

CHAIRMAN'S CORNER

by James A. Kaplan

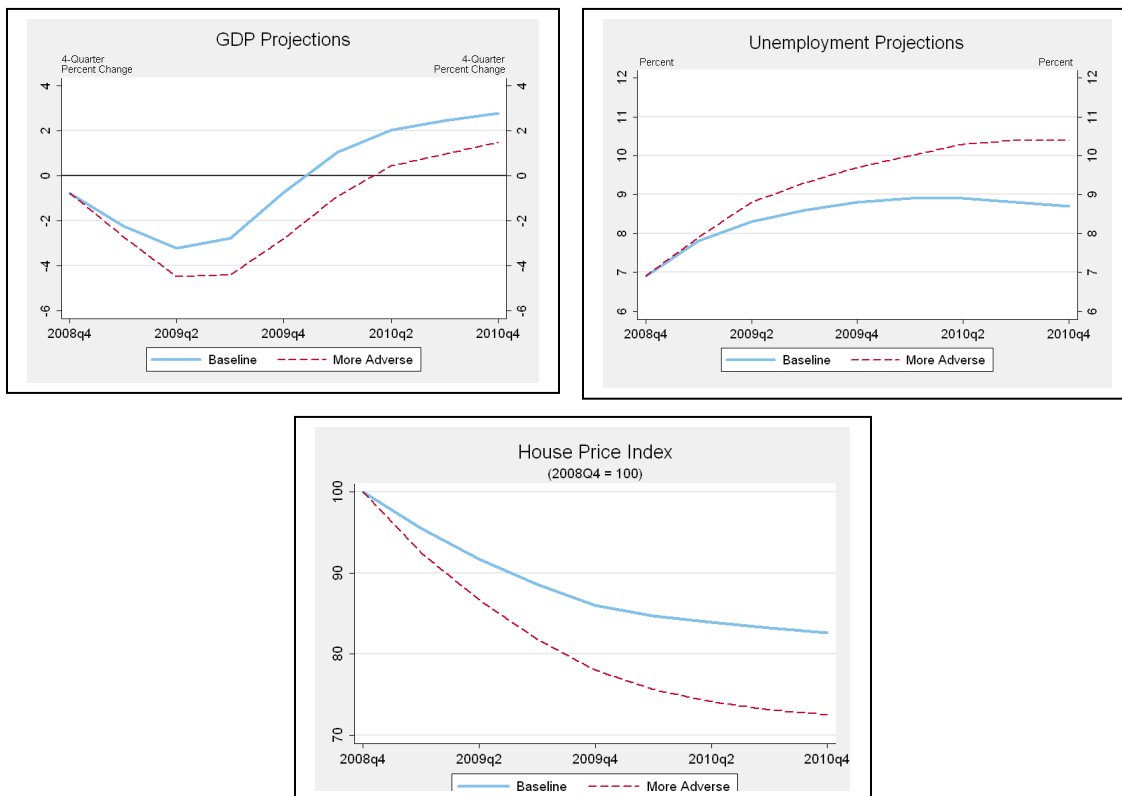


**The Supervisory Capital Assessment Program:
“The Test Nobody Failed”**

April 30, 2009

The Board of Governors of the Federal Reserve System, in applying their stress test, announced that “most U.S. banking organizations currently have capital levels well in excess of the amounts required to be well capitalized.”

The stress test exercise focused on two macroeconomic scenarios. The first was based on publicly available economic assumptions (the “Baseline Forecast,” or “Consensus Expectation”). The second projection was intended to capture “more adverse” circumstances, shown in the graphs¹ below:



The primary focus of the study was to determine whether the banks had sufficient cash flow to fund obligations, as well as sufficient Shareholders’ Equity to offset Loan Losses, under these two scenarios.

The reliance on Shareholders’ Equity as a critical measure of solvency was emphasized in the study. This makes sense, given that the composition of bank capital has shifted from one

¹ “The Supervisory Capital Assessment Program Design and Implementation” – Board of Governors of the Federal Reserve System, April 24, 2009

based on Shareholders' Equity to that based on debt-like hybrid securities, such as Preferred Equity and Subordinated Debt.

However, I am troubled by two major issues. First, the more adverse of the two test scenarios assumes a substantial improvement in GDP over the coming year; unemployment projections reaching a peak at 10.5%; and a deceleration in the rate of decline in the Housing Price Index. While these conditions may be more adverse than the Baseline Forecast, they fall short of measuring stress to the point of failure – the bottom 5th percentile, where a “black swan” may be found.

