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January 6, 2011

Preliminary Banking Industry Country Risk Assessments In 23 Countries

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For well over a decade, Standard & Poor's Ratings Services has assessed national banking industries as part of its approach to evaluating the creditworthiness of individual banks. Starting in 2009, we commenced a review of our Banking Industry Country Risk Assessment (BICRA) methodology with the intention of increasing the significance of the systemwide analysis of banking industries in our credit ratings on individual banks. As a result, we proposed a change to our methodology with the publication of "Request for Comment: Methodology For Determining Banking Industry Country Risk Assessments" on May 13, 2010. In response to comments we have received since then, we further modified and reopened the request for comment as part of our proposed criteria for rating banks, which we published today: "Request for Comment: Banks: Rating Methodology." Our proposed methodology for rating banks uses the two main components of our BICRAs, the economic risk and industry risk scores, to determine an "anchor" stand-alone credit profile (SACP) for the banks we rate.

Standard & Poor's assigns BICRA scores to the banking industries of 92 countries. We believe that the further articulation of our BICRA methodology could help market participants better understand how we assess economic and banking-industry-specific factors on a systemwide basis to produce a BICRA that reflects our view of the relative riskiness of a country's banking industry.

This commentary is designed to accompany today's request for comment by communicating our initial view of how today's proposed BICRA methodology could affect the BICRA scores for the 23 countries in which approximately 80% of the financial institutions with Standard & Poor's credit ratings are based. We have designated the results as "preliminary" BICRA scores to distinguish them from the ones we continue to publish under the current methodology (see "Banking Industry Country Risk Assessments," published monthly).

A Time Of Change In The Financial Sector

Since the second half of 2007, banks (particularly in developed markets) have experienced a prolonged period of market disruption and economic uncertainty marked by substantial losses on loans and securities, severe bouts of illiquidity, and unprecedented government intervention. The depth of the downturn of 2007-2009, particularly in the U.S. and Europe, and its significant negative impact on the broader economy led many market participants, including us, to review some of the key developments in the financial sector over the past decade.

Starting in 2010, we have seen an uneven rebound for banks in many countries. Meanwhile, national financial supervisors and international organizations are reworking banking regulations aimed at preventing future industry downturns of such magnitude. However, the market's judgment of the success of the new laws and regulations will likely not be known for some time.

Changes In Our Proposed Methodology

Today's request for comment describes various significant changes to our methodology and places weight on:

- Economic imbalances, such as excessive credit growth, asset price bubbles, and current account deficits;
- The degree of riskiness of certain banking products and practices; and

- The systemwide funding profile of a country's banking industry.

Under our proposed BICRA methodology, we treat growing imbalances during periods of economic expansion and limitations in a banking industry's systemwide funding profile as weaknesses, particularly when an economy and banking system are characterized by excessive growth in credit and significant net external borrowing.

Our proposed methodology rests on a framework of six factors that we will assess on a six-point scale ranging from very low risk to extremely high risk. Three factors underpin each of our economic risk and industry risk scores (see table 1). The economic and industry risk scores combine to produce the BICRA. The BICRAs and economic and industry risk scores are relative rankings that range from 1 (lowest risk) to 10 (highest risk).

Table 1

Six BICRA Factors

Economic risk	Industry risk
A. Economic stability and resilience	D. Institutional framework
B. Economic imbalances	E. Competitive dynamics
C. Credit risk in the economy	F. Systemwide funding

BICRA--Banking Industry Country Risk Assessment. Source: Standard & Poor's.

Preliminary BICRAs Compared With Current BICRAs

We applied the proposed BICRA methodology (as communicated in the request for comment published on May 13, 2010 and the refinements in paragraph 17 of today's request for comment) to 23 countries. The results range from preliminary BICRA group 1 for Canada, Hong Kong, Sweden, and Switzerland to preliminary BICRA group 9 for Kazakhstan (see table 2).

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Table 2
Preliminary BICRA Scores*

	Preliminary BICRA group	Preliminary Economic risk	Preliminary Industry risk	Current BICRA group
Canada	1	2	1	1
Sweden	1	1	2	1
Switzerland	1	1	2	1
Hong Kong	1	2	1	2
France	2	2	2	1
Australia	2	2	2	1
Italy	2	3	2	2
Netherlands	2	2	3	1
Japan	2	2	3	2
Germany	3	1	4	2
Korea	3	3	3	4
Taiwan	3	3	4	4
U.S.	3	4	3	3
New Zealand	3	4	3	2
Spain	3	4	3	3
U.K.	3	4	3	3
Mexico	4	4	4	4
Brazil	5	5	5	5
India	5	6	5	6
China	5	6	5	6
Turkey	6	7	5	6
Russia	8	7	8	8
Kazakhstan	9	9	9	9

*1-10 from lowest risk to highest risk, BICRA--Banking Industry Country Risk Assessment.
Source: Standard & Poor's.

In Table 2, we used colors to organize the preliminary BICRA scores and the current BICRAs in three groups: lowest risk (the color green), for BICRA groups and economic and industry risk scores of 1-2; intermediary risk (the color yellow), for BICRA groups and economic and industry risk scores of 3-6; and highest risk (the color red) for BICRA groups and economic and industry risk scores of 7-10.

The preliminary BICRA groups for Australia, France, Germany, the Netherlands, and New Zealand reflect our view of their higher relative risk profiles compared with their current BICRA groups. The preliminary BICRAs for Australia, France, and the Netherlands move down to BICRA group 2 from BICRA group 1 under the existing methodology. Despite these countries' move to BICRA group 2, we note that BICRA group 2 corresponds to our assessments of low risk for most of the six factors that constitute the BICRA. Germany and New Zealand move to preliminary BICRA group 3.

The preliminary BICRA groups for China, Hong Kong, India, Korea, and Taiwan reflect our view of their relatively lower risk profiles compared with their current BICRA groups. The preliminary BICRA group for Hong Kong is BICRA group 1, the lowest risk group. There are four countries in BICRA group 1 (Hong Kong, Canada, Sweden, and Switzerland) under the proposed BICRA methodology, fewer than the current BICRA group 1.

The movements in our relative assessments reflect several themes. One is the tendency of developed market economies to experience economic imbalances through cycles of expansion and contraction in credit, particularly credit linked to the real estate sector. A key measure we use to analyze the cycle is the ratio of private sector credit to gross domestic product (GDP; see table 3). This measure carries more weight in our proposed BICRA methodology and contributed to the lower preliminary BICRA group scorings of Australia, France, and New Zealand, reflecting our view of the moderately higher risk of these countries' banking industries.

Table 3

Domestic Credit To The Private Sector And Nonfinancial Public Enterprises As % Of GDP

	Preliminary BICRA group	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010*
Canada	1	112.9	110.6	113.8	113.9	114.0	116.0	118.3	121.4	127.3	132.0	142.3	137.8
Hong Kong	1	155.1	152.6	151.5	148.0	148.8	147.6	146.2	139.4	139.7	143.0	158.0	190.0
Sweden	1	N.A.	N.A.	101.9	103.0	103.7	105.1	111.9	116.8	125.7	131.3	139.4	138.1
Switzerland	1	167.9	158.5	153.6	152.7	156.9	158.8	164.4	169.5	173.6	164.7	174.8	170.4
Australia	2	79.7	84.4	86.8	86.1	91.5	97.6	101.0	107.0	111.6	121.4	124.0	127.3
France	2	84.8	88.6	92.2	90.6	94.3	97.6	100.5	108.5	120.8	122.9	124.7	124.6
Italy	2	73.6	79.8	81.7	83.8	87.7	88.8	93.1	99.4	107.1	111.8	117.4	116.8
Japan	2	202.2	196.5	191.8	183.0	175.4	168.1	164.8	158.0	152.1	153.2	156.1	151.3
Netherlands	2	139.7	149.2	151.1	158.1	166.4	177.9	185.8	186.2	206.0	212.8	224.0	226.6
Germany	3	115.6	118.6	118.2	116.9	115.4	112.2	111.7	109.0	105.1	108.3	112.3	108.9
Korea	3	140.5	126.3	127.5	126.1	128.8	125.5	128.7	139.7	145.9	160.4	161.5	163.8
New Zealand	3	109.5	112.3	111.9	104.1	108.2	116.1	119.1	129.7	139.1	146.3	151.0	152.8
Spain	3	82.3	88.7	91.8	96.2	102.3	112.4	132.2	153.2	167.1	171.9	176.7	176.2
Taiwan	3	139.5	134.8	134.4	124.6	125.2	131.4	139.6	139.8	137.1	144.0	144.0	139.9
U.K.	3	118.8	129.6	134.6	138.7	143.6	151.3	160.2	171.4	188.0	211.4	214.7	204.9
U.S.	3	133.0	136.6	142.3	147.0	151.2	154.8	159.9	166.4	173.5	174.0	173.5	166.6
Mexico	4	19.5	16.2	13.3	14.8	14.4	13.7	14.8	17.1	18.7	17.6	18.1	17.9
Brazil	5	32.3	32.6	30.5	30.7	28.6	28.6	30.8	31.2	35.4	41.3	46.1	48.3
China	5	111.5	112.3	111.3	118.9	127.2	120.1	113.3	110.7	107.5	103.7	127.3	132.4
India	5	25.9	28.8	29.1	32.8	32.1	35.6	39.3	43.3	45.2	49.0	49.2	52.8
Turkey	6	N.A.	N.A.	15.5	14.6	14.6	17.4	22.4	26.1	29.7	33.0	39.5	45.0
Russia	8	N.A.	14.5	17.6	19.0	22.2	25.2	26.8	31.7	38.7	42.1	45.6	44.5
Kazakhstan	9	N.A.	N.A.	16.4	19.0	22.6	26.9	36.3	48.1	59.3	49.9	59.8	57.7

*Estimate. BICRA--Banking Industry Country Risk Assessment. N.A.--Not available. Sources: Standard & Poor's economic research, national sources.

In contrast to the lowering of the preliminary BICRAs for Australia, France, the Netherlands, and New Zealand, the preliminary BICRAs of several Asian countries have improved. In our view, many Asian countries have experienced a more moderate 10-year trend of credit growth--or, in some cases, decline--than most European and North American countries. Asia broadly experienced a long period of adjustment--and, for some countries, deleveraging--after the Asian crisis of 1997-1998 (see charts 1 and 2).

The coordinated increase in retail deposits and loans to the private sector in the huge developing economies of China and India have, in our opinion, led to balanced growth of their banking industries with respect to the funding of loan growth. Thus, our assessment of systemwide funding as "low risk" is another key factor in the improved BICRAs of these countries.

Chart 1

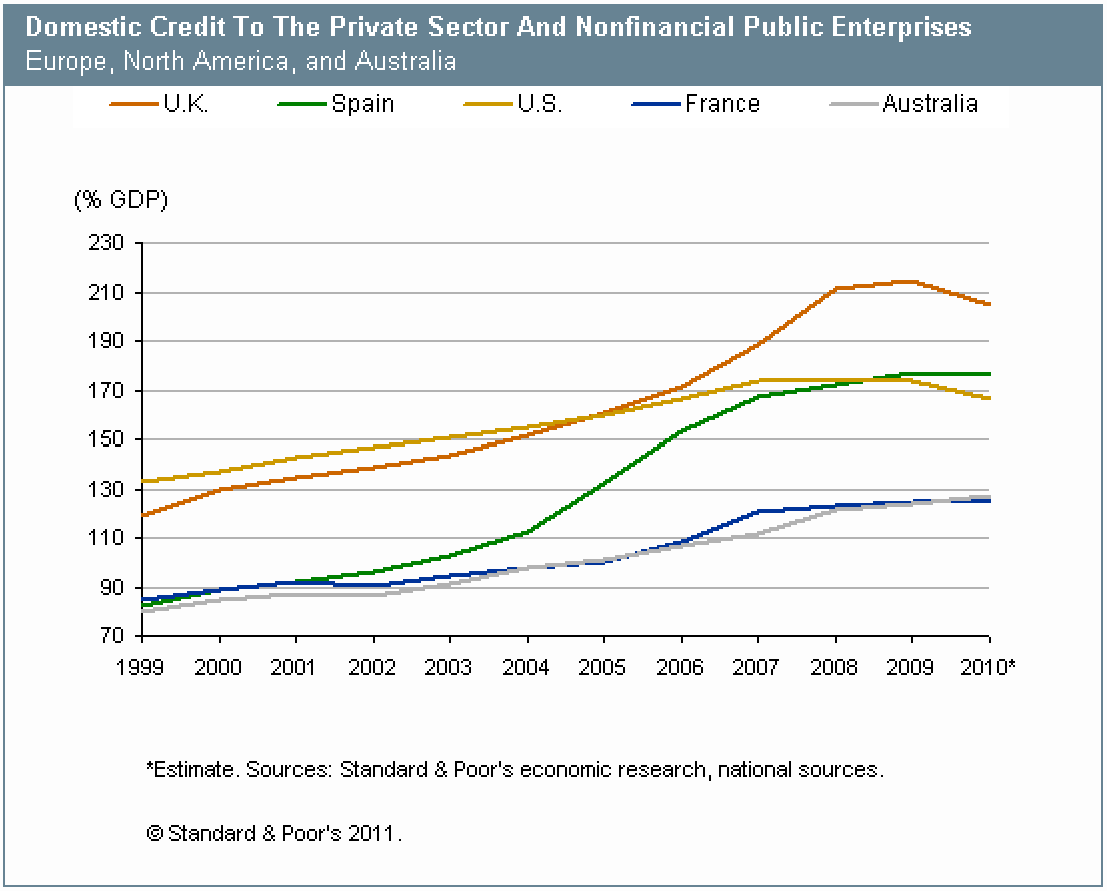
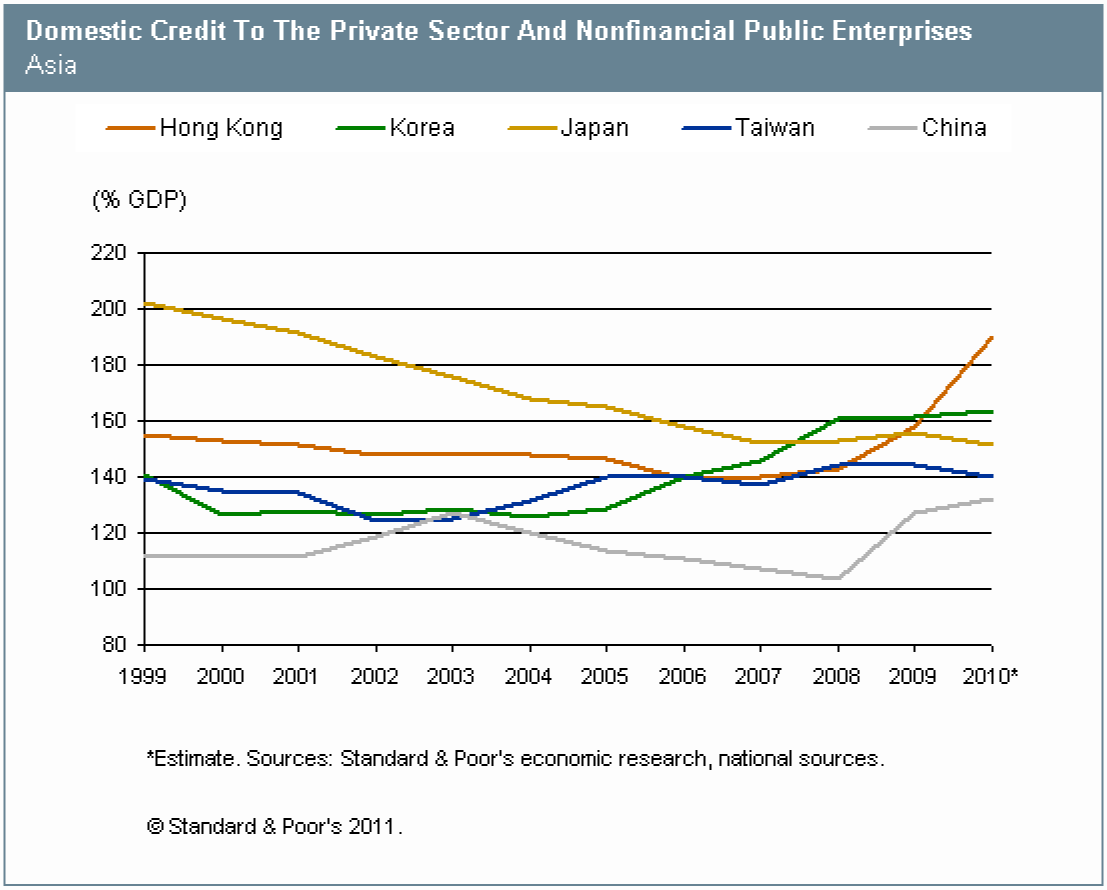


