WESTWOOD CAPITAL, LLC

RESEARCH

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SCAP and Trading
Life after the Stress Test – The First 14 Days
(also: Beware the Ides of May!)

Highlights

- A bit more than two business weeks have elapsed since the long-awaited results of the Supervisory Capital Assessment Program ("SCAP" or, more commonly, the "Stress Test") were released. It seems an appropriate time to consider the results with the benefit of both having done some additional analysis and having gauged market and institutional responses.

- Despite the Federal Reserve Bank's protestations to the contrary, the SCAP is inherently schizophrenic – because it is alternately a solvency test of the banking system's more troubled institutions, on the one hand and, on the other, an identifier (with some material qualifications) of those banks that are likely to be able to fully participate in the economy during the next several years.

- In this report, we examine three areas of the SCAP that deserve considerably more attention than they have received thus far:

    - The estimation and determination of resources likely to be available to the Stressed-out 19 to offset the $600 billion of projected losses under the Stress Test's "more adverse scenario" – in particular, the Fed's calculation of the future "Pre-Provision Net Revenue" (PPNR) of the banks – which is apparently a lot less adverse than meets the eye.

    - The methods used by the Fed in calculating the $600 billion in asset level losses, and the very substantial accommodations made with the banks on an individual basis. We demonstrate that these accommodations rendered the study's advertised loan loss percentage ranges nearly irrelevant.

    - The Fed's election to focus on Tier 1 Common Capital (T1CC), rather than Tangible Common Equity (TCE) in measuring the bank's overall health – and the favorable nature of T1CC from the point of view of the banks.

- As an addendum to this report, we include a passing observation we have entitled "Beware the Ides of May." In it, we look at the stock market rally that began on March 10th of this year, and compare it to the similarly timed rally in 2008. The continuing, although potentially sputtering, rally materialized principally out of a conviction on the part of some traders that many institutions in the financial services sector were going to avoid calamity – or, at least, massive equity dilution and/or nationalization – and were, when the rally began, substantially undervalued. In light of our view of the banks' still uncertain future – and the lessons of last year – we question some of the assumptions underlying the current enthusiasm.

Overview

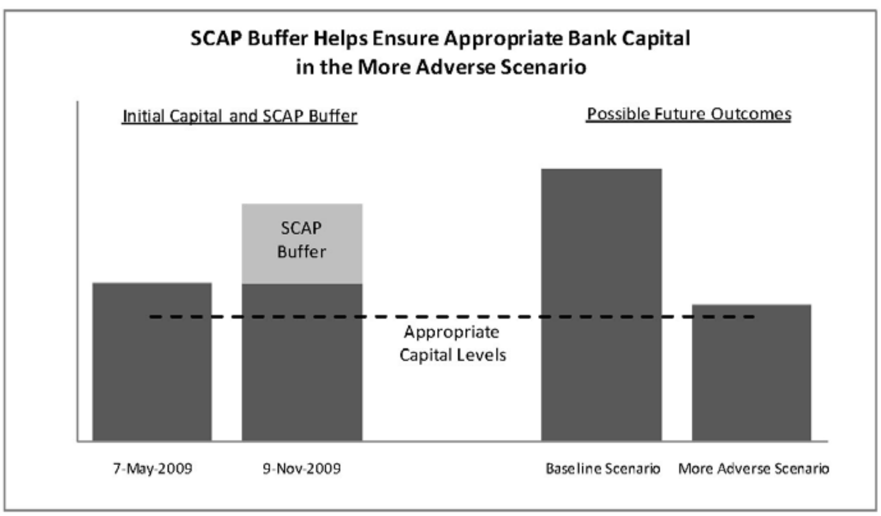
A bit more than two business weeks have elapsed since the long-awaited results of the Supervisory Capital Assessment Program ("SCAP" or, more commonly, the "Stress Test") were released. It seems an appropriate time to consider the results with the benefit of both having done some additional analysis and having gauged market and institutional responses. At the very least, the passage of the first 14 days allows for a more critical look at the Stress Test.

In its presentation of the SCAP's results, the Federal Reserve Bank (FRB) reviewed the open book test it had assigned to our nineteen largest financial institutions and achieved its presumed policy goal of "no bank left behind." In an iterative process with the institutions it supervises, the FRB, on behalf of the U.S. Treasury Department, utilized a regulatory form of "affirmative action" that enabled (if not encouraged) its more challenged charges to argue for higher grades and obtain special advantages.

