

‘Stress Tests’ Signal New Phase to Bank Recapitalization

The government released the results of its long-awaited financial “stress tests” of 19 large U.S. bank holding companies on May 7. The government’s Supervisory Capital Assessment Program (SCAP) will require that ten banks raise a total of \$74.6 billion of common equity Tier 1 capital. The ten banks that must raise capital and the nine that passed the test with no requirement to raise further capital are listed in the table below.

Do Not Need Capital	Capital Actions Announced or Completed	
American Express (AXP)	No plans announced	
BB&T (BBT) ¹	Announced ~\$1.5 bn equity raise, cut common dividend; announced intention to repay \$3.1 bn TARP preferred	
Bank of New York Mellon (BK) ¹	Raised \$1.2 bn in equity; announced intention to repay \$3 bn TARP preferred	
Capital One Financial (COF)	Announced ~\$1.6 bn equity raise; announced intention to repay \$3.55 bn TARP preferred	
Goldman Sachs Group (GS) ¹	Raised \$5.75 bn in equity; announced intention to repay \$10 bn TARP preferred	
JP Morgan Chase (JPM) ¹	No plans announced, but has announced desire to repay \$25 bn TARP preferred	
MetLife (MET)	No plans announced	
State Street Bank & Trust (STT)	No plans announced	
U.S. Bancorp (USB)	Announced ~\$2.5bn equity raise plus \$1 bn non-guaranteed debt; announced intention to repay \$6.6 bn TARP preferred	
Need Capital	Amount (\$ billion)	Capital Actions Announced or Completed
Bank of America (BAC) ¹	33.9	Announced intent to raise required capital via asset sales, at-the-market sales of common equity, and preferred-to-common exchanges
Citigroup (C)	5.5 ²	Expand preferred-to-common exchange offer
Fifth Third Bancorp (FITB)	1.1	Plans not yet announced
GMAC LLC	11.5	Plans not yet announced
KeyCorp (KEY)	1.8	Announced plans to raise ~\$750 mn common equity
Morgan Stanley (MS) ¹	1.8	Raised \$4 bn in common equity
PNC Financial Services (PNC)	0.6	Plans not yet announced
Regions Financial (RF)	2.5	Plans not yet announced
SunTrust (STI)	2.2	Plans not yet announced
Wells Fargo (WFC)	13.7	Raised \$8.6 bn in common equity

¹ These banks have recently issued non-government-guaranteed debt, a prerequisite to paying off TARP preferred. Source: Bloomberg.

² In addition to previously announced preferred exchange and other capital actions of \$58.1 bn.

We think that there are two critical aspects to the SCAP. First, the tests themselves are credible. As with any attempt to project potential losses at banks, the tests rely on information about the assets being tested and assumptions regarding future loss rates, earnings, and other unknowns. Many market participants, including ourselves, have made similar estimates. What distinguishes the SCAP analysis from others, however, is that the tests were based on highly detailed data from the individual banks that is simply not available to others. This information allowed regulators to make comparisons across institutions and to apply assumptions consistently.

In addition, the loss rates used in the “adverse scenario,” which drove the requirements for additional capital, are severe. For loans, the aggregate two-year loss rates used in the analysis slightly exceeded the worst two-year loss experience in the Great Depression. For securities and other trading exposures, the tests assumed a repeat (in percentage terms) of the losses banks experienced on those assets in the second half of 2008. While it is possible that losses run higher than these severe experiences, we think it is quite unlikely. Similarly, assumptions about bank earning power appear conservative, especially in light of strong pre-provision earnings in the first quarter of this year.

Some commentators complain that the SCAP tests are simply another opinion on potential bank losses. That is true, but it also is a very well-informed opinion, taking advantage of the best data set available and applying stressful assumptions to the projections. We think the results of the tests are credible and provide useful – and reassuring – information to the market.

The second critical element of the SCAP is that it requires the 10 banks that “failed” the stress scenario to raise not just Tier 1 capital but *common equity* capital,¹ and the amounts are manageable. We think that – with the likely exception of GMAC – each of the banks that must raise capital can do so without tapping the government’s Capital Assistance Program. Already, Morgan Stanley has raised its entire mandatory capital buffer and Wells Fargo raised more than 60% of its required buffer, both by issuing common equity. Keycorp also announced plans to issue common equity. To meet its requirement, Citigroup will increase the size of its previously announced preferred exchange; given where Citigroup’s common stock is trading currently, investors who exchange will receive common stock worth even more than the par value of the preferreds! The remaining banks should be able to meet their capital requirements through a combination of equity issuance, asset sales, and private preferred exchanges. Although not all exchanges will turn out as well for preferreds as the Citigroup exchange, we expect that preferred exchanges will occur at a premium to market prices.

The new emphasis on common equity capital arising from the SCAP is generally beneficial for preferred securities, since common equity is the main layer of capital supporting preferreds.² However, we must think carefully about the impact of this shift in regulatory preferences on types of preferreds issued by each bank. For example:

- For banks that need SCAP capital and raise common equity, both common equity and Tier 1 capital will increase. That is good for all classes of preferred securities.

¹ Tier 1 capital is comprised of common equity (including retained earnings), preferred stock, qualifying preferred securities, and certain other items in limited amounts. Troubled Asset Relief Program (TARP) preferreds generally are equal in seniority to and included in preferred stock.

² Of course, preferred capital varies in its capital priority as well. For example, preferred stock eligible for the dividends-received deduction (DRD) is junior to taxable preferreds (e.g. trust preferred) in payment and liquidation, though both comprise Tier 1 capital. Common equity is junior to both DRD and taxable preferred securities.

- For banks that do not need SCAP capital but raise common equity to repay TARP preferred, common equity capital increases but Tier 1 capital decreases if the amount of common equity raised is less than the amount of TARP preferred repaid.³ In such cases, DRD preferreds benefit from more common equity, but taxable preferreds suffer from the net reduction in more-junior capital (since TARP preferreds typically are junior to taxable preferreds).

Nothing about this phase of the recapitalization process is going to be standardized or simple!

We think the results of the SCAP – both the message that banks should be able to survive the recession and the requirement to raise additional capital – should put to rest the market’s fears of widespread nationalization of the largest U.S. banks. We are not suggesting that banks’ troubles are over. The economy is still in recession, and loan losses are likely to continue to rise for at least several more quarters. In addition, the SCAP did not examine banks with assets below \$100 billion, many of which have preferred securities outstanding, although we expect that many of the insights gained from conducting the stress tests will inform future examinations of those smaller banks.

Looking ahead, we think that the preferred securities market should now begin to discriminate more finely between stronger and weaker institutions as it moves away from the “all banks are insolvent” mania that gripped the market in February and March. We believe that favors our fundamental, credit-oriented approach to the preferred market. We fully anticipate more twists and turns as this financial crisis unfolds and ultimately is resolved, and we continue to see abundant opportunity in the preferred securities market for patient long-term investors.

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³ On May 11, 2009, three banks (BBT, BK and COF) announced plans to issue common stock and repay TARP preferred, subject to regulatory approval. Earlier in May, GS issued common stock and announced its desire to repay TARP preferred. JPM has announced the same desire, though it has not issued common stock. In each of these cases, common equity raised (assuming sales amounts are as planned) is less than the amount of TARP preferred to be repaid.