Chart 2



An important and related aspect of our analysis of economic risk is the cycle of real estate prices and the relation of the real growth rate in house prices to real GDP growth. Today's proposed BICRA methodology assigns greater weight to the potential for a significant correction in asset prices when a country is in the expansionary phase of the cycle. Since we have applied the proposed methodology at a time when several countries, such as the U.S. and Spain, are well into a correction in house prices (see table 4 and chart 3), this aspect, which we address in the economic imbalances factor, does not lead to a change in our preliminary BICRA group assignment for these countries. Prior changes in the BICRA group of Spain, the U.S., and the U.K. in 2008 (to BICRA group 2), the U.S. and the U.K. in 2009 (to BICRA group 3), and Spain in 2010 (to BICRA group 3) under the methodology currently in force were due in part to our assessment of the risks in the residential real estate lending segment. In contrast, and parallel to our assessment of credit expansion, house price appreciation and the potential for a future correction is a factor in the change in the preliminary BICRA groups of France, Australia, New Zealand, and the Netherlands under the proposed methodology.

Table 4

Annual Real Growth In House Prices

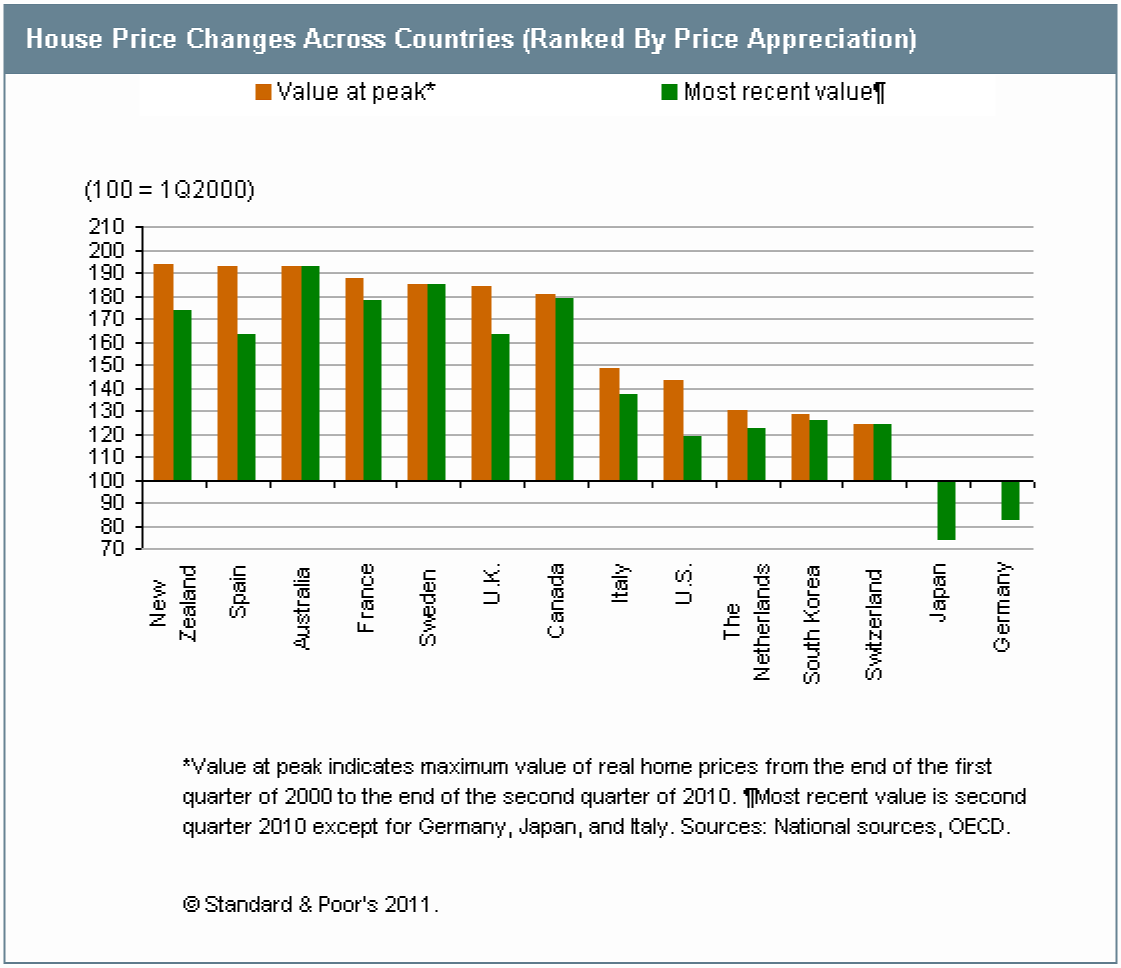
(%)	2001	2002	2003	2004	2005	2006	2007	2008	2009	June 2010*
Canada	5.7	6.6	10.3	6.2	8.5	8.7	10.5	(12.0)	18.6	7.8
Hong Kong	(8.3)	(9.4)	3.6	27.9	7.2	2.0	23.3	(14.8)	27.8	18.5
Sweden	2.1	7.8	4.3	9.1	9.0	9.4	9.6	(5.3)	5.1	7.7

Table 4

Annual Real Growth In House Prices (cont.)										
Switzerland	1.8	4.5	1.3	1.5	0.8	0.7	(0.1)	1.7	6.8	4.0
Australia	11.8	15.0	18.2	(1.7)	0.3	5.7	10.7	(7.9)	11.2	15.3
France	7.0	8.7	10.1	13.8	12.6	7.8	2.7	(4.6)	(4.2)	4.7
Italy	6.4	6.4	7.8	6.5	4.3	3.4	1.9	(3.4)	(3.4)	N.A.
Japan	(3.0)	(3.7)	(5.3)	(5.3)	(3.3)	(2.0)	(0.5)	(2.4)	(1.4)	N.A.
Netherlands	4.4	2.2	1.8	3.2	1.4	3.0	2.1	1.2	(5.3)	(3.6)
Germany	(2.6)	(3.5)	(2.5)	(3.5)	(3.0)	(0.3)	(1.0)	(0.7)	(1.9)	N.A.
Korea	(0.1)	13.5	5.3	(2.4)	(1.9)	3.9	6.3	(0.6)	(2.6)	(1.0)
New Zealand	2.6	10.9	24.1	9.2	12.9	6.5	5.7	(12.5)	4.2	2.5
Spain	8.5	14.8	17.4	12.9	9.6	4.9	0.2	(5.8)	(7.1)	(5.6)
Taiwan¶	(0.2)	2.3	6.8	6.3	13.6	13.2	(0.3)	5.0	16.8	2.7
U.K.	2.9	23.0	7.9	10.4	(0.2)	5.9	7.1	(11.3)	(1.5)	4.7
U.S.	5.9	4.7	4.9	7.2	7.7	2.9	(3.5)	(6.2)	(5.8)	(6.7)
Mexico	N.A.	N.A.	N.A.	N.A.	N.A.	7.1	5.9	4.2	4.7	N.A.
Brazil	2.1	5.0	(0.4)	4.4	0.1	0.9	2.3	6.1	2.0	N.A.
China §	1.2	4.8	4.5	5.5	6.6	4.9	3.4	6.4	8.5	5.1
India**	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	8.6	8.4	13.7
Turkey	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.M.	N.M.	N.M.
Russia	N.M.	N.M.	5.1	13.2	5.3	44.7	11.6	1.2	(19.8)	N.A.
Kazakhstan	N.M.	N.M.	N.M.	N.M.	N.M.	N.M.	N.M.	N.M.	N.M.	N.M.

*First-half 2010 growth rates are year-on-year real growth rates, unless otherwise noted. ¶Third-quarter 2010 real growth in house prices. §2009 and first-half 2010 data are estimated using major cities index. **First-half 2010 annualized. N.A.--Not available.

Chart 3



Comparison Of Economic Risk

The three countries with preliminary economic risk scores of 1--Germany, Sweden, and Switzerland--are characterized by our view of their sound public finances, relatively rich populations, and substantial and recurrent current account surpluses. In this group of three, Sweden has, in our view, a moderate economic imbalance due to its moderately high rate of increase in credit and residential real estate prices. Germany and Switzerland have no such credit or real estate imbalances. Germany has a weaker profile in our assessment of credit risk in the economy compared with Sweden and Switzerland. Its ratio of systemwide nonperforming assets to loans (3.3% at year-end 2009) was higher than Switzerland's very low rate (1.3%) and Sweden's ultra-low rate (0.4%).

The six countries with preliminary economic risk scores of 2--Australia, Canada, France, Hong Kong, Japan, and the Netherlands--also are characterized by our view of their sound public finances and rich populations, although in our opinion Japan and Hong Kong have somewhat weaker economic stability and resilience than the others. These six countries have one or more factors that we assess as comparatively weaker than countries with preliminary economic risk scores of 1: current account deficits for Australia and France, moderately high house price appreciation in the case of Hong Kong, Australia, and Canada, and high private sector debt leverage in the

Netherlands and Japan.

We have assessed the three countries with preliminary economic risk scores of 3--Italy, Korea, and Taiwan--on our view of their relatively weaker economic stability and resilience than the countries with economic risk scores of 1 and 2. In our view, Italy has relatively weaker government finances, Korea has moderately high inflation, and Korea and Taiwan, as export-oriented economies, are more vulnerable to external shocks. We assess credit risk in the economy as "intermediate risk" for all three countries due to our view of their relatively weaker underwriting standards and less-robust loan recovery frameworks than the countries with preliminary economic risk scores of 1 and 2.

For the countries with preliminary economic risk scores of 4--Mexico, New Zealand, Spain, the U.K., and the U.S.--we assess the credit risk in the economy factor as "intermediate" or "high risk". This differentiates them from countries with lower preliminary economic risk scores. Our scoring of what we view as their relatively weaker characteristics includes our view of a less-developed legal framework for loan recoveries (Mexico), high concentration in lending to the construction industry (Spain), and relatively high levels of private sector debt (New Zealand, Spain, the U.S., and the U.K.), among others. Of this group, Mexico is the only country we assess as "low risk" for economic imbalances, due to the low leverage and undeveloped stage of financial intermediation there. The other countries with this score have current account deficits, are net external debtors, or--like Spain--are in the midst of a significant ongoing correction after a construction boom. We assess Spain's economic imbalances as "high risk."

Of the group of 23 countries, Brazil is the only one with a preliminary economic risk score of 5. This reflects our view of Brazil's transitional position, which we view as having greater economic risk than those countries with preliminary economic risk scores of 4 or lower. This is due to our view of Brazil's relatively weaker economic stability and resilience and higher risk profile of credit risk in the economy. Nonperforming loans peaked at 7% of total loans in 2009. By contrast, we assess Brazil's economic imbalances as "intermediate risk" compared to our assessment of "high risk" for developing country peers such as Turkey, Russia, and China.

We have assigned China and India the same preliminary economic risk score of 6. In our view, India has less fiscal and monetary flexibility and higher current and projected inflation than China. Meanwhile, we view China as having greater economic imbalances and being more vulnerable than India to a potential disorderly correction in credit markets because it periodically experiences sharp surges in borrowing by the private sector and nonfinancial public enterprises, such as that experienced in 2009 and to a lesser extent in 2010. We view credit risk in the economy of both countries as "high risk." In our opinion, deficiencies in both countries' legal frameworks create uncertainty for lenders and lengthens the time to recover bad debts, while asset quality is detrimentally affected by government policies that encourage lending to specific economic segments. For China, the high level of indebtedness of private and state enterprises also contributes to the assessment of "high risk."

We have assigned preliminary economic risk scores of 7 to Russia and Turkey. In our opinion, both countries have more volatile growth patterns and higher inflation than countries with preliminary economic risk scores of 6 and lower. Both also have relatively large and volatile equity markets. Russia also has risk imbalances in the real estate construction sector, in our opinion. Turkey has current account deficits and moderately high net external borrower positions that in our view leave it vulnerable to international capital flows.