The average grade for the group was a 74 – as in certain of the Stressed-out 19 may require an aggregate of $74 billion in additional Tier 1 Common Capital to get through these next two years. That was the headline most of us read two weeks ago: "Banks Require Additional $74 billion in Capital." And, somehow, that made us feel as though the crisis had been contained ($74 million used to be considered a lot of money, but today produces not much more than shrugs).

Nevertheless, some in the business media – The Wall Street Journal comes to mind – opened their stories with the real bottom line, noting that the Fed is projecting that the 19 banks may experience $600 million in additional loan losses in 2009 and 2010. This was the more appropriate headline, because the SCAP report made quite clear that the Fed expects that a "hypothetical" bank in the study – even with the additional prescribed common capital – could be expected, under the report's "more adverse scenario" (a bad case, but not a worst case), to be only marginally appropriately capitalized by the end of 2010.

The implication of the above outcome is actually more profound than has met the eye of many analysts. What the Stress Test actually says is that the more challenged of the 19 banks – at least based on the Fed's assumptions and with a not-too-onerous amount of new equity – are not expected to be more than barely adequately capitalized at the end of 2010. The implication of that conclusion is that if reality tracks along the lines of the more adverse scenario, some of our largest banks will be in no position to foster the creation of new credit as their capital is not unlikely be progressively more consumed by losses. The diagram below – drawn directly from the Fed's report, says it all:



And that gets us to the heart of the SCAP's inherent schizophrenia – because it is alternately a solvency test of the banking system's more troubled institutions, on the one hand and, on the other, an identifier (with some material qualifications) of those banks that are likely to be able to fully participate in the economy during the next several years. Despite the FRB's protests to the contrary, it is clear to us that if their assumptions, regarding a continued severe recession, come to pass – several major U.S. banks, including three of the four largest (Bank of America, Citicorp, and Wells Fargo) may remain marginal contributors to the process of capital formation that is so essential to economic recovery. The FRB goes to great lengths to deny that the SCAP is, in any manner, a solvency test. We see the FRB's words – but its quantitative analysis tells a different story.

A Bloomberg wire story yesterday noted that certain multinational banks are reporting far wider interbank borrowing rates than others to the British Bankers' Association, the organization that compiles and announces LIBOR each business morning in London. The gap in spreads between the cost of interbank borrowing for banks the markets deem most creditworthy and those deemed least to has widened to an average of 7.5 basis points this month – up from 4.9 basis points in April and 1.5 basis points before the crisis was in full swing. We would continue to monitor these spreads as it is apparent that the markets are in the process of separating the wheat from the chaff, even as the Stress Test aimed for a more homogenous outcome.

Having established our premise, we now need to look into some of the principal assumptions that led to the SCAP's conclusions. In this report, we examine three issues we feel deserve the greatest scrutiny:

- The estimation and determination of resources likely to be available to the Stressed-out 19 to offset the $600 billion of projected losses – in particular, the Fed's calculation of the future "Pre-Provision Net Revenue" (PPNR) of the banks.

- The methods used by the Fed in calculating the $600 billion in asset level losses, and the accommodations made with the banks on an individual basis.

- The Fed's election to focus on Tier 1 Common Capital (T1CC), rather than Tangible Common Equity (TCE) in measuring the bank's overall health.

Finally, as an addendum to this report, we include a passing observation we have entitled "Beware the Ides of May." In it, we look at the stock market rally that began on March 10th of this year, and compare it to the similarly timed rally in 2008. The continuing, although potentially sputtering, rally materialized principally out of a conviction on the part of some traders that many institutions in the financial services sector were going to avoid calamity – or, at least, massive equity dilution and/or nationalization – and were, when the rally began, substantially undervalued. This rally has, in a mere eight weeks, taken 10 year historical average inflation adjusted earnings multiples for the S&P 500 from a conservative (but not panic stricken, by standards of depressions or other very severe recessions) 13.1, to a relatively average 15.5 – suggesting that the S&P 500 stocks are no longer the bargains they once appeared to be.

Despite yesterday's rally on the heels of a poll of consumers' confidence that – in the face of continuingly falling home prices, ongoing deterioration in the value of pretty much all other financial assets, and worsening unemployment – the world is not coming to an end and they can actually envision the possibility of going shopping on credit someday soon (although only 2.3% of those polled are considering buying a home), our view of the economy fails to discern meaningful drivers of real earnings growth.

