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Banking Check Up – Survival of the Fittest

The basic definition of a stress test states that it is a simple form of scenario analysis typically used to assess market risk where a portfolio is subjected to severe and prolonged adverse simulated conditions indicating how much capital would be at risk under extreme conditions. The frail US financial system suffered from falling housing prices and increasing foreclosures thereby causing banks to take huge losses on mortgages and mortgage-related securities. Therefore, the political objective of the stress test for the Obama Administration is to restore investors' confidence in the Banks while assuring that the weak firms will be strengthened. They have said none of the banks will be allowed to fail.

The scenarios used to measure how the banks will perform were:

1. If unemployment rises between 8.8% and 10.3% in 2010
2. The economy grows by 2.1% and 0.5% in 2010
3. Home prices fall by 4% to 7%.

To determine a bank's capital needs, regulators looked at a host of different measures, including Tier 1 capital. The stress tests have been criticized as a confidence-building exercise whose relatively positive outcome was inevitable but information leaked has received positive acceptance from investors.

The results of the test revealed that among the 10 banks that need to raise more capital, Bank of America needs US$33.9 billion which is the highest among the banks, Wells Fargo $13.7 billion, GMAC $11.5 billion, Citigroup $5.5 billion and Morgan Stanley $1.8 billion. The five other firms found in need of a capital cushion were the regional banks such as Regions Financial Corporation, SunTrust Banks, KeyCorporation; Fifth Third Bancorp; and PNC Financial Services Group. The banks will have until 8 June to develop a plan and have it approved by their regulators. If the companies cannot raise the required funds, the government has indicated that it is prepared to dip further into its bailout fund to meet this objective. The tests found that if the recession were to worsen, losses at the 19 stress-tested firms during 2009 and 2010 could total $600 billion. Of those losses, $185.5 billion would be from mortgages, $82.4 billion from credit card loans and $53 billion from commercial real estate loans which are the loans on banks' books that analysts say are now most vulnerable to default. Together the 19 firms that took the test hold two-thirds of the assets and half the loans in the U.S. banking system.

Following the test, banks will have six months to raise private capital or accept government funds in the form of convertible preferred securities, which would acquire voting rights if converted to stock. The Treasury has used approximately half of the $700 billion allocated by Congress for rescuing the banking industry most of which was spent under former President George W. Bush.

The Treasury stated that the stress testing concept does not imply a new capital standard and it is not expected to be maintained on an ongoing basis which brings into light the utility of the existing metrics.

Under current regulations, the capital requirements of banks are based on Tier 1 and Tier 2 ratios, which measure capital to risk-weighted assets. Tier 1 is the more important of the two and consists of shareholder equity, retained profits and goodwill, minus accumulated losses. An important distinction in the current environment is that the value of the equity is not based on the current price in the market but what was originally paid to purchase the stock. A bank must have a Tier I ratio of at least 4% to be adequately capitalized and a combined Tier 1 and Tier 2 ratio of 8%. Tier 2 is a more complicated measure and essentially involves supplementary capital, consisting of five categories: undisclosed reserves, revaluation reserves, general provisions, hybrid instruments and subordinated-term debts.

The Treasury looked at another key metric in undertaking its stress test known as tangible common equity (TCE) that essentially measures the book value of common shares, excluding such intangibles as goodwill and deferred taxes. Some believe that Tier 1 is a “more favorable metric” given the devalued nature of many bank stocks. The Tier 1 ratio is also seen as advantageous because it factors in the riskiest assets.

The government's description of the test and requirements for capital recovery plans includes the following conditions:

Capital Targets: The banks are being directed to achieve capital buffers that would allow them to have a Tier 1 risk-based ratio of at least 6%, and a Tier 1 common risk-based ratio of at least 4% at the end of 2010 under the more adverse economic scenario set out by the government. The emphasis on Tier 1 common capital reflects the view that common equity is critical to absorbing losses and to protect more senior stakeholders and creditors. Any tested bank needing to boost its capital buffer will have until 8 June to develop a detailed capital-raising plan and until 9 November to implement that plan.