Kazakhstan is only just recovering from a massive collapse of its financial sector in 2009, when three of the largest

10 banks in the country defaulted. One-third of the sector's total loans is currently nonperforming. The private sector is quickly deleveraging after a boom in lending, in particular to real estate projects, in 2003-2007. During this period, banks substantially financed their loans through cross-border borrowings, which dried up at the onset of the downturn. Kazakhstan's preliminary economic risk score of 9 takes into account what we view as the extremely high risk profile of Kazakhstan's private sector borrowers, among other elements. Thanks to the country's oil and gas riches, the government has the means to support economic growth in Kazakhstan and facilitate the restructuring of private sector debtors, but in our view the task will be difficult.

Table 5

Preliminary BICRA Scores Under The Proposed Criteria

		Preliminary economic risk descriptions				Preliminary industry risk descriptions			
Country	Preliminary BICRA Group	Economic stability and resilience	Economic imbalances	Credit risk in the economy	Preliminary economic risk score	Institutional framework	Competitive dynamics	Systemwide funding	Preliminary industry risk score
Sweden	1	Very low	Low	Very low	1	Low	Low	Low	2
Switzerland	1	Very low	Very low	Very low	1	Low	Low	Very low	2
Canada	1	Very low	Low	Low	2	Very low	Very low	Low	1
Hong Kong	1	Low	Low	Low	2	Very low	Low	Very low	1
France	2	Very low	Low	Low	2	Low	Low	Low	2
Australia	2	Very low	Intermediate	Low	2	Very low	Very low	Intermediate	2
Italy	2	Low	Intermediate	Intermediate	3	Low	Low	Very low	2
Netherlands	2	Very low	Low	Low	2	Intermediate	Intermediate	Low	3
Japan	2	Low	Low	Low	2	Intermediate	Intermediate	Very low	3
Germany	3	Very low	Very low	Low	1	Intermediate	High	Very low	4
Korea	3	Intermediate	Low	Intermediate	3	Intermediate	Low	Intermediate	3
Taiwan	3	Intermediate	Low	Intermediate	3	Intermediate	High	Low	4
U.S.	3	Very low	Intermediate	High	4	Intermediate	Intermediate	Very low	3
N.Z.	3	Low	High	Intermediate	4	Low	Low	Intermediate	3
Spain	3	Low	High	Intermediate	4	Low	Low	Intermediate	3
U.K.	3	Very low	Intermediate	High	4	Intermediate	Intermediate	Low	3
Mexico	4	Intermediate	Low	High	4	Intermediate	Intermediate	Intermediate	4
Brazil	5	Intermediate	Intermediate	High	5	Intermediate	High	Intermediate	5
India	5	High	Intermediate	High	6	High	High	Low	5
China	5	Intermediate	High	High	6	High	High	Low	5
Turkey	6	High	High	High	7	Intermediate	Intermediate	High	5
Russia	8	High	High	Very high	7	Very high	Very high	High	8
Kazakhstan	9	High	Very high	E. high	9	Very high	Very high	Very high	9

BICRA--Banking Industry Country Risk Assessment. N.Z.--New Zealand. E. high--Extremely high. Source: Standard & Poor's.

Comparison Of Industry Risk

The countries with preliminary industry risk scores of 1 (the lowest risk group)--Canada and Hong Kong--are, in our opinion, characterized by successful and proactive regulatory frameworks that have shielded the two countries from the worst effects of the global banking crisis. In the case of Hong Kong, its regulatory framework has strengthened protection in the residential real estate segment during periods of price inflation.

We consider competitive dynamics in Canada's financial industry, like those in Australia's, to be "very low risk" because of the dominance of a few banking groups that have relatively stable market shares and stable and adequate risk adjusted returns. We assess Hong Kong's banking industry as having a "very low risk" funding profile, primarily due to the ample stock of customer deposits there. Hong Kong's ratio of customer deposits to loans is the highest of the 23 countries with preliminary BICRAs.

The five countries with preliminary industry risk scores of 2--Australia, France, Italy, Sweden, and Switzerland--have assessments of "low risk" or "very low risk" for the three proposed BICRA factors related to industry risk, with the exception of the "intermediate risk" funding profile of Australia. Their banking industries are moderately less risky, in our opinion, than those of the countries with industry risk scores of 3 or greater, but we assess certain aspects of their banking industry profile as inconsistent with the very lowest industry risk score of 1.

Of this group, we consider Italy's banking industry risk profile to have improved the most over the past decade, as it has reaped significant benefits from nationwide bank consolidation. A combination of a high savings rate and the smaller size of the banking industry compared to those of many other developed countries means that Italian banks can satisfy most of their funding needs from retail funding sources. Australian banks' significant dependence on cross-border funding is, in our view, incompatible with the very lowest industry risk score, despite our view that regulation and governance is "very low risk" and that the industry's competitive dynamics leads to stability, for similar reasons to those cited for Canada.

The seven countries with preliminary industry risk scores of 3--Japan, Korea, the Netherlands, New Zealand, Spain, the U.K., and the U.S.--have certain characteristics of their institutional frameworks and competitive environments that lead to our assessment of "intermediate risk" under our proposed BICRA methodology, as opposed to the assessments of "low risk" for countries with industry risk scores of 1 and 2. Weaknesses in bank regulation in countries such as the U.S. and the U.K. were exposed by the financial crisis of 2007-2009. Virtually all developed market countries are revamping banking regulation to reinforce their financial systems for the future. This contributes to our assessment of "intermediate risk" as opposed to "high risk."

Certain characteristics of the domestic competitive banking environments of Japan, the Netherlands, the U.K., and the U.S. lead us to assign these countries an assessment of "intermediate risk" in the BICRA factor competitive dynamics. This includes our view of the apparent propensity toward aggressive commercial practices and a high proportion of nonbank competitors in the U.S., and relatively low systemwide risk-adjusted returns in Japan. In our opinion, Korea, New Zealand, and Spain depend to a material degree on cross-border borrowings and other wholesale sources to fund their domestic banking businesses. In our view, these countries' competitive dynamics characteristics are a relative weakness compared to the other banking industries in this group and to the banking industries of countries with preliminary industry risk scores of 1 and 2.

The three countries with preliminary industry risk scores of 4--Germany, Mexico, and Taiwan--display some characteristics that lead to the view that these countries' banking sectors have relatively higher industry risk score than the countries with scores of 1-3. In our view, the structure of Germany's banking industry creates risks for banks, due to the domestic market dominance of less profit-oriented public law and cooperative financial institutions, the high fragmentation of the banking market, and persistent overcapacity in the industry caused by high barriers to exit. In our view, the resultant fierce domestic competition lowers profitability and at times puts underwriting quality under pressure, particularly in cross-border loans and investments. This contrasts with Germany's "very low risk" funding profile.

Taiwan has a similar profile of low risk-adjusted profitability, which we attribute to the fragmented industry structure and competitive distortions of government-owned banks, which represent half of the system's assets. We assess Mexico as having intermediate risk in all three factors--this ranks the Mexican banking industry as lower risk than most other developing markets with a similar economic profile, but higher risk than developed market countries with industry risk scores of 1-3.

The four countries with preliminary industry risk scores of 5--Brazil, China, India, and Turkey–-have, in our view, more factors that we assess as "high risk" than the countries with industry risk scores of 4 or lower. All four countries are in transition and changing because of globalization and developments in information technology. We assess the institutional frameworks in China and India as "high risk," because of our view of weaknesses in corporate governance, financial disclosure, and transparency of accounts. In our view, Brazil's, China's, and India's state ownership and government policies that mandate lending to specific economic segments create distortions in the competitive environment and could lead to inadequate risk pricing, particularly in China and India, where the systemwide risk-adjusted operating margins (before loan loss provisions) are narrower. In our opinion, Turkey has a "high risk" funding profile due to the material amount of foreign currency borrowing (and lending) in the domestic market, the cross-border debtor position of the banking industry, and the inability of banks to secure term funding in Turkish lira. By contrast, we assess the systemwide funding of China and India as "low risk," because of the relatively low amount of foreign currency and cross-border funding and the high proportion of assets funded with customer deposits in both countries.

Russia's preliminary industry risk score of 8 indicates a higher risk banking industry than Brazil, India, China, and Turkey. In our opinion, Russia's banking rules and practices may allow banks to circumvent the spirit of regulations (e.g., on risk concentrations and related party lending). Moreover, in our view disclosure of bank ownership is poor, while the competitive profile of the banking industry is unbalanced, with hundreds of small and midsize private sector banks vying for business with a few powerhouse state banks. In funding, retail depositors and nongovernment wholesale creditors are prone to rapid fund withdrawals. On the other hand, in our opinion, the central bank managed well the funding turmoil in Russia provoked by the global financial crisis in late 2008 and 2009.

We assess Kazakhstan as having a preliminary industry risk score of 9, the second-highest risk category. The banking collapse of 2009 described in "Comparison Of Economic Risk" above was, in our view, triggered by very weak industry fundamentals, in particular governance and funding.

Table 6

Selected Comparative Data for the BICRA Analysis*

	Preliminary BICRA group	GDP (bil. US$)¶	GDP per capita (US$)	Domestic credit to private sector and NFPE (bil. US$) §	Systemwide core customer deposits (bil. US$)§**
Canada	1	1,336	39,622	2,075	1,297
Hong Kong	1	211	29,968	333	678
Sweden	1	406	43,870	609	279
Switzerland	1	492	63,182	907	1,073
Australia	2	950	43,270	1,263	494
France	2	2,649	41,161	3,496	1,840
Italy	2	2,113	35,187	2,573	1,302

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Table 6

Selected Comparative Data for the BICRA Analysis* (cont.)

Japan	2	5,084	38,448	8,038	9,916
Netherlands	2	805	48,919	1,862	808
Germany	3	3,330	40,609	3,880	3,306
Korea	3	833	17,221	1,474	901
New Zealand	3	110	25,560	181	78
Spain	3	1,460	31,864	2,677	N.A.
Taiwan	3	379	16,373	563	589
U.K.	3	2,179	35,261	4,842	2,568
U.S.	3	14,119	45,865	24,479	7,119
Mexico	4	873	8,027	163	131
Brazil	5	1,574	8,215	852	N.A.
China	5	4,984	3,729	6,350	5,955
India	5	1,286	1,073	656	727
Turkey	6	615	8,055	235	268
Russia	8	1,231	9,702	590	368
Kazakhstan	9	109	6,981	65	33

*Data as of Dec. 31, 2009. ¶Nominal GDP in local currency converted to $US at the average $US to local currency exchange rate for 2009. §Nominal amount in local currency converted to $US at the Dec. 31, 2009 $US to local currency exchange rate. **Calculated as 100% of deposits of individuals + 50% of deposits of enterprises. N.A.--Not available. Sources: Standards & Poor's, National sources.

Table 7

Selected Comparative Metrics For The Economic Risk Analysis

	Standard deviation of real GDP growth 2000-2010*	Coefficient of variation of real GDP growth 2000-2010*	Current account balance to GDP (2007-2010* average, %)	Residential real house prices (2007-2010* average annual increase, %)	Domestic credit to the private sector and NFPE (2007-2010* average annual increase in percentage points of GDP)
Canada	1.9	0.9	(0.9)	4.1	4.1
Hong Kong	3.6	0.8	11.4	13.0	6.1
Sweden	2.9	1.3	8.1	3.6	5.3
Switzerland	1.8	1.0	8.3	3.8	0.2
Australia	0.9	0.3	(4.8)	5.1	5.1
France¶	1.6	1.1	(1.4)	0.5	4.0
Italy	2.2	4.1	(2.9)	0.5	4.4
Japan	2.1	2.2	3.5	(1.5)	(2.2)
Netherlands¶	2.4	1.7	7.0	(1.4)	10.1
Germany§	2.3	2.3	6.5	(1.0)	0.0
Korea	2.3	0.5	1.8	0.5	6.0
New Zealand§	2.0	0.7	(6.3)	1.0	5.8
Spain	2.5	1.1	(7.6)	(4.0)	5.8
Taiwan	3.3	0.9	8.5	6.1	0.0
U.K.	2.4	1.4	(1.7)	(0.4)	8.4
U.S.	1.9	1.0	(4.0)	(4.5)	0.1
Mexico§	3.5	1.8	(1.0)	5.5	0.2
Brazil	2.6	0.7	(1.4)	5.1	0.0

Table 7

Selected Comparative Metrics For The Economic Risk Analysis (cont.)

China	1.4	0.1	8.0	5.9	5.4
India	2.1	0.3	(2.6)	N.A.	2.4
Turkey	5.0	1.3	(4.2)	N.A.	2.4
Russia§	4.4	0.8	8.2	9.4	3.0
Kazakhstan§	3.5	0.4	(1.0)	N.M.	2.4

*2010 is estimated. ¶Four-year average current account balance as % of GDP calculated over 2006-2009. §Average annual increase in residential real house prices calculated over 2006-2009. NFPE--Nonfinancial public enterprises. N.A.--Not available. N.M.--Not meaningful. Sources: Standard & Poor's, National sources.

Table 8

Selected Comparative Metrics For The Industry Risk Analysis

	Preprovision NOI as % of loans*	Systemwide core customer deposits as % of total loans¶	Market share of gov't-owned and not-for-profit banks (%)§	Gross problematic assets range (%)**	Government support classification
Canada	2.3	89.1	12.1	5-15	Supportive
Hong Kong	4.3	159.8	0.0	5-15	Supportive
Sweden	2.0	37.3	11.0	5-15	Supportive
Switzerland	0.8	121.3	34.7	5-15	Supportive
Australia¶¶	2.5	33.5	2.5	5-15	Supportive
France	1.7	66.2	17.6	5-15	Supportive
Italy	2.1	56.9	3.0	10-20	Supportive
Japan	0.9	105.8	18.0	5-15	Interventionist
Netherlands	0.9	54.8	15.0	5-15	Supportive
Germany	1.6	85.2	40.0	5-15	Supportive
Korea¶¶	1.8	71.1	14.7	10-20	Interventionist
New Zealand¶¶	2.1	40.6	2.7	10-20	Supportive
Spain	1.9	N.A.	27.8	10-20	Supportive
Taiwan¶¶	1.1	101.3	53.7	10-20	Interventionist
U.K.¶¶	1.7	68.6	45.0	10-20	Supportive
U.S.	3.1	97.8	22.8	10-20	Supportive
Mexico	8.9	80.5	0.0	15-30	Supportive
Brazil	8.5	N.A.	37.0	15-30	Supportive
China	3.2	95.3	75.0	25-40	Interventionist
India	3.5	97.0	79.5	15-30	Interventionist
Turkey	8.9	114.4	31.0	25-40	Supportive
Russia	6.6	98.5	50.0	35-50	Supportive
Kazakhstan	5.6	63.7	25.0	35-50	Supportive

*Estimated systemwide net operating income before loss provisions as % of systemwide loans (2006-2009 average, %). ¶As of Dec. 31, 2009 and calculated as deposits of individuals + 50% of deposits of enterprises. §As % share of total customer deposits Dec. 31, 2009. **For definition of gross problematic assets see "Banking Industry Country Risk Assessments" Jan. 4, 2011. ¶¶Four-year average of estimated net operating income before loss provisions as % of loans calculated over 2007-2010. N.A.--Not available. N.M.--Not meaningful. Sources: Standard & Poor's, National sources.