Offsets to Projected Losses

The FRB calculates that the Stressed-out 19 will have three sources of capital to absorb the losses projected under the SCAP:

- (i) T1CC of the banks as of the beginning of the projection period – January 1, 2009;
- (ii) Excess loan loss reserves that existed at the beginning of the projection period; and
- (iii) Earnings before additional reserves – so-called "Pre-Provision Net Revenues," that the banks are projected to earn during the anticipated two year duration of the crisis.

The SCAP requires that banks do not fall below (or, if already below, restore themselves to) a 4% T1CC ratio in order to be deemed adequately capitalized (which presumably is the level at which the FRB believes banks will be able to provide some benefit to the economy, as opposed to merely surviving). The FRB employs an algorithm – not detailed in the SCAP report – regarding the level of loan loss reserves banks will need to have in place by the end of the projection period – December 31, 2010 – in order to protect themselves from lagging, crisis-generated loan loses, and normal ongoing losses. Presumably, the loan loss reserves projected for December 31, 2010 will be lighter than those existing at this time – given the report-wide assumption that the economy will improve within the two year projection period – and the delta between the beginning and ending levels is counted as being available to offset the 2009-2010 losses.

Interestingly, however, the offsets in (ii) and (iii) above are lumped in to a single line item in the SCAP report, totaling a whopping $363 billion, making it difficult to conclude how much of that amount is expected to come from pre-provision earnings (including the healthy – albeit potentially extraordinary – Q1 2009 earnings) and how much is excess loan loss reserves. This is a relatively critical bit of analysis that is missing, because it distracts one from being able to conclude just how rosy an earnings scenario the FRB is employing (no, doubt, amid much pom-pon waving by the subject banks).

But make no mistake, the FRB has assumed the Stressed-out 19 will be making a handsome living over the two years during which nearly every halfway-sane economist predicts a severely recessionary to stagnant growth/high unemployment environment.

Interestingly, a sizable portion of the adjustments to projected PPNR levels demanded – and no doubt received – by the banks may have resulted from the use by JPMorgan Chase, Bank of America, Wells Fargo and PNC Financial of purchase accounting to mark down the value of loan portfolios acquired during the failures/surrenders of Washington Mutual, Countrywide, Merrill Lynch, Wachovia and Nationsbank, among other acquisitions[1]. Purchase accounting allows loans to be placed on the books of an acquiring institutions at the values the acquirer is deemed to have paid for them (allowing for allocation among various assets acquired), as opposed to face value. To the extent that the acquiring banks, over time, recover principal at a pace that exceeds their written-down carrying values – that excess constitutes additional income and would, naturally, bolster PPNR. It is no small irony that certain institutions may benefit from bargain purchases shepherded by the FRB and the FDIC, at a cost to the FDIC's Depository Trust Fund and a potential cost to taxpayers, with the result that such banks are not being forced to raise more dilutive capital or accept direct Federal aid – with all the strings that would be attached to same.

[1] Again, thanks to Bloomberg (Ari Levy and Elizabeth Hester) for reporting on this yesterday.

We thought it would be useful to reflect on the projected PPNR levels for each of the 19 institutions, in comparison to those of 2006, 2007 and 2008. To do this, we have assumed that fully half of all existing loan loss reserves of the banks is the delta between January 1, 2009 levels and December 31, 2010 required levels – an assumption we believe is given quite the benefit of the doubt to the FRB in that it lowers the proportion of the foregoing $363 billion that needs to come from PPNR.

The results are as follows for each institution. Note particularly the projected PPNR levels under the more adverse scenario, in relation to past periods. Those with an interest in comparing banks' actual performance to the assumptions in the SCAP would be well advised to look not only how loan losses are tracking relative to the Stress Test (as we assume everyone will be), but also to going forward levels of PPNR, to see if institutions are performing sufficiently to offset continuing losses and remain sufficiently capitalized.

