

Industry Flash

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US Banks

Corporate Bond Research 

New Treasury Stress Test Guidelines Do Not Appear Onerous

- **Treasury's plan appears relatively bank-friendly and investor-friendly** — The Treasury has released guidelines for new stress tests for the largest US banks and the terms for the banks to issue convertible preferred securities to the government to address any capital shortfalls. The Treasury's announcement indicates, in our opinion, that the US government is following a relatively bank-friendly, investor-friendly approach.
- **Treasury's goal is to increase banks' capital** — We think that several banks may need to increase their capital because of the new stress test. However, the Treasury's goal, in our view, is to increase banks' capital while minimizing the amount and duration of any government's direct ownership of common stock.
- **Stress scenarios do not seem onerous or draconian to us** — The guidelines require the banks to estimate their potential losses under a baseline scenario and a "more adverse" scenario for a two-year period. These scenarios do not seem onerous or draconian to us; indeed, they appear fairly close to the scenarios that JP Morgan discussed this week when it announced its dividend cut. We think that most banks may be using similar assumptions in running their own stress tests.
- **Emphasis on common equity** — The Treasury did not set a target equity ratio and said that it was not imposing a new capital standard, while pointing out that common equity should be the "dominant" component of Tier 1 capital. We interpret this statement to mean that common equity should be at least half of Tier 1, which would indicate a ratio of tangible common equity to risk weighed assets of 3%, although it could be somewhat higher (i.e., 4%). Although the banks and regulators will discuss the stress tests, the Treasury made it clear that bank regulators would determine the amount of equity capital that banks need.

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New Treasury Stress Test Guidelines Do Not Appear Onerous

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We think that several banks may need to increase their capital because of the new stress test. However, the Treasury's goal, in our view, is to increase banks' capital while minimizing the amount and duration of any government's direct ownership of common stock. The Treasury said that "government ownership is not an objective" and "our goal will be to keep the period of government ownership as temporary as possible".

The guidelines require the banks to estimate their potential losses under a baseline scenario and a "worse case" scenario for a two-year period. These scenarios do not seem onerous or draconian to us.

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The Treasury did not set a target equity ratio and said that it was not imposing a new capital standard, while pointing out that common equity should be the "dominant" component of Tier 1 capital. We interpret this statement to mean that common equity should be at least half of Tier 1, which would indicate a ratio of tangible common equity to risk weighed assets of 3%, although it could be somewhat higher (i.e., 4%). (We assume that the 6% well-capitalized standard remains in place). Although the banks and regulators will discuss the stress tests, the Treasury made it clear that bank regulators would determine the amount of equity capital that banks need.

The stress tests are to be concluded by the end of April.

If the regulators determine that a bank requires more capital, the bank can issue convertible preferred shares to the government. However, a bank would have six months to obtain capital from private (non-government) sources, if it chose to go that route. The preferred shares would be convertible into common shares at a 10% discount to the stock price as of February 9, 2009 (based on the average price for the preceding 20 days). This provision appears intended to reduce the potential dilution to equity holders, since banks' stock prices were generally higher at that time.

The preferred would be convertible at the bank's option and "when and if needed to retain the confidence of investors or to meet supervisory expectations regarding the amount and composition of capital".

The preferred would be convertible at the bank's option and "when and if needed to retain the confidence of investors or to meet supervisory expectations regarding the amount and composition of capital." (We think that in any case banks would consult with their regulators as to the need and timing for any such conversion.) The preferred will bear a 9% coupon (compared to the initial 5% coupon on most TARP preferred) and it will be mandatorily convertible in seven years. The holders of the preferred (i.e., the government) will not have any voting rights until the conversion.

Banks can also elect to replace their existing TARP preferred with the new convertible preferred shares. The bank could issue an amount equal to 1-2%

of its risk weighted assets, plus any amount necessary to redeem its TARP preferred, if it chose to replace it with the new convertible preferred. Such a step could give the bank more flexibility to increase its common equity base quickly, if necessary. However, the trade-off is that the bank would pay 400 basis points more on the new preferred.

A bank must receive regulatory approval to issue convertible preferred in an amount exceeding the normal limits. Any such bank will be redeemed as needing "exceptional assistance" and may be subject to additional terms and conditions.

Banks can redeem the convertible preferred at any time, with the approval of bank regulators, either with the proceeds of a common stock offering or additions to retained earnings.

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Figure 1. Treasury's Economic Scenarios: Baseline and More Adverse Alternatives

	2009	2010
<i>Real GDP</i> ¹		
Average Baseline ²	-2.0%	2.1%
Alternative More Adverse	-3.3%	0.5%
JPMorgan Chase -- Stress Case	Two-year recession	
<i>Unemployment</i> ³		
Average Baseline ²	8.4%	8.8%
Alternative More Adverse	8.9%	10.3%
JPMorgan Chase -- Stress Case	10% +	
<i>House Prices</i> ⁴		
Average Baseline ²	-14%	-4%
Alternative More Adverse	-22%	-7%
<i>Peak-to-Trough House Price Decline</i>		
JPMorgan Chase -- Stress Case	-40%	
Treasury -- More Adverse Case	-48%	

1. Percent change in annual average. 2. Baseline forecasts for real GDP and the unemployment rate equal the average of projections released by Consensus Forecasts, Blue Chip, and Survey of Professional forecasters in February. 3. Annual average. 4. Case-Shiller 10-City Composite, percent change, fourth quarter of the previous year to fourth quarter of the year indicated.

Earlier this week, JPMorgan cut its dividend so that it would have adequate capital even in the event of a highly stressed environment. The company defined a "highly stressed environment" as a two-year recession with 10%+ unemployment and a 40% decline in housing prices peak-to-trough. JPMorgan noted that it was not predicting such a scenario.

Sources: US Treasury, JPMorgan investor presentation (February 23, 2009) and Citi Investment Research.

Appendix A-1

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