Related Criteria And Research

- Banking Industry Country Risk Assessments, Jan. 4, 2011
- Request for Comment: Methodology For Determining Banking Industry Country Risk Assessments, Jan. 6, 2011
- Request for Comment: Methodology For Determining Banking Industry Country Risk Assessments, May 13, 2010

Rationales For The Preliminary BICRA Scores

Australia

- The preliminary BICRA for Australia is BICRA group 2 under the proposed criteria, compared with BICRA group 1 under the current criteria.
- Primary credit analyst: Sharad Jain
- Secondary credit analyst: Kyran Curry

Economic risk. The preliminary economic risk score for Australia is 2. This score takes into account our view of economic stability and resilience as "very low risk," our view of Australia's economic imbalances as "intermediate risk," and our view of credit risk in its economy as "low risk."

We expect that Australia will maintain its record of very stable economic growth, with inflation kept within the central bank's 2%-3% annual average target range over the cycle. Australia benefits from a wealthy, open, and resilient economy, reflected in its high per capita GDP; a stable, transparent policy environment; strong institutions; and sound public finances (sovereign credit rating AAA/Stable/A-1+). Furthermore, Australia's economic resilience is supported by a floating and key internationally traded currency.

In our view, the main economic imbalances to which Australia's banking system is exposed are its persistent current account deficits, which average about 5% of GDP; a moderate rise in real estate and equity prices in recent years; high external debt to current account receipts of more than 200%; and moderate to high credit growth. These risks are mitigated, in our view, by a floating and highly liquid currency, and extensive hedging of external debt. Also, the current account deficits mainly reflect the high capital needs associated with expanding the productive capacity of its mining sector. A sizable proportion of this work is funded by foreign direct investment (FDI). In our opinion, the risk of house price correction is mitigated by a combination of strong demand and some supply constraints, and a strong labor market.

We expect that credit and impairment losses and nonperforming loans will remain among the lowest globally. We consider Australia's lending practices to be conservative compared with most other developed countries, and its payment culture and legal and taxation frameworks are supportive of creditors. In our view, these factors offset the moderate levels of private sector debt at about 125% of GDP.

Industry risk. The preliminary industry risk score for Australia is 2. This score takes into account our view of Australia's institutional framework and competitive dynamics as "very low risk," and our view of Australia's systemwide funding as "intermediate risk."

We consider Australian banking regulation to be conservative. Regulators monitor banks closely and frequently, and regulatory coverage of the banking system is extensive. We also believe that financial statements published by the leading financial institutions contain a good level of disclosure. We expect the regulator to be able to proactively identify problems in the banking system and take necessary preventive actions.

In our view, the Australian banking industry is supported by strong earning and cost efficiency metrics; very low risk appetite as demonstrated by the limited use of predatory or aggressive commercial practices; and minimal market distortions due to government intervention or competition from the nonbanking sector. We believe that the probability of a material change in the competitive environment is low, and that the four major banks are likely to continue to dominate the Australian banking sector.

In our view, a weakness for the Australian banking sector is its reliance on offshore wholesale borrowings, which constitute 20%-25% of total liabilities. Although the core customer deposits' contribution to total funding is relatively low at 25%-30%, we consider that the retail depositors' confidence in the banking system is high, based on Australian banks' very strong franchises. We note that bank failures or bank deposit runs have been extremely rare. Additionally, in our opinion, the government and regulator are responsive and flexible to the changing needs of the banking industry.

Brazil

- The preliminary BICRA for Brazil is BICRA group 5 under the proposed criteria, the same as under the current criteria.
- Primary credit analyst: Milena Zaniboni
- Secondary credit analyst: Ricardo Brito

Economic risk. The preliminary economic risk score for Brazil is 5. This score takes into account our view of Brazil's economic stability and resilience and economic imbalances as "intermediate risk." Our view on credit risk in Brazil's economy is that it is "high risk."

We expect GDP growth to moderate in the medium term after shrinking by 0.2% in 2009 and rebounding to 7.5% in 2010. Prospects remain robust based on a well diversified economic structure supported by domestic demand. However, Brazil continues to underperform in terms of GDP growth when compared to other emerging markets. That said, some of the historical weaknesses in the country's economic structure--such as its still relatively closed economy and low level of financial intermediation--helped to moderate the impact of the international crisis on Brazil, compared to other emerging markets. For one of the first times in its economic history, the Brazilian government was able to introduce countercyclical monetary and (limited) fiscal policies at the downward part of the cycle.

We assess the economic imbalances in Brazil as intermediate. Credit expansion in recent years has been relatively high, and real house prices have increased by 5% per year since 2006. The equity market is large and relatively volatile. On the other hand, the current account deficit is minimal, and the Brazilian economy has a net asset position in relation to the rest of the world.

We assess credit risk in the economy as high for Brazil. Some aspects of underwriting and payment culture, such as the lack of a credit bureau and lengthy legal process for loan recoveries are relative risk points, in our opinion. Systemwide credit risk is limited, however, by the relatively low level of bank intermediation (loans equal 48% of GDP) and the short-term nature of loans, which allows bank to adjust fairly quickly to economic cycles. Past due loans decreased to 5.5% of total loans in September 2010, after peaking at 6.8% in July 2009.

Industry risk. The preliminary industry risk score of 5 for Brazil takes into account our view of Brazil's institutional framework as "intermediate risk," our view of its competitive dynamics as "high risk," and our view of its systemwide funding as "intermediate risk."

The assessment of institutional framework takes into account the restructuring of the banking industry in the 1990s and ongoing efforts to strengthen regulation and supervision. All financial entities, not just banks, are supervised at a conglomerate level, which reduces risk of unseen exposures at nonregulated entities. Government-owned banks are subject to the same regulatory standards as private sector banks.

In our view, Brazil's banking industry is competitive and concentrated, with the three largest banks accounting for 55% of the system, and the 10 largest for almost 90%. The level of automation is high and banks benefit from good settlement processes and good risk assessment. Nonetheless, the relatively high proportion of government-owned banks (37% of systemwide assets) and government policies requiring banks to lend to designated sectors on a mandatory basis distorts the competitive environment, in our opinion.

Large, systemically important banks mainly rely on fairly stable domestic retail deposits. The financial system, given its domestic orientation, has been largely shielded from external shocks. We see limited risk of capital flight given the historical confidence in the domestic banking system. The domestic capital market has been developing fast, but issuers still face competition from the sovereign's own financing needs, which are mostly funded in the domestic market.

Canada

- The preliminary BICRA for Canada is BICRA group 1 under the proposed criteria, the same as under the current criteria.
- Primary credit analyst: Rodrigo Quintanilla
- Secondary credit analyst: Devi Aurora

Economic risk. The preliminary economic risk score for Canada is 2. This score takes into account our view of Canada's economic stability and resilience as "very low risk" and our view of economic imbalances and credit risk in Canada's economy as "low risk."

Canadian banks benefit from operating in a relatively stable economic and political environment. The economy weathered the global recession relatively unscathed, being relatively diversified, flexible, competitive, and export-oriented. The government has a high level of fiscal and monetary flexibility due to low indebtedness, which also supports the high sovereign credit rating on Canada (AAA/Stable/A-1+).

Canadian asset prices appear relatively in check and the government moved proactively to stem house price ebullience, supporting our assessment of economic imbalances. Real house prices have risen 4.1% a year for the past four years. Canada's current account and external debt position indicate low risk; the current account deficit was just below 3% of GDP in 2009 and an estimated 1.9% in 2010.

Our assessment of credit risk in the economy is based on Canada's conservative credit culture and strong legal framework. Credit risk is also low because of government guarantees on mortgages, small business loans, and farm loans. The nonperforming ratio of the seven largest banks stood at 1.4% at July 31, 2010, which we anticipate will decline over time. The more favorable credit environment is due to the relatively low-risk mortgage market in Canada, where mortgages are not tax-deductible, borrowers assume personal liability for their debt, and it is mandatory for mortgages with a loan-to-value ratio above 80% to have insurance. Coverage of problem loans (average of the seven largest Canadian banks) was prudent at 85% at year-end 2009 and should act as a buffer against credit deterioration.

Industry risk. The preliminary industry risk score for Canada is 1. This score takes into account our view of Canada's institutional framework and competitive dynamics as "very low risk" and systemwide funding as "low risk."

Our assessment of the institutional framework is supported by our view of Canada's conservative regulatory standards, overall prudent risk practices, and the proactive stance of the Canadian regulators. No systemically important Canadian financial institution failed, either during the current crisis, or for many years preceding it. Governance and systemwide transparency are very strong, and reporting is extensive.

In our opinion, the Canadian banking industry, which is dominated by seven banking groups, is highly stable and insulated from the influence of foreign interests or outright acquisitions by nonresident financial institutions. We do not foresee a material change in the structure of the system in the medium term. A highly concentrated banking market constrains lending margins and profitability, but banks have been able to maintain what we view as still respectable and recurring returns.

In our opinion, systemwide funding in Canada benefits from the deep and liquid domestic bond market, which remained open and functioned well throughout the recent financial crisis. This largely compensates for the relatively low share of core customer deposits to lending (31%). The healthy consumer deposit franchises constitute a sound and comparatively cheap funding source, which enable the Canadian banks to maintain limited recourse to securitization. They are, however, reliant on noncore wholesale deposits to fund investment banking operations. The banking sector is highly reliant on cross-border funding, with foreign-currency liabilities accounting for 35% of systemwide liabilities in 2009. Foreign currency borrowings are well matched with foreign-currency assets.

China

- The preliminary BICRA for China is BICRA group 5 under the proposed criteria, compared with BICRA group 6 under the current criteria.
- Primary credit analyst: Qiang Liao
- Secondary credit analyst: Terry Sham

Economic risk. The preliminary economic risk score for China is 6. This score takes into account our view of China's economic stability and resilience as "intermediate risk," and our view of economic imbalances and credit risk in the economy as "high risk."

China benefits from strong and resilient economic growth, still-moderate inflation, and a stable exchange rate. It has a vast and largely diversified economy, and the sovereign is highly rated (The People's Republic of China, AA-/Stable/A-1+) despite China's comparatively low level of wealth and income per capita. Offsetting elements include China's poor economic structure, which is heavily biased toward external demand, and its limited monetary flexibility to deal with challenges in the economy.

Our assessment of economic imbalances as high risk reflects the rapid expansion of credit in 2008-2010 and residential property price inflation during the same period. That said, we do not consider the four-year average to be alarming, given the strong economic growth. Moreover, China has a very strong external position and current account surpluses.

Our assessment of credit risk in the economy reflects our view of China's very high private sector credit-to-GDP ratio for a low-income emerging economy. In addition, China's developing legal system could create uncertain prospects for recoveries at stressed times, despite a largely creditor-friendly bankruptcy law enacted in 2006. On the positive side, indebtedness in China's household sector is low, while lending practices and underwriting standards for personal loans have improved over the past decade. The leverage of private sector companies is moderate, with the aggregated countrywide liability-to-asset ratio for industrial firms at around 58% at year-end 2009. Corporate loan mix is diverse across industries. We project that the nonperforming asset ratio for the system will increase but should remain below 10% over the next few years.

Industry risk. The preliminary industry risk score for China is 5. This score takes into account our view of China's institutional framework and competitive dynamics as "high risk," and our view of China's systemwide funding as "low risk."

In our view, many banks demonstrate weakness in their corporate governance, due to undue government influence at times. We also consider that the transparency of the performance of China's rural credit cooperatives, rural banks, and certain city commercial banks is limited. Since 2003, the regulators appear to have had a good track record in reducing excessive risk-taking behavior by introducing strict prudential ratios, fostering prudent risk management practices, and pressing ahead with banking sector reform. The quality of listed banks' financial reports appears adequate, with key financial information disclosed quarterly.

Our assessment of competitive dynamics primarily reflects our view of China's high market distortion caused by the prevalence of government ownership. In our view, this encourages banks to focus on loan growth for short-term returns, while ignoring risk pricing adequacy. There is little use of securitization and derivatives to shift risks off the balance sheet. Preprovisioning margins appear adequate, supported by protected interest rate spreads, and good cost efficiency. The market share of the major banks appears stable, which we attribute to regulatory barriers to entry.

A strong core customer deposit base supports systemwide funding in China. Deposits represent a high proportion of system liability and more than fund the banking sector's loan book. Cross-border and foreign currency borrowing is low. Although we have observed rare cases of depositor run, depositor confidence appears generally high, partly attributable to the Chinese government's proactive role and strong capacity to support troubled banks. Counterbalancing factors include a still-small, though rapidly growing, debt market, and the lack of an explicit deposit protection scheme.

France

- The preliminary BICRA for France is BICRA group 2 under the proposed criteria, which compares with BICRA group 1 under the current criteria.
- Primary credit analyst: Elisabeth Grandin
- Secondary credit analyst: Bernard de Longevialle

Economic risk. The preliminary economic risk score for France is 2. This score takes into account our view of France's economic stability as "very low risk" and our view of economic imbalances and the credit risk in the economy as "low risk."

The French economy benefits from relatively stable past and projected real GDP growth. The French economy is open, diversified, and wealthy, and benefits from a skilled and relatively productive labor force. France withstood the financial and economic crisis of 2008-2009 better than most large mature economies in Europe. Real GDP grew by 0.4% in 2008 and shrank by 2.5% in 2009. That said, we forecast that its current and projected GDP growth for

2010 and 2011 will be 1.6% for both years, which lags peers.

Our assessment of economic imbalances reflects our view of France's small current account deficit and a moderate rise in private sector debt to GDP in recent years. The 10% (peak to trough) correction in national house prices in 2008 and 2009 cooled down the housing market. Since the trough in the third quarter of 2009, prices have risen (by approximately 10% to Sept. 30, 2010). The cooling off in 2009 and the continued excess of housing demand over supply lessen the risk of a disorderly correction in France.

