BANK STRESS & CAPITAL BUFFER

by Steve Brown

Banks these days have enough "stress," but that doesn't mean nationalization is in the cards. Consider the recently released details of the Treasury's new Capital Assistance Program ("CAP"), which was designed to "ensure the ability of US financial institutions to lend to creditworthy borrowers in the face of a weaker than expected economic environment and larger than expected potential losses." The program is designed to provide a strong underpinning (to restore investor confidence) to financial institutions in the event of potentially large future losses.

The program generally breaks down into two major elements. The 1st is a forward-looking capital "stress test" and the 2nd is a lever bankers can pull to obtain common equity ("capital buffer") from the US Gov't as a bridge to private capital in the future. To begin, CAP focuses on the 19 largest banking companies in the US (banks with assets in excess of $100B), which represent 75% of all banking assets in the country.

The Treasury investment is in the form of convertible preferred shares, which can be converted to common equity at any time by the financial institution. The shares carry a 9% dividend and automatically convert to common in 7Ys (gives the bank time to find new outside capital). Banks are also required to comply with strict executive compensation restrictions and are also restricted from paying dividends or buying back stock, without prior approval. Banks that have already borrowed under TARP/CPP can swap the preferred shares for CAP convertible shares. Pricing on the capital from the Treasury is set at a 10% discount from the institution's stock price as of 2/9/09.

The stress testing component is run by regulators using two economic scenarios (used to estimate losses that will occur over the next 2Ys). Results of the test will not be disclosed, but banks that experience strain will be given 6 months to raise additional capital to ensure a buffer is in place or take down additional capital from the Treasury. Stress testing must be completed by the biggest banks by the end of April.

Specifics of the stress test are pretty straightforward. The "baseline" scenario assumes the economy contracts at 2.0% this year (and grows 0.5% in 2010), unemployment rises to an average of 8.4% (and 10.3% in 2010) and housing prices fall 14% (plus 4% more in 2010). Meanwhile, the "adverse" scenario assumes GDP contracts at 3.3%, home prices fall 22% (plus 7% more in 2010) and unemployment rises to 8.9% in 2009.

There are some twists to the CAP program that are worthy of exploring. CAP is a new program and it does not replace TARP/CPP. Next, CAP is open to qualifying financial institutions (even if the institution did not participate in CPP) and is not among these 19 largest banks in the country. Third, there is no limit to how much money a single institution in this group can have under CAP. Fourth, approved banks can immediately issue between 1% and 2% of total risk-weighted assets, plus any amount of CAP convertible preferred stock (as long as the proceeds are used to redeem shares sold under the original TARP/CPP). Fifth, banks have until May 25, 2009, to apply for CAP and will have up to 6 months after receiving preliminary approval to close. Finally, banks have to demonstrate how they will use the funds to support lending activities.

Let's get back to the pricing piece of this puzzle. By setting a price at such low historical levels, CAP effectively sets a floor on the stock price of these biggest banks and sends a message to investors that the Gov't is committed to keeping banks afloat.

Our advice for community bankers is to consider what would happen to your bank if the test scenarios outlined in CAP came true. We don't know if that will add more stress or not, but understanding risk, conducting "what if" scenarios and making sure you have a plan of action should help reduce it.

BANK NEWS

US Bank

Because TARP "is a lousy program," the Bank said they will repay the CPP capital "as soon as possible."

Lending Activity

The Fed's Beige Book finds that net lending activity is down and credit quality was lower in most districts.

FOMC Meeting Changes

As they struggle to fix the economic mess, the FOMC announced they have expanded 4 upcoming policy-setting meetings from 1 day events to 2 day. The change is being made "to allow additional time for discussion."

Small Business

Credit unions are snatching a larger proportion of small business loans from banks, with volumes growing 18% in 2008.This cannot go on forever, however, since credit unions are subject to the 12.25% cap on business loans (as a percent of assets).

Image Capture

The check clearing transition to digital has reached an 85-95% penetration. Despite that, some payment instruments (money orders, damaged checks, etc.) are still being moved around domestically by trucks and planes. As such, look for costs per item to continue to rise.

Mortgages

Citi will begin temporarily reducing mortgage payments for people who find themselves newly unemployed. Monthly payments will be reduced an average $500 for borrowers who are 60 days or more delinquent.

FOMC Speaker

FRB Atlanta President Dennis Lockhart said the economy is shrinking "at a rather dramatic rate" and that recovery signs aren't likely until the second half of 2009.