Stressed 19 - PPNR Historical Comparison
(Billions of $)

					Historical Pre-provision Net Revenue				
Institution	**Resources Other Than Capital to Absorb Losses**	**Excess Loss Reserves**	**Implied PPNR 2009, 2010**	**Annualized Implied PPNR**	**2008**	**2007**	**2006**	**Average**	**Average 2007, 2006**
American Express	11.9	0.48	11.4	5.7	9.4	9.7	7.8	9.0	8.8
Bank of America	74.5	11.54	63.0	31.5	31.3	29.3	37.0	32.5	33.1
BB&T	5.5	0.79	4.7	2.4	3.5	3.0	2.7	3.1	2.9
Bank of NY Mellon	6.7	0.21	6.5	3.2	2.5	3.6	2.2	2.8	2.9
Capital One	9.0	2.26	6.7	3.4	5.7	6.5	5.1	5.8	5.8
Citibank	49.0	14.80	34.2	17.1	(19.4)	17.6	34.8	11.0	26.2
Fifth Third	5.5	1.39	4.1	2.1	1.9	2.2	2.0	2.0	2.1
GMAC LLC	(0.5)	1.72	(2.2)	(1.1)	6.8	1.2	4.2	4.1	2.7
Goldman	18.5	0.00	18.5	9.3	2.3	17.6	14.6	11.5	16.1
JP Morgan	72.4	11.58	60.8	30.4	23.8	29.7	23.2	25.5	26.4
KeyCorp	2.1	0.90	1.2	0.6	0.7	1.8	1.8	1.4	1.8
MetLife	5.6	0.15	5.4	2.7	5.1	5.8	3.9	4.9	4.8
Morgan Stanley	7.1	0.00	7.1	3.6	2.3	3.4	9.1	4.9	6.2
PNC Financial	9.6	1.96	7.6	3.8	2.8	2.4	4.1	3.1	3.3
Regions	3.3	0.91	2.4	1.2	(3.9)	2.6	2.1	0.3	2.4
State Street	4.3	0.01	4.3	2.1	2.8	1.9	1.8	2.2	1.8
SunTrust	4.7	1.18	3.5	1.8	3.2	2.9	3.2	3.1	3.1
US Bancorp	13.7	1.76	11.9	6.0	7.1	7.0	7.4	7.2	7.2
Wells Fargo	60.0	10.51	49.5	24.7	15.4	25.6		20.5	25.6

Notes:
Wells Fargo PPNR reflects Wells' pro-forma operating statements including Wachovia for 2007 and 2008.
2008 Wells Fargo/Wachovia combination includes add-back of a $24.8 billion goodwill impairment recognized in that year.
2008 GMAC Pre-Provision NR is calculated after adding back impairments from investments in operating leases.
Excess loss reserves are assumed to be 50% of the existing loss reserves as of 12/31/2008.

Grading on a Curve – The Estimation of Loan Losses Under the More Adverse Scenario

One thing that stood out to us immediately is that the SCAP report makes a big show of what is perhaps its most important set of assumptions – the range of loan loss percentages applied to each class of bank loan assets under the more adverse scenario. The loan loss ranges, as they were leaked prior to the release of the study, were hailed by many (including ourselves) as eminently reasonable in light of the severity of the collapse of the debt bubble. The SCAP report's Table 1 sets forth somewhat wider ranges than those expected before its release – still and all, they are reasonably defensible.

What is far more interesting, however, is the fact that the indicated loan loss ranges are not those actually used in the actual analysis of each of the institutions. In fact, the ranges are far wider – an indication, if one is charitable, of their having been tailored to the unique circumstances of each institution's assets. If less charitable, one might conclude that the bespoke ranges are a reflection of the heavy negotiations that ensued between the banks and their regulators – with each bank holding out for every last attribution of quality and recoverability of their assets, in the knowledge that to do otherwise could likely result in being required to massively dilute their shareholders, at best (and, at worst, risking the prospect of nationalization).

Regardless of interpretation, the actual loan loss percentages applied to the loan classes for each institution vary substantially from the advertised ranges – to such an extent that such ranges are, as a practical matter, rendered pretty much irrelevant. Our findings are set forth below:

