



A Tale of Two Financial Institutions – Bank of America and Citigroup

The Financial Markets wait with abated breath for May 7th 2009. This is the day or around the day when the results of the stress tests that were done over the last couple of months on 19 of the largest US banks will be released to the public. The aim of the stress test was to give an indication of how much additional capital would be needed to cushion banks against potential future losses should economic conditions worsen. Under a pessimistic scenario, the Fed used an unemployment rate of 10.3% in 2010, a contraction in the US economy of 3.3% in 2009 and a 0.5% growth in 2010.

Prior to the final results being released, preliminary results show that two major banks, Bank of America and Citibank would need to raise additional capital. While the actual figures aren't known estimates vary from one analyst to another. For example, Chris Kotowski at Oppenheimer estimates that Bank of America would need about \$36 billion, while Paul Miller an analyst at Friedman, Billings, Ramsey Group Inc. (FBR) estimates that BofA would need about \$60 - \$70 billion to maintain an equity ratio above 3% at the end of 2010. This is based on FBR's own stress test that used a projected unemployment rate of 12% or 1.7% higher than the Fed. In addition to that, the Fed would have taken a closer look at off-balance sheet items which they say is like a wild card in any such examination. Despite the variations in estimates, it is apparent that both banks need additional capital despite the fact that they each would have already received \$45 billion in TARP funds.

How can they raise additional capital?

1. Issue more shares

Given the current market condition of rising defaults on mortgage, auto and consumer loans, which has prolonged this crisis; it is difficult to source additional capital. In addition to that, investors are more cautious of where they invest. They would be unwilling to invest in companies where the probability of losses occurring would be greater should the recession worsen. Citigroup in fact, has already used this avenue last year when it issued \$3 billion in new common stock, and \$6 billion in preferred equity. A year later, the economic climate has not improved and Citi still needs additional capital. Bank of America also used this option when it acquired Countrywide Financial and Merrill Lynch. BofA spent \$4 billion for Countrywide and the Merrill Lynch deal resulted in 1.71 billion common stock and 359,100 preferred stock being issued. Do you think that investors would support another share issue for these companies at this time?

2. Convert their private and TARP preferred stock to common equity.

This would only boost their capital on paper it would not result in the company getting any additional funds. According to FBR, if BofA were to convert \$27 billion of private preferred equity it would boost their tangible common equity ratio to

about 4.3%. It would also reduce the preferred dividend expense, thus improving profitability and cash flow of the company.

On February 27, 2009, Citigroup decided to adopt this route. It converted \$27.5 billion of preference shares held by private shareholders and \$25 billion of preferred stock held by the US government into common stock. Common stock brings with it voting rights. The advantage of a conversion to these shareholders means that they will be empowered to decide who the board of directors should be, the objectives of the company and matters relating to stock splits and new share issues.

3. Sell assets

Both banks are large financial institutions with operations worldwide. The present aim of these companies should be to survive the present crises. This is why they will need to determine what the strategic direction of the company should be and divest those companies and exit those markets that don't align with its strategic objectives. Citigroup has recognized this and is in the process of selling its Japanese brokerage unit, Nikko Cordial to Sumitomo Mitsui Financial Group Inc. for 500 billion yen (\$5.2 billion).

4. Seek more funding from the US government

This route is seen as a last recourse. This is because; government funding brings with it greater regulation and restrictions to a company on matters such as how these funds should be spent, payment terms and even the compensation levels of executives. The fact that such restrictions would severely limit management control on such day-to-day matters would be a major drawback for any bank trying to survive let alone compete.

It can be anticipated that Bank of America and Citigroup would be able to convince the government that they made an error in their stress test so that by the time the final results are released they will not be forced to raise additional capital. If they fail, they would have to adopt one or more of the above stated measures to ensure their continued existence and raise many more questions on their ability to compete in a significantly different environment.

Table 1: Regional Market Performance (as at 1 May 2009)

Index	Closing Value	Weekly Change (%)	Monthly Change (%)	YTD Change (%)	1 Year Change (%)
TTSE Composite	805.63	-0.37	-1.68	-4.43	-25.02
All Trinidad	1,101.97	-0.07	-1.77	-4.57	-20.40
JSE Index	79,714.41	1.11	1.57	-0.55	-26.79
JSE Select	1,696.84	3.37	3.79	-14.51	-43.30
All Jamaica	62,639.63	2.65	1.87	-15.35	-42.78
BSE Composite	873.75	-0.06	-0.01	-5.01	-15.19

Table 2: International Market Performance (as at 1 May 2009)

Index	Closing Value	Weekly Change (%)	Monthly Change (%)	YTD Change (%)	1 Year Change (%)
S&P 500	877.52	1.30	8.19	-2.85	-37.74
Nasdaq Composite	1,719.20	1.47	10.80	9.02	-30.70
Dow Jones Industrial	8,212.41	1.69	5.81	-6.43	-36.88
German Dax	4,769.45	2.04	15.45	-0.85	-31.36
FTSE 100	4,243.71	2.11	7.28	-4.30	-30.29
Nikkei 225	8,828.26	1.38	5.70	0.93	-35.87
Hang Seng	15,520.99	1.72	14.80	7.88	-39.74
DJ Eurostoxx	2,375.34	2.39	13.24	-3.11	-37.90

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