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MARKET NOTE

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Leaking (and Reeking) of Stress

An important article today provides a glimpse of expected bank stress test results and their negative implications for the entire banking system. It suggests that the government is using worst-case assumptions that would see losses totaling over half (and perhaps significantly more) of Tier 1 bank capital as of year end 2008. We will learn more directly from the government on Friday, but in the interim this a very disturbing bit of leaked information.

Last evening, Deborah Solomon and Damian Paletta of *The Wall Street Journal* posted what is likely to prove to be a very important scoop on the assumptions being used by the government in conducting stress tests on the 19 largest banking institutions. While the details on the stress test methodology are slated to be released by the Federal Reserve Bank and U.S. Treasury on Friday – if the below piece of reportage is correct, it has concerning implications for the banking system, also as set forth below. Here is the relevant portion of the story that *The Wall Street Journal* published today (the entire story is at http://online.wsj.com/article/SB124035671205840995.html):

> "In the stress tests, regulators used some estimates of likely losses on loans that were tougher than observers had expected.
>
> Under a more adverse scenario, which assumes a 10.3% unemployment rate at the end of 2010, banks would have to calculate two-year losses of up to:
>
> 8.5% on their first-lien [residential] mortgage portfolios,
> 11% on home-equity lines of credit,
> 8% on commercial and industrial loans,
> 12% on commercial real-estate loans, and
> 20% on credit-card portfolios,
>
> according to a confidential document the Federal Reserve gave banks in February that was viewed by The Wall Street Journal. Regulators are expected to have used other assumptions as well when measuring a bank's strength.
>
> Such scenarios could make banks with heavy exposures to these products appear weaker than expected."

If this leaked information proves accurate, the implications to U.S. bank capitalization under these assumptions would be quite serious. Below, we have done a quick calculation applying the loss percentages above to the latest FDIC data (from 12/31/08) to the entire banking system and then to a subset of banks that are the subject of stress tests. Note that the subset does not include all of the 19 institutions being stress tested, just those that were in FDIC data as of 12/31 (and excluding institutions such as MetLife, GMAC, Morgan Stanley, Fifth Third, American Express and Regions Financial Corp), for a total of 13 institutions in our subset.

($ in Billions - as of 12/31/2008)	**Federal Reserve's Loss Assumption**	**All Institutions Assets**	**All Institutions Losses**	**Stress-Test Group Subset Assets**	**Stress-Test Group Subset Losses**
Stress-Tested Category:					
1st Lien - Residential Mortgages	8.5%	1,817.0	154.4	709.6	60.3
Home Equity Loans (Includes junior lien mortgages)	11.0%	895.3	98.5	513.6	56.5
Commercial & Industrial Loans	8.0%	1,496.3	119.7	775.7	62.1
Commercial Real Estate (Including multi-family residential)	12.0%	1,273.7	152.8	321.3	38.6
Credit Cards	20.0%	506.2	101.2	113.8	22.8
Total		**$5,988.5**	**$626.7**	**$2,433.9**	**$240.2**
Notes					
Total Assets		$13,847.3		$7,100.4	
Total Net Loans and Leases (Whole Loans)		7,702.1		3,277.6	
Total Tier 1 Capital as of December 31, 2008		999.1		426.7	
Projected Losses as % of Tier 1 Capital		63%		56%	

Stress-test Subset includes the following 13 institutions:

JP Morgan Chase	*US Bank*
Citibank	*Capital One*
Bank of America	*The Bank of New York Mellon*
Wells Fargo (Includes Wachovia)	*PNC Bank*
Suntrust Bank	*Goldman Sachs Bank*
State Street Bank and Trust	*BB&T*
Keybank	

There are several additional matters worth pointing out in connection with the above:

- These assets, and stressed losses, exclude, among other things, all of the following:
  - All securities held by banks – including over $800 billion of mortgage and asset backed securities that are not otherwise guaranteed by the government – which may or may not have been sufficiently written down to date.
  - Over $1.7 trillion of other whole loans that the FDIC does not include in any of the categories that are the subject of today's article.
- The article notes that the Fed document stated that these losses are expected to be taken over a two year period, giving the banks some ability to earn out of them (but relative to present levels of earnings, even with a decent bounce, that would be a modest offset).
- The stress level assumptions were made back in early February, and continued economic deterioration in the interim may justify the revisiting thereof.

- Our estimate of the total projected losses to date taken by U.S. banks, combined with the forgoing numbers and an estimate of additional securities and loan losses excluded per the above, would still be less than a number of other reputable projections – particularly the IMF's revised projection, released yesterday of $2.7 trillion in total losses to U.S. banks.

- We note that we are using the most recent information available from the FDIC, which is at 12/31/08. There have certainly been changes to the data in the interim, perhaps even some positive changes.

We will know more on Friday when the government releases its full (or near-full) description of the stress test program. But if the information in the Journal today is accurate, the results should be eye-opening, to say the least. We are not commenting on what the stress test disclosure or results will ultimately contain – we're just "doing the math" on the information set forth in today's article.

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