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The U.S. Federal Reserve's Stress Test Results: The Beginning Of The End Or The End Of The Beginning For U.S. Banks?

Primary Credit Analyst:
Tanya Azarchs, New York (1) 212-438-7365; tanya_azarchs@standardandpoors.com

Secondary Credit Analyst:
Rodrigo Quintanilla, New York (1) 212-438-3090; rodrigo_quintanilla@standardandpoors.com

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The U.S. Federal Reserve's Stress Test Results: The Beginning Of The End Or The End Of The Beginning For U.S. Banks?

The much-anticipated results of the stress-testing exercise the Federal Reserve Bank (Fed) undertook for the top banks in the U.S. came out on May 7, 2009. These show that 10 of the 19 largest banks need a total of $75 billion in capital to maintain at least 4% of common equity Tier 1 capital if the environment becomes a lot more adverse than experts currently expect.

This compares to Standard & Poor's Ratings Services' assessment of an $18 billion need for these 19 banks. Despite the significantly higher capital requirements determined by the Fed's stress tests as compared to our stress tests, we do not see this as an unmanageable amount, and most management teams of the identified banks promptly issued statements about how they would raise the capital.

If the rigor of the stress-testing process succeeds in allaying market uncertainties about bank solvency, we believe it could set the stage for the rehabilitation of the banking industry, which may include a return to funding itself without the need of government backing. We do not think that means the industry will return to robust profitability anytime soon. If nothing else, our stress tests show that loan losses will weigh heavily on earnings. In fact, we estimate that the industry's pretax profit margin will be a negative 40% in 2009.

We will be incorporating our own stress tests and any insights gleaned from the Fed's (particularly regarding capital raising) into our rating actions on U.S. banks during the next several weeks. The additional equity capital raised is a positive development for the banks, and we intend to take such additional capital into consideration in our rating decisions for banks that are on CreditWatch Negative (see "Ratings On 23 Financial Institutions Placed On CreditWatch Negative," published May 4, 2009, on RatingsDirect).

On May 4, 2009, we placed 22 banks on CreditWatch in view of rising industry risk due to loan losses that our stress tests demonstrated. Overall, the ease or difficulty with which companies can raise that capital and wean themselves of government support could also play a role in our rating decisions.

Table 1

Supervisory Capital Assessment Program Results

Company	Rating	Government support uplift	Capital needed (Bil. $)	Capital need (% of risk-weighted assets)
Bank of America Corp.	A/Stable/A-1	3 notches	33.9	2.00
Wells Fargo & Co.	AA/Watch Neg/A-1+	N.M.	13.7	1.30
GMAC LLC	CCC/Negative/C	N.M.	11.5	6.70
Citigroup Inc.	A/Stable/A-1	4 notches	5.5	0.60
Regions Financial Corp.	A/Watch Neg/A-1	N.M.	2.5	2.10
SunTrust Bank	BBB+/Negative/--	N.M.	2.2	1.40
Morgan Stanley	A/Negative/A-1	3 notches	1.8	0.60
KeyCorp	A-/Watch Neg/A-2	N.M.	1.8	1.70
Fifth Third Bancorp	A-/Watch Neg/A-2	N.M.	1.1	1.00

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Table 1

Supervisory Capital Assessment Program Results (cont.)				
PNC Financial Services Group	A/Watch Neg/A-1	N.M.	0.6	0.20

N.M.-Not meaningful.

Comparing The Fed's Test With Standard & Poor's

We also use stress testing to determine credit and earnings risks, and assess capital adequacy. We have a base scenario and a more adverse stressed scenario, though we seek to incorporate only the base scenario into our ratings, whereas the Fed based its capital requirements on its more adverse scenario. In comparing our results to the regulators', the final capital requirements were not very different from ours considering that we did not include trading account losses in our estimates. Thus, we identified a need for an additional $18 billion of capital for these banks, versus the Fed's $74 billion, which included losses of $99 billion on trading securities. Although we did not incorporate losses on trading securities into our stress test methodology, we consider that potential in our assessment of capital adequacy as this relates to ratings.

The loss assumptions by loan category for the Fed's adverse case were generally in line with our stress case, with notable exceptions in the residential mortgage and multifamily categories, where the Fed assumes higher loss rates than we do, and the credit card category, where they assume lower ones. Our loss assumptions represent our expectations for the universe of rated banks. We will adjust these loss assumptions to reflect variations in the mix of the banks' portfolios, which could result in substantial differences.

Particularly in the residential mortgage area, the experience to date has been very varied, as evidenced by the quarterly loss rates we are currently tracking for these banks. We believe that we can learn from the deviation of the loss rates reported in each loan category for each bank in the Fed stress-test results. We presume that banks that report higher loss assumptions in any particular category are holding a riskier mix of assets.