Both tests are based on an improving economy, which may be a reasonable forecast, but is hardly suitable to measure performance under duress. It would appear the Federal Reserve set out to prove that the banks were stable by avoiding outlier events – such as, shall we say, a global pandemic? -- That could stress them to the breaking point. A more appropriate test would have utilized multiple sets of assumptions including a worsening economy over the 2009 and 2010 time period.

The second issue that should be of great concern, but seems to have been minimized in the analysis, is the lack of liquidity within the banks' capital structures. A substantial portion of the assets held by the major banks are classified as “Level 3,” commonly referred to as toxic assets. The banks themselves recognize these assets are hard to value and hard to sell, making them, by definition, illiquid. They are grouped together on the financial statement and are assigned what the bank chooses to consider a Fair Market Value. Level 3 assets are typically of far lower quality than marketable securities, and have proven to be even more highly illiquid during periods of crisis.

In order to better assess the true valuation of the banks as represented by Shareholders' Equity, I recalculated the Shareholders' Equity assuming a 60% reduction in Level 3 assets would take place under conditions of stress (an optimistic assumption). The table below indicates the impact on Shareholders Equity of losses that would theoretically be realized upon liquidation of these assets. Even if the Fair Value assigned by the banks is remotely realistic, in some cases the adjusted Shareholders Equity is actually negative, and in the majority of cases it drops below 10%.

Theoretical Impact of Sale of Level 3 Assets

(Assuming liquidation at 40% of "fair value")

Bank	Total Assets*	Shareholders'	% of	Level 3 Assets	% of	Level 3 Assets	Shareholders'	Adjusted
	as of 3/31/09	Equity	Total Assets	as of 12/31/08	Equity	Reduced by 60%	Equity Less 60% of Level 3 Assets	of Total Assets
Capital One Financial Corp.	\$177,360,000,000	\$26,740,000,000	15.08%	\$145,947,000,000	545.80%	\$58,378,800,000	-\$60,828,200,000	-34.30%
Morgan Stanley	\$1,130,000,000,000	\$33,980,000,000	3.01%	\$72,944,000,000	214.67%	\$29,177,600,000	-\$9,786,400,000	-0.87%
MetLife, Inc.	\$501,680,000,000	\$23,730,000,000	4.73%	\$17,408,000,000	73.36%	\$6,963,200,000	\$13,285,200,000	2.65%
Goldman Sachs	\$925,000,000,000	\$63,550,000,000	6.87%	\$59,574,000,000	93.74%	\$23,829,600,000	\$27,805,600,000	3.01%
Citigroup, Inc.	\$1,820,000,000,000	\$143,900,000,000	7.91%	\$145,947,000,000	101.42%	\$58,378,800,000	\$56,331,800,000	3.10%
JPMorgan Chase & Co.	\$2,080,000,000,000	\$170,200,000,000	8.18%	\$113,400,000,000	66.63%	\$45,360,000,000	\$102,160,000,000	4.91%
Wells Fargo & Co.	\$1,290,000,000,000	\$100,300,000,000	7.78%	\$22,749,000,000	22.68%	\$9,099,600,000	\$86,650,600,000	6.72%
PNC Financial Svcs Group Inc.	\$286,400,000,000	\$26,500,000,000	9.25%	\$7,012,000,000	26.46%	\$2,804,800,000	\$22,292,800,000	7.78%
Bank of America Corp.	\$2,320,000,000,000	\$239,500,000,000	10.32%	\$48,400,000,000	20.21%	\$19,360,000,000	\$210,460,000,000	9.07%
U.S. Bancorp	\$264,000,000,000	\$27,200,000,000	10.30%	\$4,782,000,000	17.58%	\$1,912,800,000	\$24,330,800,000	9.22%
BB&T Corp.	\$143,400,000,000	\$16,180,000,000	11.28%	\$1,693,000,000	10.46%	\$677,200,000	\$15,164,200,000	10.57%
SunTrust Banks Inc.	\$179,100,000,000	\$21,600,000,000	12.06%	\$1,430,651,000	6.62%	\$572,260,400	\$20,741,609,400	11.58%
Bank of New York Mellon Corp.	\$203,400,000,000	\$28,240,000,000	13.88%	\$712,000,000	2.52%	\$284,800,000	\$27,812,800,000	13.67%

*includes perpetual preferred

This simple analysis leads me to believe that the Federal Reserve Board has elected to present a far more optimistic picture than the reality we may actually face. By confining their testing to parameters only slightly worse than the Baseline, they have biased the results, in effect mirroring the historic practice of the banks themselves that led to the recent collapse.

Based upon the results of its study, the Federal Reserve has made recommendations to the subject Bank Holding Corporations, including an assessment of each bank's capital need to ensure "the safety and soundness of individual BHCs and the stability of the broader financial system" through 2010. We should be confident that their recommendations are adequate as long as actual events do not prove to be particularly stressful.

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