minus three to plus one notch. We find that there are twice as many banks where the combined impact is negative than positive (see chart 8). The combined impact is neutral for one-third of the banks.

Chart 8



Of the 61 banks with a RAC ratio above 7% at year-end 2012, one-third have a risk position that we assess as moderate or weak. This indicates that our risk-adjusted capital framework's stressed losses have understated the riskiness of their activities. So, when we combine our conclusions about capital and earnings and risk position for these banks, this weighs negatively in the overall construct of the ratings. The only exception here is NCB, for which strong capital and earnings offsets our view of its risk position as moderate.

Greater Loan Forbearance Could Distort Capital Ratios

Banking authorities and central banks are becoming increasingly aware about the consequences of lending forbearance because delayed recognition of loan losses may constrain credit availability and dampen growth prospects. Countries that have endured several years of recession, such as in the periphery of the eurozone, are currently the focus of such worries. In that light, Europe's forthcoming asset quality review and balance sheet assessment of the region's banks in the next few quarters is critical. It could help ensure that banks step up and complete the recognition of loan losses and balance sheet repair. But this is not to single out these countries or the regulatory climate in Europe. As economies slow down in other parts of the world, national regulators may have to monitor the possibility of greater lending forbearance. We are particularly concerned that banks that are modestly capitalized and do not generate high enough earnings may be slower to recognize losses in their loan book and may choose to roll over credits to troubled borrowers, rather than report them as NPLs and take write-offs, suffering a weakening in their capital position.

Appendix

The RAC ratios in this commentary may differ from our forecasts or estimates for these ratios that we have previously published in our bank-specific reports. The ratios do not reflect the actions taken since the end-2012 reporting date, such as variations in capital or reduction in risk-weighted assets. TAC is calculated using the 2012 year-end reported financial statements for each bank, when available (see the footnotes to table 1). Standard & Poor's risk-weighted assets (RWAs) apply the parameters (Banking Industry Country Risk Assessments or BICRAs, economic risk scores, and sovereign ratings) as of the end-2012 reporting date.

We are also publishing as part of this report our assessments of "capital and earnings" and "risk position" for the top 100 banks. Our opinion of balance sheet strength (which combines our assessments of "capital and earnings" and "risk position") can be a more useful benchmark than the RAC ratio for understanding how capital affects our ratings.

Capital and earnings, and risk position are two of the four bank-specific factors that we analyze when rating banks. We assess both on a six-point scale: very weak, weak, moderate, adequate, strong, and very strong. These assessments provide a more direct and forward-looking relative assessment of capital strength than RAC ratios based on data that are already reported.

In general, an "adequate" assessment has no impact on the stand-alone credit profile (SACP). All else being equal, a "moderate" assessment would lower the SACP by one notch, a "weak" assessment would lower the SACP two or three notches, and "very weak" by five notches. On the other hand, a "strong" assessment would raise the SACP by one notch, and a "very strong" assessment by two notches.

Because our analysis is forward-looking, we base our capital and earnings assessment primarily on our projected RAC ratio for a bank for the current calendar year and subsequent year and other factors. We associate ranges of our projected RAC ratio with different capital and earnings assessments. For example, we consider capital and earnings adequate when the projected RAC ratio is 7%-10%, and moderate if it is 5%-7%. Therefore, a comparison between a bank's current RAC ratio and the capital and earnings assessment gives an indication of how we expect the RAC ratio to develop. If, for example, a bank's current RAC ratio is tangibly less than 7%, and we view capital and earnings as adequate (and not moderate as suggested by our defined ranges), one can conclude that we expect the RAC ratio to improve to at least close to or above 7%.

Here's a description of the terms we use in table 1:

- ICR, SACP: We base the issuer credit ratings (ICR), SACP, and component scores in table 1 on the operating company of the institution.
- Capital and earnings, risk position: We produce these component scores from our bank-specific analysis that assesses factors relating to a particular institution's capital strength and risk profile. We combine these with the anchor and component scores for business position, and funding and liquidity to produce the SACP.
- RAC ratio as of year-end 2012: These RAC ratios are based on 2012 year-end financial statements. The date of

reporting is the "as of" date.

- The RAC ratios at year-end 2012 are point in time. We do not update them for changes in capital measures after the reporting date. However, these ratios are the starting point for our projected RAC ratios, which factor in our forward-looking view about capital and other factors.

Standard & Poor's RWAs apply the parameters (BICRAs, economic risk scores, and sovereign ratings) as of the reported date. The parameters affect the risk factors that we apply to a bank's reported exposure data to calculate Standard & Poor's RWAs. According to our capital criteria, greater economic risk leads to higher risk-weighted assets and lower RAC ratios (and vice versa), everything being equal. The changes in the parameters since December 2012, which are listed in the table 3, are therefore not reflected into the calculations of the RAC ratios.

Table 3

Changes To Ratings Parameters (Economic Risk, BICRAs, And Sovereign Ratings) In 2012 And 1H2013

	Changes in 2012	Changes In First-Half 2013 (up to June 30)
Economic risk		
	Belgium (From 1 to 2)	Italy (From 5 to 6)
	France, Netherlands (From 2 to 3)	Slovenia (From 7 to 8)
	Italy (From 3 to 5)	
	Spain (From 5 to 7)	
BICRA		
	Canada (From 1 to 2)	France (From 2 to 3)
	Italy (from 3 to 4)	Italy (From 4 to 5)
	Netherlands (From 2 to 3)	Ukraine (From 9 to 10)
	Spain (From 4 to 6)	
Sovereign rating		
	Austria, France (From AAA to AA+)	Turkey (From BB to BB+)
	Italy (From A to BBB+)	Argentina (From B- to CCC+)
	Korea (From A to A+)	Honduras (From B+ to B)
	South Africa (From BBB+ to BBB)	Tunisia (From BB- to B)
	Spain (From AA- to BBB-)	Italy (From BBB+ to BBB)
		Peru (From BBB to BBB+)

Note: This table excludes the changes since 2013 regarding Cyprus. BICRAs--Banking Industry Country Risk Assessments.

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