Protective consumer regulation, households' cultural aversion to risk, and prudent bank underwriting practices in France support our assessment of low credit risk in the economy. Corporate creditworthiness remains sound. Corporate debt to GDP was relatively stable at 63% in 2009. Household debt has increased continuously over the last decade but was still comparatively low by year-end 2009 at 52% of GDP. The low credit risk translates into a low level of credit losses for banks: we estimate that systemwide credit losses in the recession year of 2009 and in the first nine months of 2010 were less than an annualized 0.7% of systemwide loans.

Industry risk. The preliminary industry risk score for France is 2. This score takes into account our view of France's institutional framework, competitive dynamics, and systemwide funding as "low risk."

We believe that France's regulatory and legal framework allows for effective supervision in a way that supports the creditworthiness of the country's financial institutions. The recent track record supports the success of this framework; there were no banking failures in the past three years, and, while some institutions had troubles, these were manageable. The regulatory framework has encompassed the entire financial industry since 1984; it is the same for all broadly defined financial institutions.

We believe that several reforms over the past decade have improved the competitive environment by reducing market distortions and state interference. The French banking industry is relatively concentrated, with six large national banking groups, but in our opinion price differentiation remains good, thanks in part to the existence of decentralized cooperative networks. There is an almost total absence of small players vulnerable to loss of market confidence. The nationwide banks have solid and sustainable franchises and generate adequate and stable returns from their domestic commercial and retail activities. We estimate that the domestic operations of French banks generated an average ratio of pretax income to revenues of 29% in 2005-2009.

A high savings rate and strong customer confidence in banks underpin our assessment of systemwide funding. Banks benefit from the high proportion of retail and corporate savings invested in interest rate products--mainly bank deposits and mutual funds. This provides for a large pool of stable customer resources. French banks have access to the country's relatively deep and diversified domestic capital markets and have good access to European debt markets to fund the excess of domestic loan over deposits.

Germany

- The preliminary BICRA for Germany is BICRA group 3 under the proposed criteria, compared with BICRA group 2 under the current criteria.
- Primary credit analyst: Harm Semder
- Secondary credit analyst: Stefan Best

Economic risk. The preliminary economic risk score for Germany is 1. This score takes into account our view of Germany's economic stability and resilience and economic imbalances as "very low risk" and our view of credit risk in Germany's economy as "low risk."

Our assessment of economic stability and resilience is based on our view of Germany as a modern, highly diversified, and competitive economy, with a proven ability to absorb large economic and financial shocks, notably the unification with East Germany in the 1990s and the deep recession of 2008-2009. We currently forecast that real GDP growth for Germany will be the highest among the Western European economies.

When assessing Germany's economic imbalances, we took into account the country's improved international competitive position. It has achieved this through corporate restructuring, wage restraint, a high savings rate, and sizable current account surpluses since the early 2000s. Germany is one of the few Western European countries that has not experienced a credit boom or a commercial or residential real estate boom over the past decade.

Germany has seen unprecedented fiscal and monetary easing, which we take into account in our assessment of credit risk in its economy. It has also benefited from the absence of large corporate defaults, and the manageable level of its private sector debt. We believe that nonperforming loans and associated credit loss provisions peaked in 2010. Nonetheless, Germany's economic development, as an export-driven nation, remains vulnerable to swings in global economies and trade flows, macroeconomic risks, and dislocations of global capital markets.

Industry risk. The preliminary industry risk score for Germany is 4. This score takes into account our view of Germany's institutional framework as "intermediate risk," competitive dynamics as "high risk," and systemwide funding as "very low risk."

Our assessment of the institutional framework takes into account the good corporate governance and market transparency in Germany, as well as the country's efficient deposit protection scheme. In the industry's severe downturn of 2007-2009, however, German regulators did not take preemptive measures and intervened only at a late stage, when banks were no longer able to meet regulatory minimum standards. Some large German banks had to be rescued.

The competitive dynamics assessment reflects our view of the unabated dominance of the domestic banking market by less profit-oriented public law and cooperative financial institutions; high fragmentation of the banking market; persistent overcapacity in the industry caused by high barriers to exit; and fierce domestic competition, which lowers profitability and puts underwriting quality under pressure. German banks' average cost-to-income ratio was about 65% and returns on average assets have been marginal since 2007. The banking industry displays significant disparities in the size and business profile of its participants, causing an unbalanced industry profile. The stable retail segment is dominated by hundreds of small savings and cooperative banks, which are well funded and well capitalized, but less profit-oriented. Conversely, a small number of large, systemically important banks with confidence-sensitive funding profiles and comparatively higher loan leverage are active in the more cyclical and volatile corporate and wholesale markets and in capital markets activities, notably outside Germany.

Our assessment of the systemwide funding reflects our view of the depth and breadth of the domestic funding market, including access to long-term funding through German "Pfandbriefe." Moreover, German banks maintain an aggregate net external asset position because of the domestic funding surplus from low domestic credit growth and from the country's high savings rate.

Hong Kong

- The preliminary BICRA for Hong Kong is BICRA group 1 under the proposed criteria, compared with BICRA group 2 under the current criteria.
- Primary credit analyst: Terry Sham

- Secondary credit analyst: Qiang Liao

Economic risk. The preliminary economic risk score for Hong Kong is 2. This score takes into account our view of Hong Kong's economic stability and resilience, economic imbalances, and credit risk in the economy as "low risk."

Our assessment of economic stability and resilience is based on Hong Kong's high degree of economic policy flexibility, supported by its strong government finances and a highly credible currency peg. The economy is highly competitive and resilient. That said, we consider economic growth is moderately vulnerable to Hong Kong's reliance on external demand.

The assessment of economic imbalances reflects our view of Hong Kong's very strong external position and current account surpluses, offset by the fairly volatile prices in property and equity markets and recent periods of rapid credit expansion.

When assessing credit risk in the economy, we took into account the strong payment culture, which in our view is supported by an effective legal framework, efficient loan recovery process, and high adherence to the rule of law. The nonperforming loans ratio and credit cost of the banking sector in Hong Kong is consistently maintained at a low level, with a particularly good track record on mortgage loans. However, we consider the ratio of private sector debt, including trade finance and corporate bonds issued, to be moderately high. In addition, we believe the risk arising from direct and indirect exposure to mainland-China-related entities is a key credit risk. We also recognize a fairly high concentration on property-related lending.

Industry risk. The preliminary industry risk score for Hong Kong is 1. This score takes into account our view of Hong Kong's institutional framework and systemwide funding as "very low risk," and our view of Hong Kong's competitive dynamics as "low risk."

We consider the regulatory standards in Hong Kong to be prudent and the coverage to be comprehensive. In our view, the regulator appears effective, as demonstrated by what we believe is a good regulatory track record. The regulator is largely free from political interference on banking supervisory matters. It is proactive in curbing aggressive lending behavior, particularly on residential mortgages, and fostering prudent risk management practices, even in benign markets. Governance in Hong Kong is generally good, and the quality of financial reports and degree of standardization are high. However, banks are only required to disclose their financial information semiannually, rather than quarterly.

Competitive dynamics benefit from the very good overall industry performance, which shows strong earnings capacity. The competitive environment is quite stable, with the four largest banks consistently maintaining their market shares. There is minimal use of securitization and derivatives to shift risks off the balance sheet, and no discernable market distortions affecting the sector.

The extremely strong deposit base supports our view of systemwide funding in Hong Kong. Bank funding consists mainly of customer deposits. Core customer deposits (measured as 100% of deposits of individuals and 50% of deposits of nonfinancial enterprises) significantly exceed systemwide loans. As a whole, the banking sector does not rely on cross-border funding to finance domestic assets. In addition, there is effective contingent support provided by a credible monetary authority. Counterbalancing factors include a sizable financial sector as a proportion of GDP. In addition, most liabilities are denominated in foreign currencies, though most of these are likely to be in U.S. dollars, to which the Hong Kong dollar is pegged.

India

- The preliminary BICRA for India is BICRA group 5 under the proposed criteria, compared with BICRA group 6 under the current criteria.
- Primary credit analyst: Geeta Chugh
- Secondary credit analyst: Deepali Seth

Economic risk. The preliminary economic risk score for India is 6. This score takes into account our view of India's economic stability and resilience and credit risk in its economy as "high risk," and our view of its economic imbalances as "intermediate risk."

While, in our view, India's economic growth prospects are strong, a weak economic structure and high inflation levels expose the economy to cycles. A large and persistent fiscal deficit limits the government's ability to stimulate growth through fiscal policies, though the monetary policies are somewhat conservative. Also, while India has a stable democratic political system, its policy-making framework is cumbersome and often ineffective, encumbered by an entrenched bureaucracy, coalition politics, and fragmented administration and power.

Economic imbalances are supported by moderate increases in domestic credit to the private sector as a percentage of GDP, though we have also noted sharp increases in real estate asset prices in certain regions. On the external front, India's current account deficit is low. Its strong growth potential draws large net FDI inflows and foreign portfolio investment. It has a strong external balance sheet, with foreign exchange reserves in excess of US$300 billion. This provides it, in our view, with reasonable resilience against potential changes in capital flows.

When assessing credit risk, we take into account Indian banks' untested risk management practices and their high exposure to directed lending. The foreclosure process is slow and recoveries are low, particularly with respect to large borrowers. Mitigating factors include that overall private sector debt in India measures a still-moderate 51% of GDP in 2009. Banks have been consistently enhancing their risk management practices, though their efficacy has yet to be tested in a prolonged downturn. The banking sector as a whole has low sector concentration, low exposure to currency risk, and moderate loan-to-value ratios in mortgage lending.

Industry risk. The preliminary industry risk score for India is 5. This score takes into account our view of India's institutional framework and competitive dynamics as "high risk," and our view of India's systemwide funding as "low risk."

The disclosure of Indian banks are generally adequate, but lags that of their peers. Disclosure on Basel II's Pillar 3 (which requires lenders to publicly provide details of their risk management activities, risk rating processes, and risk distributions) is limited. There is no regulatory requirement to record or disclose special mention (watch list) loans. Furthermore, banks often give little detail in their quarterly statements. The governance standards are evolving and seem to be lax for some banks. On the positive side, the Reserve Bank of India (RBI) continuously monitors the macroeconomic environment and at times introduces countercyclical measures to slow credit expansion.

The Indian banking industry is fragmented and highly competitive, which has forced down lending margins. Banks have reported stable profitability of around 1% in terms of return on assets during the period 2007-2009. India's risk appetite is moderate, although at times predatory pricing is seen in residential mortgages, car loans, and lending to top-tier corporations. Priority-sector lending norms have some distorting effect on the competitive landscape for banking.

India has a high proportion of stable retail deposits and has low reliance on cross-border funding. Indian banks'

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deposit franchise is supported by extensive branch networks, large and growing domestic savings, increasing proportion of deposits in household savings, and a large retail base. Additionally, banks have access to large secured borrowing via repurchase agreements with the RBI. However, banks have limited ability to borrow from the domestic debt capital markets, which are shallow for nongovernment debt.

Italy

- The preliminary BICRA for the Republic of Italy (A+/Stable/A-1+) is BICRA group 2 under the proposed criteria, the same as under the current criteria.
- Primary credit analyst: Renato Panichi
- Secondary credit analyst: Taos Fudji

Economic risk. The preliminary economic risk score for Italy is 3. This score takes into account our view of Italy's economic stability and resilience as "low risk," and our view of Italy's economic imbalances and credit risk in the economy as "intermediate risk."

Italy is a large and diversified economy that has a large domestic market and a strong manufacturing export sector. Over the past decade, economic growth and inflation have shown low volatility. On the down side, Italy's very high public debt prevents the government from investing meaningfully in infrastructure and in closing the gap in wealth between north and south Italy.

Our assessment of economic imbalances takes into account the modest decline in house prices since the end of 2007. Prices also exhibited a lower rise than that of neighboring European countries during the housing boom in the past decade. Conversely, there has been a gradual but constant buildup in corporate leverage. Corporate debt rose to 83% of GDP at year-end 2009 from 56% at year-end 2000. Italy's current account deficit has moderately deepened since 2006. Net external debt is relatively high, though we consider that eurozone membership shields the country from balance-of-payments pressures.

Our assessment of credit risk in the economy balances relatively low household leverage (42% of GDP and 60% of household disposable income at year-end 2009) with the banking industry's track record of heavy credit losses and high levels of nonperforming assets relative to countries at a similar level of economic development. Most loans are to the midsize companies that are the backbone of the Italian economy. A drop in business during the recession put pressure on the operating margins of these companies and led to an increase in their indebtedness.

Industry risk. The preliminary industry risk score for Italy is 2. This score takes into account our view of Italy's institutional framework and competitive dynamics as "low risk," and our view of Italy's systemwide funding as "very low risk."

Our assessment of Italy's institutional framework reflects our view of the alignment of regulatory standards to best practices over the past several years. Strong system solidarity and what we view as effective regulatory moral suasion have ensured the resolution of individual bank crises in the past decade, generally through a restructuring that ended with a merger with a financially sound bank. On the negative side, small banks tend in our view to have comparatively poor governance compared to the larger banks. Furthermore, banks still appear to enjoy a measure of leeway that allows them to delay recognizing credit losses.

Our assessment of competitive dynamics takes into account Italy's traditional commercial banking business model that allowed the banks to survive well through the 2008-2009 financial crisis. Italian banks have displayed good preprovisioning earning capacity throughout the cycle. Italian banks' revenues are highly sensitive to short-term interest rates; this increases the cyclicality of profits compared with those achieved in banking systems where banks borrow and lend at longer terms. Italian banks have not generally used aggressive commercial practices, even during the period of credit expansion over the past decade.

We believe systemwide funding is very low risk in Italy. Italian households place a large part of their relatively high savings in bank deposits and bank retail bonds, which make up about two-thirds of total funding. As a result, wholesale funding generally represents less than 20% of Italian banks' source of funds. No Italian bank required government guarantees for funding between 2008 and 2010, and recourse to European Central Bank during the same period has been among the lowest in the eurozone.

Japan

- The preliminary BICRA for Japan is BICRA group 2 under the proposed criteria, the same as under the current criteria.
- Primary credit analyst: Naoko Nemoto
- Secondary credit analyst: Ryoji Yoshizawa

Economic risk. The preliminary economic risk score for Japan is 2. This score takes into account our view of Japan's economic stability and resilience, economic imbalances, and credit risk in the economy as "low risk."