Management Review: The companies will have to prove that executives possess the leadership expertise and are able to keep banks' balance sheets sufficiently strong to continue prudent lending to meet the credit needs of the economy.

Capital Recovery Plans: Any bank required to boost capital will need to develop a detailed capital plan to be approved by its primary supervisor, in consultation with the Federal Deposit Insurance to highlight plans for issuing or restructuring capital instruments; selling business lines, assets or minority interests; and restricting dividends and stock repurchases, repayment of government capital injections and to wean themselves from FDIC-guaranteed debt.

Government Capital Facility: The Treasury is offering support through its Capital Assistance Program (CAP) to bridge any shortfall of private capital.

TARP Repayment: Any of the 19 stress test banks wishing to repay government bailout funds must prove their overall soundness, capital adequacy and the ability to lend. Banks must be able to maintain the heightened capital buffer determined by the stress test after repaying government funds. They must also be able to issue enough senior unsecured debt without FDIC guarantees to show they can meet funding needs independent of government guarantees.

Other Details: The government said it has no plans to expand the stress test process beyond the 19 largest banks. Authorities said the capital demands will serve as a one-time buffer to give market participants and banks confidence that major banks will continue to provide credit, even if the economy takes a sharp turn for the worse. Once the heightened buffers are in place, regulators will use the normal supervisory process to determine banks' capital needs. The government reaffirmed its commitment 'to stand firmly behind the banking system' to ensure banks continue to lend during this period of financial strain.

The new proposed structure for the financial sector could signal a recovery and new opportunities for financial institutions to raise capital in the private sector, and for the government to exit from the banking business. Most banks will have to devise solutions to meet the target capital ratios, and consider government capital infusion programs as a backup, not a first option. Firms that are unable to raise enough private capital may seek further federal aid by converting the government's preferred stakes to common equity. For an institution like Citigroup, for example, that could result in the government owning more than 50%of the company but the government has stated that its focus is to exit the banking sector rather than extend its ownership.

Current Happenings in Local and International Markets:

- SBTT loan rates drop
- TT Manufacturers worry about job cuts
- Sagicor gets negative grade from int'l rating company
- Carib Cement announces 20% reduction in profit
- Stocks on the JSE suffer their worst decline in 14 years
- Insolvency test puts added pressure on Jamaican general insurance companies
- Layoffs dlow to 539K in April; jobless rate rises
- Fannie Mae seeks $19 billion in gov't aid after posting $23.2 billion Q1 loss
- Morgan Stanley Raises $3.5 Billion Selling Stock at $24 Apiece
- Emerging-Market Stocks Rise for Biggest Weekly Gain in 5 Months
- Libor Has Biggest Weekly Drop Since March on Stress-Test Relief

Table 1: Regional Market Performance (as at 7 May 2009)

Index	Closing Value	Weekly Change (%)	Monthly Change (%)	YTD Change (%)	1 Year Change (%)
TTSE Composite	799.70	-0.73	-1.86	-5.13	-27.70
All Trinidad	1,089.25	-1.15	-2.25	-5.67	-22.91
JSE Index	79,850.91	0.14	1.24	-0.38	-27.34
JSE Select	1,717.45	1.01	3.34	-13.47	-43.32
All Jamaica	63,266.78	0.92	1.69	-14.50	-42.72
BSE Composite	841.26	-3.72	-3.89	-8.54	-18.38

Table 2: International Market Performance (as at 7 May 2009)

Index	Closing Value	Weekly Change (%)	Monthly Change (%)	YTD Change (%)	1 Year Change (%)
S&P 500	907.39	3.96	11.26	0.46	-34.84
Nasdaq Composite	1,716.24	-0.06	9.90	8.83	-29.62
Dow Jones Industrial	8,409.85	2.96	7.96	-4.18	-34.37
German Dax	4,804.10	0.73	11.14	-0.13	-32.11
FTSE 100	4,398.68	3.65	11.91	-0.80	-29.74
Nikkei 225	9,385.70	6.31	6.26	7.30	-33.45
Hang Seng	17,217.89	10.93	15.33	19.67	-32.77
DJ Eurostoxx	2,406.08	1.29	11.11	-1.85	-37.86