	First Lien Mortgages	Second/ Junior Lien Mortgages	C&I Loans	CRE	Credit Cards
Adverse Scenario					
Advertised Range - Low	*7.0*	*12.0*	*5.0*	*9.0*	*18.0*
Advertised Range - High	*8.5*	*16.0*	*8.0*	*12.0*	*20.0*
Actual Range - Low	*3.4*	*6.3*	*0.0*	*2.1*	*17.4*
Actual Range - High	*11.9*	*21.2*	*22.8*	*45.2*	*37.9*
Institution					
Loss Assumption Greater than Advertised Range					
Loss Assumption Less than Advertised Range					
American Express	na	na	na	na	20.2
Bank of America	6.8	13.5	7.0	9.1	23.5
BB&T	4.5	8.8	4.5	12.6	18.2
Bank of NY Mellon	5.0	na	5.0	9.9	na
Capital One	10.7	19.9	9.7	6.0	18.2
Citibank	8.0	19.5	5.8	7.4	23.0
Fifth Third	10.3	8.7	11.0	13.9	22.3
GMAC LLC	10.2	21.2	2.7	33.0	na
Goldman	na	na	1.2	na	na
JP Morgan	10.2	13.9	6.8	5.5	22.4
KeyCorp	3.4	6.3	7.9	12.5	37.9
MetLife	5.0	14.1	0.0	2.1	na
Morgan Stanley	na	na	2.4	45.2	na
PNC Financial	8.1	12.7	6.0	11.2	22.3
Regions	4.1	11.9	7.0	13.7	na
State Street	na	na	22.8	35.5	na
SunTrust	8.2	13.7	5.2	10.6	17.4
US Bancorp	5.7	8.8	5.4	10.2	20.3
Wells Fargo	11.9	13.2	4.8	5.9	26.0

T1CC vs. TCE

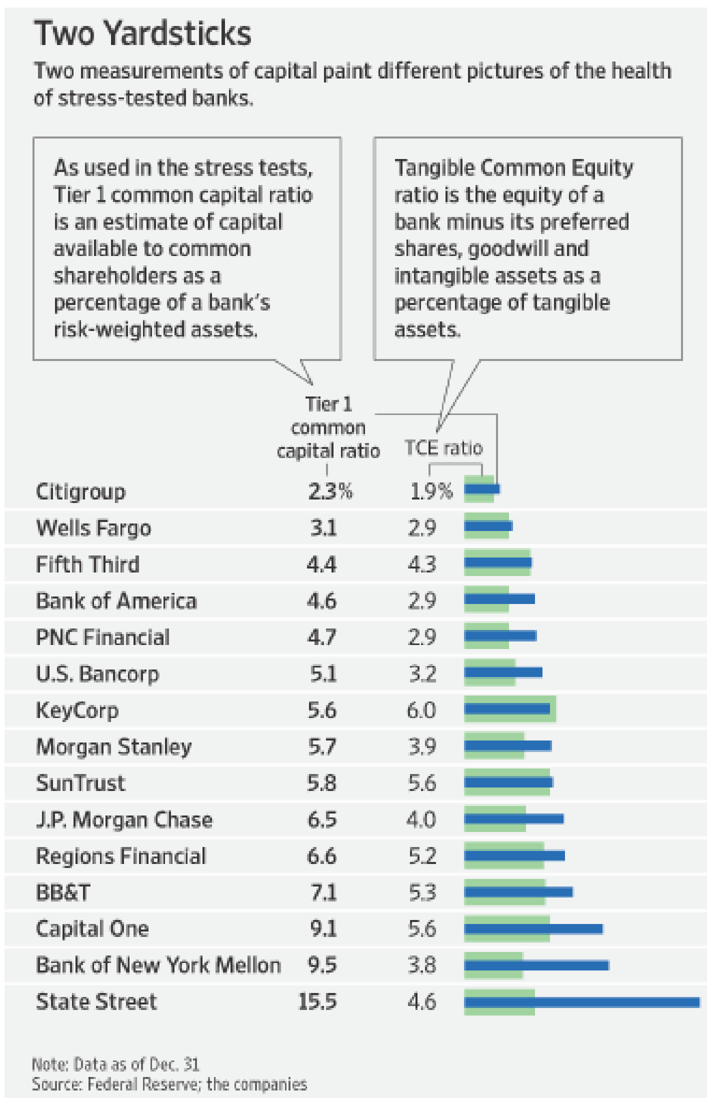
We'd like to say we are mystified about the SCAP's use of T1CC as the measuring stick for the banks' ongoing viability – but we're not. Tangible Common Equity months ago replaced Tier 1 Capital in the analytical community, so why did the FRB introduce a new metric (well, not new, but little used)?

After the failures of Fannie Mae and Freddie Mac – and the concurrent failures and/or bailouts of banking institutions last year – it became clear that the preferred equity and, especially, goodwill, other reserve and special account items included in Tier 1 Capital were severely clouding the picture of bank capitalization.

TCE, on the other hand, is just what is appears to be – it is first loss capital that has been invested in, or retained from after-tax earnings of, a given institution.   Essentially, it is what ultimately supports the enterprise in its present operational and financial position, after other equity-like components and goodwill prove to be of little value and preferred shareholders are seeking control or other remedies to restore lost dividends and threats to their investment.

