LESS STRESS THAN EXPECTED

by Steve Brown

The banking industry and investors in general sighed with relief after the 19 large bank stress test results were finally released yesterday. While the results show the group will need to raise $75B in new capital, the news was met with open arms by investors - primarily because it was expected to be worse and since it should finally put a stake in the heart of nationalization or solvency discussions for some big banks. Perhaps now, with the results and noise behind us as an industry, we can finally focus energies on the long-term rebuilding of the financial sector.

We read through all 38 pages of the "Supervisory Capital Assessment Program Results," from the Board of Governors of the Federal Reserve. The report provided lots of information about how stress testing was conducted, its purpose and other factors that are also applicable to community bankers, so we have decided to discuss that further in this section today.

To begin, the stress testing program took 2 months and was designed to test these large institutions to ensure a capital buffer was in place in the event an adverse ("what-if") scenario came to pass. The testing focused on loss rates, revenues and the loan loss reserve, as these 19 institutions were subjected to a pretty severe test. In fact, the annualized loss rates used in the test were substantially higher than the highest annual losses during the past 20Ys, were assumed to occur on all categories of loans simultaneously and would last for 2Ys in succession. As can be seen in the chart above, 9 institutions passed the test and will not need any additional capital, while 10 more will need to raise additional capital (or sell non-core assets, convert preferred shares to common or borrow from the government). In all, these banks will need to raise $74.6B in capital as a result of the tests.

On the positive side for community banks, it is interesting to note that the stress tests show the bulk of projected losses (about 70%) came from residential mortgages and consumer loans. This makes sense when you consider the sharp drop that has occurred in home prices over the past 2Ys and the expected higher projected losses on other consumer credit (including credit cards) as a result. Of interesting note, projected loss rates (as a percentage of loans for each category) on C&I loans were seen as "within the range of normal business downturns from past recessions" even under the adverse stress test (5% to 8%), as were CRE loans (9% to 12%) in general. By regulatory subsector category, projected loss rates for Construction were 15% to 18%, Multifamily was 10% to 11% and Nonfarm/Nonresidential was 7% to 9%.

We would expect the results of these tests to be debated by scholars and quant geeks for some time to come and like any "what-if" testing the scenario in question may never play out. The good news about doing this type of testing, however, is that it gives us all more transparency as it highlights a potential need for some institutions to increase Tier 1 common equity capital (the new favorite of regulators), have a capital plan in place to address adverse economic situations, refine estimates on projected loan losses and analyze support available from the ALLL. Speaking of ALLL, it was interesting to see in the report that the stress tests show most banks will need to continue to build reserves for the next 2Ys.

As readers know, we are big believers in stress testing. We feel it not only helps management better understand how their institution will respond given certain scenarios, but more importantly, such testing gets everyone to focus on contingency planning. Being prepared for an event that may never come is a better way to operate than waiting for a significant event to happen and then scrambling around trying to react.

BANK NEWS

M&A

Foothills Bank ($133mm, AZ) will purchase Capitol Bancorp's Yuma Community Bank ($72mm, AZ) for %10.5mm in cash. To raise capita, Capitol Bancorp ($5.8B, MI) began working on the sale of some of its 53 banks last month.

CAP Extended

The Treasury announced that the deadline for access to the preferred stock issued under the Capital Assistance Program has been extended another 6l months.

Unsatisfied/Not Returning

25% of those 18 to 24Y of age found visits to banks and credit unions either "not at all pleasant" or "somewhat unpleasant." Of this group, nearly 40% said it would be unlikely that they would return to these institutions. We say "who cares," since this group doesn't have any money anyway.