Japanese banks benefit from operating in a large and diversified economy with various globally competitive industries. This strength offsets certain structural problems, notably Japan's aging society, moderate deflation, and low growth. High levels of government debt mean that the government has limited flexibility in its fiscal policy, which is the constraining factor for the sovereign credit ratings (AA/Negative/A-1+).

Average real estate prices have continued to decline since 1991. We saw signs of recovery in certain locations during 2005-2007, but prices started to decline again in 2008. In our view, declining asset prices remain a risk factor, even though the decline is slowing. Private sector credit growth has been flat or negative over the past four years. On the external side, Japan has posted sizable current account surpluses and its foreign reserve level is one of the highest among developed countries.

Our assessment of credit risk in the economy is supported by conservative lending practices, a strong payment culture, and an adequate legal framework, despite the relatively high level of private sector credit to GDP. Both the corporate and household sectors have generally maintained a sound financial position. In our view, Japanese banks have improved their risk management practices and are more cautious when investing and underwriting assets than in the 1990s. Despite the sizable real GDP decline in 2008 and 2009, gross nonperforming loans at commercial banks remained flat at 2.4 % of total loans. Credit costs were only 36 basis points in 2009 and have declined since then.

Industry risk. The preliminary industry risk score for Japan is 3. This score takes into account our view of Japan's institutional framework and competitive dynamics as "intermediate risk" and our view of Japan's systemwide funding as "very low risk."

Our assessment of the institutional framework is based on our view of the track record of the Japanese authorities in applying prudent standards to banks and enhancing banks' credit profiles. At the same time, the Financial Services Agency (FSA), a single and comprehensive Japanese regulatory body, has in our view improved disclosure requirements, clarified the rules on write-downs and provisioning and implemented an early warning system during the past decade. In our view, the recent change to the definition of nonperforming loans, which relaxes the recognition of restructured loans to small and midsize enterprises, is a negative factor.

Bank profitability is weak, reflecting the effects of lingering low interest rates and high competition. The top three banks have a combined market share of 32%, a level of concentration we consider relatively low. Moreover, the government banks and Japan Post have sizable market shares (loans 17%, deposits 17%), which put further pressure on margins. It is difficult for banks to differentiate their pricing according to customers' credit profiles. Offsetting factors are banks' low risk appetite and limited competitive pressure from the nonbank sector.

Japanese individuals have strong preference for deposits with banks and about 58% of their individual financial assets are deposits. The banking sector benefits from a stable and low-cost deposit base and the share of core customer deposits to total liabilities is high at 70%. Cross-border funding is minimal. Domestic bond market is developed, but ample low-cost deposits mean that banks are not reliant on the bond market. After experiencing the 1990s banking crisis, Japanese authorities enhanced the safety net and are ready to provide support to the banking industry if necessary.

Kazakhstan

- The preliminary BICRA for Kazakhstan is BICRA group 9 under the proposed criteria, the same as under the current criteria.
- Primary credit analyst: Annette Ess
- Secondary credit analyst: Ekaterina Trofimova

Economic risk. The preliminary economic risk score for Kazakhstan is 9. This score takes into account our view of Kazakhstan's economic stability and resilience as "high risk", our view of Kazakhstan's economic imbalances as "very high risk," and our view of Kazakhstan's credit risk in the economy as "extremely high risk."

Our assessment of economic stability and resilience is based on our view of Kazakhstan's concentrated economy (the oil, gas, and metal industries represent almost half of GDP); low GDP per capita; and high inflation. In our view, Kazakhstan has relatively high political risk, with presidential succession uncertain. That said, economic prospects are likely to improve over the medium term as oil output is forecast to double by 2020.

Our view of Kazakhstan's economic imbalances is underpinned by a dramatic increase in real estate prices in 2005-2007, followed by a slightly less dramatic decrease. Current prices are about 50% below their peak value. The boom was largely fueled by an extremely rapid expansion in credit; the average annual growth rate exceeded 50% in 2005-2007. While major corrections have occurred, we believe that the economy remains prone to asset price bubbles. There are no apparent imbalances on the external side. Kazakhstan benefits from consistently high FDI coverage of its current account gap. We expect the current account to shift into a slight surplus in 2010-2011 and the narrow net external debt position to reduce further.

Our view of credit risk in the economy takes into account the relaxed lending practices and underwriting standards. During the economic boom, amid rising property prices, these deficiencies set the stage for dramatic asset quality deterioration during the economic slowdown, and thus the crash of the real estate market. Systemwide nonperforming loans reached 34% of total loans under local regulatory standards on Sept. 30, 2010. The banks' high exposure to the real estate and construction sector; high single-name concentration; and high proportion of foreign currency lending (at about 50%) also support our view.

Industry risk. The preliminary industry risk score for Kazakhstan is 9. This score takes into account our view of Kazakhstan's institutional framework, competitive dynamics, and systemwide funding as "very high risk."

The Kazakh banking sector is characterized by what in our view is a poor regulatory track record, weak governance and transparency, and high incidence of corruption and fraud. While regulators aim to impose stricter and more proactive regulation, it remains to be seen whether they will have the capacity and authority to prevent future problems.

The banking industry's performance and stability has been weak over the past decade, with very high risk appetite, despite limited market distortions. While margins were wide in absolute terms, the ability of banks to price risks proved to be poor and led to dramatic fluctuations in earnings. Three of Kazakhstan's 10 largest banks defaulted in 2009. Subsequently, the government's ownership in the banking sector increased to about 25%. We expect this to reduce over the medium term.

Our assessment for systemwide funding is fueled by the short-term nature of funding, limited role of retail deposits (representing less than 20% of total liabilities), and underdeveloped status of domestic debt markets. While significant debt restructuring among Kazakh banks has markedly reduced their reliance on foreign debt (to 23% of total liabilities on Sept. 30, 2010, from a peak of more than 50%); it remains significant and a negative factor. In addition, the sustainability of state-influenced deposits remains critical for the liquidity of the banking system.

Korea

- The preliminary BICRA for Korea is BICRA group 3 under the proposed criteria, compared with BICRA group 4 under the current criteria.
- Primary credit analyst: JaeMin Kwon
- Secondary credit analyst: Yumee Oh

Economic risk. The preliminary economic risk score for Korea is 3. This score takes into account our view of Korea's economic imbalances as "low risk," and our assessment of economic stability and resilience and credit risk in the economy as "intermediate risk."

Our view of Korea's economic stability and resilience reflects its resilient economic growth, moderate inflation, and intermediate monetary and fiscal flexibilities. The Korean economy has been resilient throughout the recent financial turmoil, posting solid growth backed by strong performance from globally competitive exporters. It achieved this growth despite some concern over its vulnerability to external factors, including the surge in oil price in 2008.

In assessing economic imbalances, we took into account the relatively low house price increases in the past couple of years and sound current account and net external position, counterbalanced by the moderately high increase in private sector leverage. Korea has maintained a current account surplus since 1999, except for a modest deficit in 2008. Korea also experienced relatively high credit growth during the past several years, but we expect the pace of this growth to slow in 2011.

Our assessment of credit risk reflects Korean banks' adequate underwriting standards, moderately strong payment culture, and high private sector leverage. Korea's average loan-to-value ratio for mortgage loans was low at 47% at year-end 2009. We attribute the high debt leverage of the corporate sector to the economy's relatively heavy concentration in manufacturing. A mitigating factor is that the corporate sector's debt-to-equity ratios have stabilized over the past decade. Household leverage is also high, but this is mitigated by asset quality measures, such as delinquency and nonperforming asset ratios, which are near to their lowest levels since 2004.

Industry risk. The preliminary industry risk score for Korea is 3. This score takes into account our view of Korea's competitive dynamics as "low risk," and our view of Korea's institutional framework and systemwide funding as "intermediate risk."

We base our assessment of Korea's institutional framework on its conservative regulatory standards, wide regulatory coverage, and average governance. Korea experienced a credit card crisis in 2003 and a general financial crisis in 1997-1998. Since then the country's credit card market has stabilized, and its regulatory track record has improved, in our view. For example, during the recent crisis, the government took action to reinforce systemwide liquidity.

Our view of Korea's competitive dynamics reflects its high industry stability, adequate risk-adjusted profitability, and limited market distortions. The competitive market environment has been stable for the past decade. Market share for major players, including government-owned banks and not-for-profit banks, has changed little. In our view, overall net interest margins and profitability are adequate. The impact of nonbank competitors is limited, given that their market position is relatively weak and major banks are expanding nonbank services.

Our view of Korea's systemwide funding reflects its banks' stable retail funding, developed domestic debt market, and moderate dependence on foreign currency funding. Retail funding is the major source of funding for Korean banks, and domestic wholesale debt markets adequately meet general funding needs. The proportion of total liabilities denominated in foreign currencies is approximately 10%, but overall dependency is moderate, in our view, because of the export-oriented nature of the Korean economy. During the recent market turmoil, the government provided guarantees and liquidity support that were backed by significant foreign currency reserves.

Mexico

- The preliminary BICRA for Mexico is BICRA group 4 under the proposed criteria, the same as under the current criteria.
- Primary credit analyst: Angelica Bala
- Secondary credit analyst: Santiago Carniado

Economic risk. The preliminary economic risk score for Mexico is 4. This score takes into account our view of Mexico's economic stability and resilience as "intermediate risk," economic imbalances as "low risk," and credit risk in Mexico's economy as "high risk."

Mexico benefits, in our view, from a track record of stable macroeconomic policy. This record underpins Mexico's stable past and projected GDP growth, moderate inflation, and a free-floating exchange-rate regime. The 6.5% economic contraction in 2009 was severe, but the impact on the financial system has so far been manageable. While the Mexican economy is characterized by a good degree of market orientation and privatization, there is limited competition in some sectors. The economy is closely tied to that of the U.S., which receives 80% of Mexican exports. In addition, U.S. tourism and significant remittances from Mexicans working in the U.S. tie the Mexican economy to that of the U.S. This renders Mexico vulnerable to U.S. economic cycles and what we view as the more subdued growth outlook in the U.S. over the next several years. Reforms to facilitate stronger growth, and domestic demand, are still pending.

Mexico has experienced a moderately high annual average rise of 5.5% in real house prices over the past four years. But domestic credit to the private sector as a proportion of GDP is low at 18%. In contrast to many countries, Mexico has not experienced a pervasive credit boom over the past several years; on the contrary, the financial system has been a relatively marginal contributor to economic growth. Mexico's current account deficit is consistently small, generally less than 1% of GDP. International reserves of over $110 billion provide support for the potential liquidity needs of the economy.

Systemwide borrowing in foreign currency is not significant, and there are no material lending concentrations by sector, except for energy. Banks still provide traditional lending products; the use of securitization is low. Our view of Mexico's credit risk is weakened by the improving, but still weak, financial culture in the general population, coupled with some gaps in the legal framework. We estimate that credit losses for 2010 will be 3.3% of total loans.

Industry risk. Our preliminary industry risk score of 4 for Mexico reflects our view of its institutional framework, competitive environment, and systemwide funding as "intermediate risk."

In our view, the institutional framework for banks in Mexico has improved substantially since the 1994 economic crisis and is approaching best international practices. We believe that the structure of the financial system, in which foreign-owned banks dominate, could make matters harder for regulators and the government should the banks experience financial distress. Although accounting practices appear adequate, information disclosure is not wholly transparent.

In Mexico, foreign-owned banks represent 70% of total assets. In our opinion, this creates a high barrier to entry. Consequently, we see a material change in the competitive environment as unlikely. Commercial banking products are traditional and bank investments focus mainly on government securities. Preprovisioning operating margins appear wide compared to other banking systems, reflecting high risk premiums in lending. Government-owned banks have a small 12% market share in loans, which includes limited commercial banking activities. During the past five years, the authorities have granted banking licenses to new banks, but these new banks mainly target the low-income segment and their market share is small.

The traditional source of funds for banks is customer deposits. The local debt market is gaining importance in providing longer-term funds, but the amount of funding from this source remains small. Retail depositors' confidence has held up relatively well over the past two decades; there does not appear to have been a material deposit run during this period. Borrowings in foreign currency constitute a small proportion of all borrowings.

The Netherlands

- The preliminary BICRA for the Netherlands is BICRA group 2 under the proposed criteria, compared with BICRA group 1 under the current criteria.
- Primary credit analyst: Alexandre Birry
- Secondary credit analyst: Elisabeth Grandin

Economic risk. The preliminary economic risk score for the Netherlands is 2. This score takes into account our view of the Netherlands' economic stability and resilience as "very low risk," and our view of the Netherlands' economic imbalances and credit risk in the economy as "low risk."

In our view, the Dutch banking system benefits from a stable political environment and a diversified and competitive economy, although the high degree of openness in the economy exposes the Netherlands to the economic performance of its trade partners. Despite some deterioration, the unemployment rate remains lower than that of most of its European peers. The 'AAA' sovereign credit rating on the State of the Netherlands and the country's deep integration into the European Monetary Union further support its overall economic stability and resilience.

We see few signs of imbalances building up. Real house price inflation has been relatively moderate, with average annual growth of 2% during the period 2005-2008, followed by a modest correction since 2009. In addition, recurring large current account surpluses underline the competitiveness of the Dutch economy. Of note, however, is the sustained growth in private sector credit relative to GDP over the past decade, particularly in the retail sector.

Our assessment of credit risk in the economy is reflected by the low loan losses in domestic retail and corporate lending, despite the sharp downturn in 2009. We observe that household indebtedness is among the highest in Europe, at close to 130% of GDP at end-2009. The ratio is boosted, however, by the tax deductibility of mortgage interest payments, which gives borrowers a strong incentive to pay into insurance products or repayment vehicles until the final maturity of the loan. Credit risk is further limited by sound lending practices and a strong payment culture.

Industry risk. The preliminary industry risk score for the Netherlands is 3. This score takes into account our view of the Netherlands' institutional framework and competitive dynamics as "intermediate risk," and our view of the Netherlands' systemwide funding as "low risk."

Our assessment of the Netherlands' institutional framework incorporates our view of the high level of transparency in the system but also what we view as weaknesses in the supervisory track record. Although we consider that the response of the authorities to the financial turmoil was broadly a success, we note that supervision by the Dutch central bank (De Nederlandsche Bank; DNB) did not prevent the failure of a smaller bank or a number of the larger institutions from requiring extraordinary support. Financial authorities have proposed a number of measures to address weaknesses in the supervisory framework and strengthen the financial industry going forward.