Tier 1 Common Capital is different. Unlike TCE, T1CC is a deductive number – equal to the percentage of the value of a bank's risk weighted assets that are available to common shareholders. It varies (positively and negatively) with several variables, including asset risk weighting. So, naturally, it is a less stringent measure and more reactive to future improvements in asset values resulting from changing perceptions of relative risks (such as ratings, as one example).

Earlier this month, the Wall Street Journal published a very illustrative table of the differences between the two measures – which we think bears redisplaying in this report:



Addendum: Beware the Ides of May!

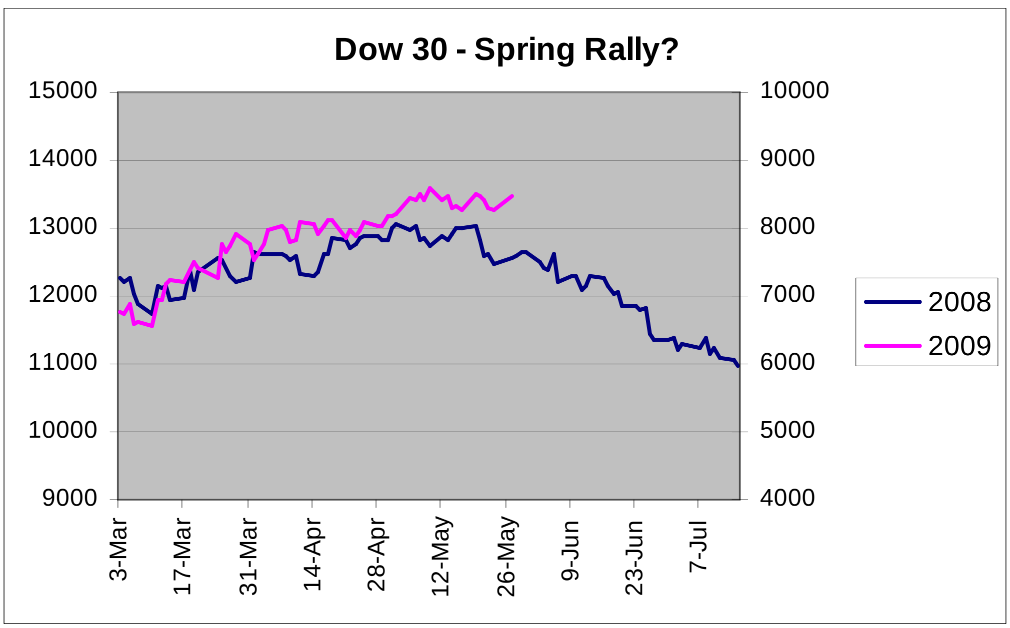
Since bottoming at 6,547 on March 9th, the DJIA has recovered 2,000 points, or over 30%, in value during one of the most spectacular rallies in history. Albeit down 40% from its high, that is still better than the "end of the world as we know it" down 54%, we saw at the market's nadir.

Nevertheless, we think we've seen this movie before – a sort of market oriented "Tragedy of Julius Caesar." While the Ides of May (the 15th, for those who forgot their classics) was, in fact, a Roman feast day, it is a long forgotten cousin to the Ides of March immortalized by Shakespeare. Yet the May version may prove to have some legs yet, at least among market historians.

The Dow (like the S&P 500) continues to find resistance at present levels. For good reason - this rally has, in a mere eight weeks, taken 10 year historical average inflation adjusted earnings multiples for the S&P 500 from a conservative (but not panic stricken, by standards of depressions or other very severe recessions) 13.1, to a relatively average 15.5 – suggesting that the S&P 500 stocks are no longer the bargains they once appeared to be.

If the current rally does, in fact, peter out at around the Dow 8,500 level, it will be repeating, nearly to the day, its behavior in 2008. Recall that at this time last year, we saw the coming to an end of the euphoria produced in April and May from the tax rebates promulgated by the Bush administration. Could the present rally – in the absence of much in the way of real earnings drivers and in the presence of continuing asset and loan value deterioration, and a worsening employment picture – disintegrate as the euphoria over nearly zero interest rates, bailouts and stimulus spending subsides?

We have inserted a chart below to guide you in answering the forgoing question – but we think you know what we consider more likely than not.



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