Table 2

Two-Year Loss-Assumption Comparisons

Loan category (%)	S&P base case	S&P stress case	Regulatory baseline	Regulatory more adverse	Adverse-case bank results
Residential mortgage	4	6	5 to 6	7 to 8.5	8.8
Home equity	8	14	9 to 12	12 to 16	13.8
Construction & land	16	20	8 to 12	15 to 18	N.A.
Multifamily	4	6	3.5 to 6.5	10 to 11	N.A.
Commercial mortgage	8	14	4 to 5	7 to 9	N.A.
Commercial & industrial	5	7	3 to 4	5 to 8	6.1
Other consumer	10	15	4 to 6	8 to 12	N.A.
Credit cards	18	26	12 to 17	18 to 20	22.5
Other loans	6	9	2 to 4	4 to 10	N.A.

N.A.-Not available.

On balance, the Fed's adverse-case loan losses were $465 billion for two years, falling between our base case of $320 billion and stressed case of $465 billion.

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Table 3

Stress-Test Results For The 19 Large Banks			
(Bil. $)	**S&P base**	**S&P stress**	**Regulatory adverse**
Preprovision income	412	412	N.A.
Reserve build	88	183	N.A.
Resources to absorb losses	324	229	363
Credit losses	383	560	465
Purchase accounting adjustments	54	54	64
Securities losses (HTM and AFL)	35	54	35
Trading and counterparty losses	N.A.	N.A.	99
Capital shortfall	18	141	75

N.A.-Not available.

Besides the losses, the Fed considered, as we do, the earnings available to cover losses through pretax, preprovision earnings. The Fed, however, did not break out its assumptions for preprovision income. Instead, it reported what it termed "resources other than capital to absorb losses," which netted out reserve-building requirements. On this measure, our base case results were similar to the Fed's, but we believe that its preprovision income was lower, offset by lower reserving requirements. The difference is that we focused on the more immediate need to build reserves to cover expected 2010 losses, whereas the Fed focused on reserve adequacy to cover presumably reduced levels of losses in 2011.

Banks' Reactions To The Stress-Test Results

Some banks quickly announced plans to raise common equity capital to meet the Fed's expected capital shortfall. Morgan Stanley immediately sold $4 billion of common equity, and Wells Fargo announced plans to raise $6 billion. Bank of America said it would raise $17 billion in a combination of new common equity issuance and privately held preferred stock conversions. Citigroup simply increased its offer to convert preferred stock by $5.5 billion.

Asset sales are another way to raise equity. Bank of America indicated it could generate $10 billion in this fashion. Keycorp said it would raise $750 million. Banks also expressed their confidence that their preprovision earnings would be higher than the Fed estimated. The difference between that estimate and actual earnings through Nov. 9 this year can be used to satisfy the equity requirement. Wells Fargo and Bank of America believe they can raise $7 billion and $7.7 billion, respectively, in this fashion.

The other banks announced no definitive plans but mentioned all of the above options. Interestingly, none but GMAC mentioned considering taking additional capital from the government. Another way in which banks can maintain capital requirements is by shrinking their loan portfolios. Although the Fed assumed none, the reality may well be that there is shrinkage as demand wanes in a poor economy.

Completion of the stress tests clears the way for banks to move toward redeeming the preferred stock purchased by the U.S. government under the Troubled Asset Relief Program (TARP). Banks that were not required to raise additional capital are clearly preparing themselves. Goldman Sachs earlier raised $5 billion in common equity intended partly to fund repurchase of its $10 billion of TARP preferred. US Bancorp is raising $2 billion with the same aim. BB&T is issuing $1.5 billion. JPMorgan and others are also issuing debt without the government

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guarantee to prove they no longer need government support, another requirement for regulatory permission to repurchase TARP preferred.

Others for whom no capital need was identified--American Express, Bank of New York, Capital One Financial, and State Street--could well look to follow suit. In assessing the credit implications of companies repaying their TARP preferred stock, we will consider the affect on the company's capitalization pro forma for the refinancing--taking account both of regulatory Tier 1 capital ratios (which have included the TARP preferred stock without limits) and our adjusted total equity-based capital ratios, which have not included the TARP preferred, given our view that companies would seek to redeem it at the first opportunity--a view that is now being born out in a number of cases (see "Equity Content Assessment Of TARP Preferred Stock Issues Revised Following Changes Under The Stimulus Act," published Feb. 20, 2009, on RatingsDirect). We will also consider how the redemption affects liquidity. In addition, we will consider whether the company is seeking to repurchase the warrants that were issued to the U.S. Treasury in conjunction with the issuance of the TARP preferred.

A Stabilizing Message From Banking Regulators

Following discussions with banking regulators regarding the Fed's stress tests and future government support, we affirmed our counterparty credit ratings on Citigroup (A/Stable/A-1) and Bank of America (A/Stable/A-1). We lowered our stand-alone assessment of Bank of America to reflect three notches of uplift due to our expectation for government support if needed. The remaining 21 banks on CreditWatch Negative are either not systemically important or do not need government support, in our view. Thus, our ratings on these banks do not benefit from any uplift relative to their stand-alone credit profiles.

The renewed access to capital demonstrated in the capital raises underway as this article goes to press appears to be a positive sign for banks after the long period of distinct market aversion for bank paper.

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