Strong domestic concentration in a mature banking sector led some of the largest Dutch banking groups to expand internationally. This came to an end when some of these institutions faced difficulties during the crisis. Two of the three largest entities, ING Groep and ABN Amro N.V. (which recently merged with Fortis Bank Nederland) are undergoing material restructuring, partly imposed by the European Commission, as a result of state aid received. The Dutch banking system appears to have moderate overall profitability, based partly on relatively low margins (around 1% systemwide on average) and a high degree of competition.

Despite some reliance on wholesale markets, systemwide funding benefits from access to diversified sources, with a good depth of domestic debt market, both secured and unsecured, complementing what we view as an adequate core deposit base. However, most players are to some extent reliant on wholesale markets, and a number of players required support from the authorities in the midst of the financial turmoil through the Dutch government's credit guarantee scheme (€44 billion of government-guaranteed debt was outstanding at Sept. 1, 2010).

New Zealand

- The preliminary BICRA for New Zealand is BICRA group 3 under the proposed criteria, compared with BICRA group 2 under the current criteria.
- Primary credit analyst: Sharad Jain
- Secondary credit analyst: Kyran Curry

Economic risk. The preliminary economic risk score for New Zealand is 4. This score takes into account our view of New Zealand's economic stability and resilience as "low risk," its economic imbalances as "high risk," and credit risk in New Zealand's economy as "intermediate risk."

We consider that the strengths inherent in what we view as New Zealand's open, flexible, and well-developed economy, and its relatively high per capita GDP, partly offset the weaknesses associated with dependence on agricultural commodity exports. A stable, transparent policy environment, strong institutions, and sound public finances (foreign currency sovereign credit rating AA+/Negative/A-1+; local currency AAA/Stable/A-1+) also support New Zealand's economic stability. Independent monetary policy settings also allow New Zealand's external imbalances to adjust. We expect that the central bank will be successful in maintaining inflation within the 1%-3% annual average target range over the cycle.

We assess New Zealand's economic imbalances as "high risk" because of its persistently high current account deficits, high external debt to current account receipts of about 200%, increasing level of private sector debt, and occasional periods of rapid growth in house and equity prices. These risks are, in our view, partly mitigated by effective hedging of external debt. We also note that FDI funds a sizable part of the current account deficit. In our opinion, the risk of house price correction is mitigated by a strong labor market, and by the modest recent rises in prices following the fall in house prices in 2008.

We expect that credit and impairment losses and nonperforming loans will remain low, reflecting the conservative lending practices and legal and taxation frameworks that support creditors. In our view, these factors partly offset the high levels of private sector debt at about 150% of GDP and the concentration of lending to agricultural sector, including the dairy sector.

Industry risk. The preliminary industry risk score for New Zealand is 3. This score takes into account our view of New Zealand's institutional framework and competitive dynamics as "low risk," and our view of New Zealand's systemwide funding as "intermediate risk."

We view the banking regulation environment in New Zealand as conservative, transparent, and predictable, supporting a stable financial market. We note that in the recent years, the Reserve Bank of New Zealand has strengthened regulation and oversight, particularly for "systemically important" banks and the nonbanking sector. Nevertheless, we consider that regulation is still evolving for some parts of the financial sector, and there remain some gaps in coverage.

New Zealand's banking industry is supported by what we view as good efficiency, limited use of predatory or aggressive commercial practices, and absence of distortions from government-owned banks. We believe that the probability of a material change in the competitive environment is low, and that the four large Australian-owned banks are likely to continue to dominate the New Zealand banking sector through their ownership of the majority of the sector's assets. At the same time, the pricing of loans and savings products at a number of nonbank financial institutions is aggressive, in our opinion.

In our view, New Zealand's debt markets are shallow and lack the capacity to fully fund bank liabilities. New Zealand's banks consequently materially rely on offshore wholesale borrowings, which constitute approximately 30% of banks' total liabilities. The ratio of customer deposits to total funding is relatively low at about 30%. In our view, these weak points are partly offset by good currency risk hedging practices and the strong franchise of the major banks. While a number of nonbanking finance companies have failed in the past three years, bank failures or bank deposit runs have been extremely rare.

Russia

- The preliminary BICRA for Russia is BICRA group 8 under the proposed criteria, the same as under the current criteria.
- Primary credit analyst: Scott Bugie
- Secondary credit analyst: Ekaterina Trofimova

Economic risk. The preliminary economic risk score for Russia is 7. This score takes into account our view of Russia's economic stability and resilience and economic imbalances as "high risk," and our view of Russia's credit risk in the economy as "very high risk."

When assessing its economic stability, we take into account Russia's relatively volatile economic growth, high inflation, and economic concentration in energy and metals exports. In our view, Russia has relatively high political risk, and a change in the ruling party could lead to an economic shock. Mitigating elements include the government's improved management of the Russian ruble exchange rate, which has been helped by government budget surpluses and relatively high accumulated reserves.

Our assessment of economic imbalances factors in Russia's proportionally large and volatile equity market and potential price fluctuations in residential and commercial real estate markets in Moscow and other large cities. Offsetting this, Russia's past and projected current account is in surplus. Overall, Russia has comparatively moderate levels of corporate and personal indebtedness. The long period of rapid credit expansion after the 1998 crisis and government default ended with the deep recession of 2009. In 2010, inflation-adjusted credit growth was flat.

Our assessment of credit risk in the Russian economy reflects our view of the high percentage of lending in foreign currencies, the poor credit standing of the nonexport economy, and Russia's weak and arbitrary legal system, which lengthens and renders uncertain the process of recovering defaulted loans. Since the downturn and recession of 2008-2009, Russian banks have restructured a high 20%-30% of corporate loans, by our estimate. We expect a 4%-5% annual loss rate on corporate loans in 2010 and 2011; this rate (while comparatively high) is limited by the significant proportion of restructured loans. Once restructured, many corporate borrowers continue to service their loans on more-favorable terms. This represents a form of forbearance.

Industry risk. The preliminary industry risk score for Russia is 8. This score takes into account our view of Russia's institutional framework and competitive dynamics as "very high risk" and our view of Russia's systemwide funding as "high risk." Bank regulation is heavily rules-based. In our opinion, this gives Russian banks the opportunity to circumvent the spirit of the regulations. Poor disclosure with respect to bank ownership and connected lending--banks lending to the economic interests of owners--remains a weakness, in our view.

In our view, the dominance of state-owned The Savings Bank of the Russian Federation (Sberbank) and JSC VTB Bank distorts competition in a way that is unfavorable for private-sector bank creditworthiness. The competitive profile of the banking industry is unbalanced, with hundreds of small and midsize private sector banks vying for business with the powerhouse state banks. Evidence suggests that despite stiff competition for business, banks continue to differentiate among borrowers by charging weaker borrowers higher rates. Preprovisioning margins are relatively wide, creating adequate capacity to absorb high credit risk charges.

In funding, Russian retail and corporate depositors are prone to rapidly withdraw their funds at any sign of problems. Banks' ability to borrow ruble borrowing for terms of over two years remains limited. Consequently, banks often borrow in the cross-border markets, although the financial industry downturn in 2008-2009 triggered a reduction in the industrywide gross cross-border debt outstanding. Retail deposits rebounded after the 2008-2009 financial crisis, in our view potentially a sign that a more mature banking culture could be taking root in Russia. Retail deposits increased almost twentyfold over the past decade (from Russian ruble (RUB) 500 billion in 2000 to RUB8.7 trillion at mid-year 2010) and now surpass corporate deposits. Government actions to provide liquidity to banks in the recent crisis were, in our view, far-reaching and effective.

Spain

- The preliminary BICRA for Spain is BICRA group 3 under the proposed criteria, the same as under the current criteria.
- Primary credit analyst: Elena Iparraguirre
- Secondary credit analyst: Jesus Martinez

Economic risk. The preliminary economic risk score for Spain is 4. This score takes into account our view of Spain's economic stability and resilience as "low risk," our view of its economic imbalances as "high risk," and our view of credit risk in the economy as "intermediate risk."

In our view, Spain benefits from a large and wealthy economy. Political risk is low. That said, Spain has structurally high unemployment and lacks significant fiscal flexibility, due to its high fiscal deficit (forecasted at 9.6% of GDP for 2010 and 6.5% in 2011) and rising public debt (expected to reach about 80% of GDP by 2013).

For several years through 2007, Spain experienced a real estate construction boom, accompanied by a significant rise in real estate prices and an explosion of private sector debt. Domestic private sector borrowings as a percentage of GDP more than doubled over a 10-year period, peaking at 177% at year-end 2009. During the same period, Spain's external debtor position meaningfully increased. Since the end of 2007, house prices have declined in real terms--by 5.0% in 2008, 7.1% in 2009, and 5.6% in the year through June 30, 2010--and private sector debt has stopped expanding. On the external front, and despite a significant reduction of the current account deficit since 2008, we are of the view that Spain will likely remain reliant on external funding.

Our assessment of credit risk in Spain's economy takes into account its high corporate sector indebtedness, the financial system's concentration in lending to Spain's troubled real estate construction and development segment, and our expectation that the system will likely accumulate a high volume of problem assets during the downturn and correction. On the positive side, Spain has, in our view, a sound payment culture, a track record of manageable through-the-cycle credit losses, an effective legal system for the resolution of defaults and the recovery of collateral, and limited credit risk arising from household indebtedness.

Industry risk. The preliminary industry risk score for Spain is 3. This score takes into account our view of Spain's institutional framework and competitive dynamics as "low risk," and our view of Spain's systemwide funding as "intermediate risk."

Although the Bank of Spain did not prevent the rapid expansion of lending during the boom, in our view, Spain's strong regulatory framework significantly prepared the financial system to face the downturn from a position of strength. In the same vein, proactive, hands-on supervision helped limit, in our view, the number of institutions requiring intervention or capital support in 2009-2010.

Our assessment of the financial system's competitive dynamics reflects our view of its relatively strong profitability and efficiency. Banks benefit from their key role in the intermediation of Spain's savings and credit, modest competition from nonbank players, and high barriers to entry. But we also took into account the competitive distortions created by savings banks during the boom, as they expanded aggressively outside their home regions. In our view, the ongoing restructuring of the savings bank segment is a step forward toward reducing these competitive distortions in the future.

The primarily retail-funded profile of Spanish banks and our view of depositors' high confidence in the system supports our view of Spain's systemwide funding. Recourse to foreign wholesale funding, however, increased meaningfully during the credit boom, compared to other financial systems, increasing the vulnerability of Spanish institutions to shifts in investor confidence. Both the European Central Bank and the Spanish government have proved supportive during the liquidity crunch, something that we view as a positive factor in our overall assessment of systemwide funding.

Sweden

- The preliminary BICRA for Sweden is BICRA group 1 under the proposed criteria, the same as under the current criteria.
- Primary credit analyst: Louise Lundberg
- Secondary credit analyst: Alexander Ekbom

Economic risk. The preliminary economic risk score for Sweden is 1. This score takes into account our view of Sweden's economic stability and resilience and its credit risk in the economy as "very low risk" and our view of Sweden's economic imbalances as "low risk."

In our view, Swedish banks benefit from operating in a stable economic and political environment. The Swedish economy, in our view, is highly competitive, diverse, and resilient. The large degree of fiscal and monetary policy flexibility, as well as the high rating on the Kingdom of Sweden (AAA/Stable/A-1+) support this stability.

We have seen no apparent indications that imbalances are building up. The moderate rises in real housing prices (annual average rise of 5.1% over the past four years) and in private sector credit (annual average of 6.0 percentage points of GDP over the past four years) are largely underpinned by demographic and structural factors. On the external side, Sweden has posted sizable current account surpluses for more than a decade, and we expect this situation to continue.

Our view of credit risk in Sweden's economy is supported by conservative lending practices and underwriting standards. Swedish banks do not offer products such as buy-to-let or subprime mortgages; all lending is "prime." Banks also benefit from a very strong payment culture and legal framework. Although real GDP declined by a sizable 5.1% in 2009, hitting the manufacturing and export sectors in particular, loan loss provisions rose to a minimal 17 bps in 2009 and have declined significantly since. Moreover, both the corporate and households sectors have generally maintained a relatively strong financial position.

Industry risk. The preliminary industry risk score for Sweden is 2. This score takes into account our view of Sweden's institutional framework, competitive dynamics, and systemwide funding as "low risk."

Our assessment of the institutional framework reflects our view of Sweden's conservative regulatory standards, the very strong track record of the regulators in dealing with past crises, and Sweden's high transparency and sound governance. The Swedish Financial Supervisory Authority could, in our view, have taken more proactive measures during the aggressive expansion by some of the Swedish banks into the Baltic states, but the authorities undertook appropriate and speedy measures during the 2008-2009 global crisis.

Four banks dominate the market, which supports our view of competitive dynamics and industry stability. The relatively narrow margins encouraged some of the banks to expand into riskier markets (The Baltics, Ukraine, and Russia). The profitability of domestic operations is, however, sound on a risk-adjusted basis and banking practices within Sweden have remained conservative. There are no particular market distortions affecting the sector.

In our opinion, systemwide funding in Sweden benefits from the deep and liquid domestic bond market, including mortgage-backed bonds, which covers about 31% of lending. It remained open and functioned well throughout the recent financial crisis. This largely compensates for the relatively low share of core customer deposits to lending (37%). That said, the banking sector has moderate reliance on cross-border funding, partly related to the structure of the Nordic banking sector. We are of the view that the Swedish authorities' proven capacity and propensity to support the sector when needed mitigates this relative dependence on external funding.

Switzerland

- The preliminary BICRA for Switzerland is BICRA group 1 under the proposed criteria, the same as under the current criteria.
- Primary credit analyst: Dirk Heise
- Secondary credit analyst: Markus Schmaus

Economic risk. The preliminary economic risk score for Switzerland is 1. This score takes into account our view of Switzerland's economic stability and resilience, economic imbalances, and credit risk in the economy as "very low risk."

We are of the view that the Swiss economy is highly diversified and competitive, with a high degree of market orientation. It benefits from stable past and projected GDP growth, which has strengthened its resilience to adverse external influences, including the global recession in 2009. Its GDP per capita (US$64,000 in 2009) is among the highest worldwide, and unemployment and inflation are both consistently low. The government's finances are robust, underpinned by a stable and predictable political environment, even though the consensus-driven political system sometimes slows down decision making.

Although we have observed a slight increase in housing prices over the past years, the increase was smaller than in other Western European countries, many of which experienced an excessive residential or commercial real estate boom over the past decade. Switzerland experienced moderate loan growth over the same period. It has maintained a strong external creditor position over the past decade with sustained current account surpluses.

Swiss banks demonstrated a conservative risk and lending culture throughout most of the domestic banking system. They maintained fairly low loan-to-value ratios, low delinquencies, and historically conservative risk provisioning. That said, based on the recession in Switzerland in 2009 and the consequent increase in corporate bankruptcies, we believe that the level of domestic nonperforming loans and associated credit costs reached its cyclical peak at the end of 2010. As a result, Swiss banks have not experienced major domestic risk costs during 2009 and 2010.

Industry risk. The preliminary industry risk score for Switzerland is 2. This score takes into account our view of Switzerland's institutional framework and competitive dynamics as "low risk," and our view of its systemwide funding as "very low risk."

In our view, Swiss banks were subject to stricter regulatory standards than those in other countries before the global financial crisis of 2008-2009. For instance, Swiss regulators added a 20% surcharge to the minimal capital standard in force under Basel II. Nevertheless, we note that Swiss regulators did not curb the aggressive global expansion by UBS AG and Credit Suisse Group AG (CSG), especially into structured products, during the 2000s. That said, we are of the view that the regulators' swift and pragmatic response to problems at UBS was broadly successful. We consider that Switzerland (aided by its independent status) addressed its previous regulatory inefficiencies in a timelier manner than its neighboring EU countries. The most notable new regulation is to require large and systemically important banks--i.e., UBS and CSG--to meet much stricter minimal capital requirements (for example, total capital to regulatory risk assets of 19%) by 2018.

The Swiss financial sector has a unique structure: CSG and UBS have global corporate, private, and investment banking businesses, while most other domestic banks focus on the Swiss commercial banking market or the European wealth management segment. In our opinion, Swiss banks have maintained their credit standards in recent years, thanks to sound earnings in core products. Although the international wealth management industry is under pressure due to national legislation and international agreements to curtail tax evasion, the continued strong brand of Swiss private banking seems to have enabled Swiss banks to protect their franchises.

In our view, the very low funding risk is supported by the high level and very stable systemwide customer deposit base, diversified funding sources, and the deep domestic capital markets.

Taiwan

- The preliminary BICRA for Taiwan is BICRA group 3 under the proposed criteria, compared with BICRA group 4 under the current criteria.
- Primary credit analyst: Eunice Fan
- Secondary credit analyst: Chris Lee

Economic risk. The preliminary economic risk score for Taiwan (AA-/Stable/A-1+) is 3. This score takes into account our view of Taiwan's economic stability and resilience and of credit risk in the economy as "intermediate risk," and our view of Taiwan's economic imbalances as "low risk."

Taiwan has moderately stable economic growth supported by a dynamic and entrepreneurial private sector and the government's flexible economic policies. These, in our view, help to mitigate the potential impact of external shocks to Taiwan's export-oriented economy. The average GDP growth over the past 10 years was 3%-4% with a moderate volatility. The inflation rate has been kept low and the political environment is generally stable.

Our assessment of Taiwan's economic imbalances is supported by what we view as its government's very strong current account and external asset positions, coupled with the moderate rise in house prices and low rise credit growth in recent years. We are of the view that the medium-term potential for a disorderly correction in assets process is low.

Our opinion of the credit risk in the economy is based on Taiwan banks' adequate lending practices and underwriting standards, as well as the country's moderately strong legal framework. These help to mitigate potential risks from an intermediate level of private sector indebtedness. Domestic credit to the private sector and nonfinancial public sector enterprises measured 144% of GDP at year-end 2009; we project this ratio will remain flat over the medium term. Private sector debt is not overly concentrated in cyclical industries, in our opinion. Underwriting standards are generally adequate.

Industry risk. The preliminary industry risk score for Taiwan is 4. This score takes into account our view of Taiwan's institutional framework as "intermediate risk," our view of its competitive dynamics as "high risk," and our view of systemwide funding as "low risk."

Our assessment of Taiwan's institutional framework is based on our view of its adequate regulatory standards, moderately good regulatory track records in managing financial crisis, adequate corporate governance, and satisfactory transparency of the system. We expect Taiwan's regulator to continue to be proactive, conduct timely and effective regulation, and provide support to the banking system under its commitment to maintain system stability.

We are of the view that Taiwan's banking industry is vulnerable to material changes in the competitive structure because of the industry's fragmented structure and relatively high overcapacity. Relatively weak systemwide preprovision earning capacity offers little cushion to absorb losses in a downturn. Moreover, the presence of government-owned banks is significant and in our view leads to competitive distortions in the pricing of certain key products. On the positive side, the industry's decreased risk appetite could buffer the banks against heightened competitive pressures. Moreover, the use of risky or complex banking products in Taiwan appears limited.

In our opinion, systemwide funding in Taiwan is stable and diversified. In addition to a high proportion of retail customer deposits, the banks also fund themselves in the domestic capital markets. The system's low use of cross-border funding makes it less vulnerable to risks of contagion during periods of turbulence in the global capital markets. In our view, the government has a satisfactory track record of providing guarantees and liquidity support during periods of market turmoil.

Turkey

- The preliminary BICRA for Turkey is BICRA group 6 under the proposed criteria, the same as under the current criteria.
- Primary credit analyst: Goeksenin Karagoez
- Secondary credit analyst: Magar Kouyoumdijan

Economic risk. The preliminary economic risk score for Turkey is 7. This score takes into account our view of Turkey's economic stability and resilience, economic imbalances, and credit risk in the economy as "high risk."

Over the past two decades, Turkey's economic growth has been volatile and hampered by political instabilities. Inflation is higher than that of most peer countries, and the export-oriented private sector is vulnerable to the economic growth and export demand of external markets. In our view, the economy and the banking industry remain vulnerable to capital flows and a potential devaluation of the Turkish lira.

Our assessment of economic imbalances reflects Turkey's volatile equity market, as well as its structural imbalances, which also drive our 'BB' foreign currency rating on Turkey. Recurrent current account deficits suggest that the economy depends on portfolio flows, FDI, and cross-border borrowings. At an average 80% of current account receipts over the past four years, we view Turkey's net external debt as relatively high.

The high proportion of foreign currency lending in Turkey and its relatively weak legal system influenced our assessment of credit risk in the economy. Although banks can offer foreign-currency-denominated loans only to companies with revenues in hard currencies, the open foreign-currency position carried by such companies constitutes an indirect credit risk for banks. Turkey's low household and corporate leverage, diversified loan books with little exposure to cyclical sectors, and relatively short-term duration of loans to enterprises are aspects that mitigate credit risks to some degree.

Industry risk. The preliminary industry risk score for Turkey is 5. This score takes into account our view of Turkey's institutional framework and competitive dynamics as "intermediate risk," and our view of Turkey's systemwide funding as "high risk."

Our assessment of Turkey's institutional framework takes into account improvements in the regulator's track record, systemwide transparency, and corporate governance practices across the system. The improvements came after a period of what we view as regulatory underperformance and repeatedcases of risky intergroup lending, in which a group's banking member would lend to the same group's industrial interests on an uneconomic basis. Many problem banks (one-third of the total number of banks) were closed over the past decade, thus purging the sector of some of its most serious abuses.

Our assessment of Turkey's competitive dynamics is supported by what we view as an appropriate system of risk pricing by banks that leads to good risk-reward dynamics. The industry has largely stabilized, in our view; several large players now dominate the market. State banks still account for about a quarter of the market. There appears to be no market distortion from nonbank institutions in Turkey, and we are of the view that the industry has adapted well to the entry of foreign banks as owners during the last decade.

Our assessment of systemwide funding reflects our view of the relative lack of term funds in the domestic market, the industry's significant borrowing in foreign currency, and the underdeveloped status of the domestic debt markets. The recent rapid expansion of mortgage loans over the past three years has led to an increase in maturity mismatches. On a more positive note, core customer deposits are growing; they funded 60% of the system's assets at year-end 2009. Most foreign currency-denominated deposits are from residents--Turkish banks' cross-border borrowing is relatively limited. In our view, Turkey has a well-functioning guarantee scheme for savings deposits. The banking regulator recently granted banks permission to issue domestic bonds--this may improve the liquidity of Turkish banks in the longer term.

U.K.

- The preliminary BICRA for the U.K. is BICRA group 3 under the proposed criteria, the same as under the current criteria.
- Primary credit analyst: Nigel Greenwood
- Secondary credit analyst: Peter Dutton

Economic risk. The preliminary economic risk score for the U.K. (AAA/Stable/A-1+) is 4. This score takes into account our view of the U.K.'s economic stability and resilience as "very low risk," our view of its economic imbalances as "intermediate risk," and our view of credit risk in the U.K. economy as "high risk."

In our view, U.K. banks benefit from operating in a stable economic and political environment. The economy is competitive, diverse, and adaptable. The independent monetary policy, flexible exchange rate regime, and the role of sterling as an important reserve currency support this stability.

The assessment of economic imbalances reflects our view of the U.K.'s track record of asset price volatility and periods of high credit growth. Between mid-2007 and mid-2009, U.K. house prices on average fell by 20%, while commercial property prices fell by 45% over a similar period. Since then, prices have recovered somewhat, but we expect volatility to persist. Further, the 8% average growth in domestic credit to GDP over the past four years is high, though we note that credit balances are now falling. On the external side, the average current account deficit to GDP has been a modest 1.7% over the past four years.

Our assessment of credit risk in the economy reflects our view of the very high leverage of households and high leverage of companies. Domestic credit to GDP is forecast to remain very high at 200% in 2011. Household debt to gross disposable income has fallen to a still-high 150% today from a peak of 161% in 2007; we do not expect this metric to improve quickly. We also consider that U.K. banks typically demonstrate higher-risk lending and underwriting standards than comparable banking systems. An offsetting factor is the strength of the payment culture.

Industry risk. The preliminary industry risk score for the U.K. is 3. This score takes into account our view of the U.K.'s institutional framework and competitive dynamics as "intermediate risk," and our view of its systemwide funding as "low risk."

Our assessment of the U.K.'s institutional framework is influenced by our view of the number of high-profile near-failures in the U.K. banking system during the 2007 to 2009 period. We see evidence of improved regulatory standards and coverage, but note that a major shake-up of the regulatory framework is underway. Governance and transparency is deemed a supportive factor.

Our assessment of competitive dynamics reflects our view that there is an above-average risk appetite in the banking system, which is not compensated for by superior earnings metrics. We do not consider that part-ownership by the government of two of the four major banking groups has distorted the market. However, the Independent Banking Commission is due to report to the government in 2011 on competition in retail banking and whether investment banking operations should be split from retail and commercial banking. Its report may influence the competitive environment.

Our assessment of systemwide funding reflects the high diversification and relative stability of funding sources of the U.K. banking industry. This, in our opinion, is due to the good depth and breadth of the sterling market and role of the City of London as a global financial center. U.K. authorities eventually demonstrated leadership and effectiveness in the difficult period of 2008 and 2009. Several U.K. banking groups are, however, still in the process of addressing sizable funding gaps.

U.S.

- The preliminary BICRA for the U.S. is BICRA group 3 under the proposed criteria, the same as under the current criteria.
- Primary credit analyst: Rodrigo Quintanilla
- Secondary credit analyst: Devi Aurora

Economic risk. The preliminary economic risk score for the U.S. is 4. This score takes into account our view of the U.S.'s economic stability and resilience as "very low risk," our view of its economic imbalances as "intermediate risk," and our view of its credit risk as "high risk."

When assessing economic stability, we take account of the U.S.'s highly competitive, resilient, and diverse economy, which has exceptionally flexible labor markets. Its emergence from the deepest recession in 80 years is being accompanied by a number of key adjustments. In particular, households are lowering leverage and raising savings, which in our view places the economy on a more sustainable path. The U.S. benefits from the dollar's standing as the most important global reserve currency, which in our view mitigates the U.S.'s external deficit and leads to minimal foreign-currency funding of the banking system.

Our assessment of economic imbalances reflects our view of the U.S.'s large and long-running current account deficit, as well as continued fragility in real estate due to the ongoing impact of the unwinding of the real estate boom of 2000-2006. Real house prices declined by 5.8% in 2009 and 6.7% as of the second quarter of 2010, according to data from the OECD. In nominal terms, house prices based on the Federal Housing Finance Agency index fell by an estimated 3.4% in 2010. The pace of decline in 2011 should, in our view, remain moderate given that the housing correction started in mid-2006.

Credit risk in the economy is affected, in our view, by embedded losses in the financial system, which have been very high as a result of lax underwriting standards, new financial products that multiplied leverage, and a legal framework that tends to benefit borrowers. Loan-to-value ratios were generally aggressive across real estate asset classes. Even though credit losses have since declined and the leverage profile of households and companies has improved, absolute leverage is still high and concerns remain, given the sluggish economic recovery.

Industry risk. The preliminary industry risk score for the U.S. is 3. This score takes into account our view of the U.S.'s institutional framework and competitive dynamics as "intermediate risk" and our view of the U.S.'s systemwide funding as "very low risk."

Having failed to prevent the banking crisis, the regulatory framework is being reshaped under the recently enacted Dodd–Frank Wall Street Reform and Consumer Protection Act, the details of which are still being analyzed. Financial institutions are adjusting their lending practices and underwriting standards under intense regulatory scrutiny. The Dodd-Frank legislation seeks to reduce regulatory arbitrage by increasing coverage, proposing new limits on activities of systemically important institutions, and calling for the establishment of a systemic risk regulator.

In our view, the financial sector's structure is relatively open and dynamic, with a large number of competitors, bank and nonbank, domestic and foreign. This promotes efficiency and innovation, but also leads to aggressive commercial products and practices that amplify the highs and lows of credit cycles. The top three banks control 38% of total commercial bank assets and the top 10 banks 59%, indicating that smaller banks have limited impact on the sector's performance and overall risk profile. Nonbanks remain significant players in the financial landscape, even though their market share of total assets has decreased to 30% from a peak of 39% in 2007, and we expect it to diminish further going forward.

Systemwide funding in the U.S. benefits from a relatively high and stable share of core retail deposits (51% of systemwide liabilities at year-end 2009) and a wide variety of funding sources, thanks to exceptional depth in the capital markets. The U.S. financial system is a diverse, efficient intermediator of funds and allocator of investments. Domestic debt markets are deep and liquid, and financial institutions' debt securities (i.e., excluding commercial paper issuance) cover about 47% of banks' liabilities.

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