

**US bank stress tests – has anybody done their homework?**

The US bank stress tests were introduced only ten weeks ago but seem to have already been overtaken by events. Practically every assumption seems to be under challenge, so the results, when announced on 4<sup>th</sup> May, will be like one of this season’s Grand Prix races: the subject of endless steward enquiries before the final winner is known. Rather than indulge in such sophistry, we have sought to summarise the published information and address some of the key issues.

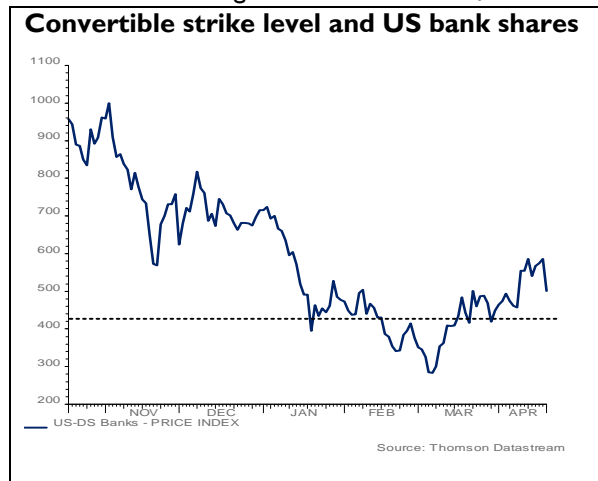
- The Capital Assistance Program is one more part of the Troubled Asset Recovery Program (TARP), designed to add capital to US banks.
- Top US banks are being subjected to stress tests designed to assess likely capital losses in a ‘baseline’ and a ‘more adverse’ scenario.

| ‘More adverse’ stress test |              |              |
|----------------------------|--------------|--------------|
|                            | 2009         | 2010         |
| <b>GDP</b>                 | <b>-3.3%</b> | <b>0.5%</b>  |
| <b>Unemployment</b>        | <b>8.9%</b>  | <b>10.3%</b> |
| <b>House Prices</b>        | <b>-22%</b>  | <b>-7%</b>   |

- Banks whose existing capital is assessed as inadequate under the test scenarios will have to raise an extra 1-2% of risk-weighted assets.
- Banks will be given six months to raise their own capital but otherwise will have to issue convertibles to the US Treasury.
- The price for the convertibles issued to the Treasury is fixed, as of 10<sup>th</sup> February.
- The outcome of the stress tests will be announced on 4<sup>th</sup> May.
- The US Treasury has \$135 billion left from the \$700 billion allocated by the TARP.

Our take on this is that the programme’s objective is to ensure that US banks have enough capital in case the recession lasts into 2010. It has elements of compulsion but falls well short of the option of nationalising undercapitalised banks. The relatively

short time-frame ensures that US banks address solvency issues promptly. The fixed price of the convertibles provides a floor for capital-raising (averting a debilitating share price spiral). The Treasury resources appear adequate against the 19 banks’ total risk-weighted assets of some \$8 trillion.



As is the nature of the US political process, the outcome of the tests has been the subject of contradictory briefings and leaks. While obviously important for the individual banks’ shares, the sector accounts for only 2% of the S&P 500 index, so the importance for most investors is that, pass or fail, US banks will have enough capital to see them through another year of recession. This underpins their ability to supply credit to fund a US economic recovery.

This positive view is supported by the share performance. While bank shares fell initially, their subsequent recovery leaves them back above their level on 10<sup>th</sup> February and so well above the level where new government convertible shares will be issued. This suggests that either investors don’t think banks will need any extra capital to pass the stress tests – in contrast to the view of most commentators – or they are happy to supply that capital themselves.

Carl Astorri  
+ 44 20 7753 1612

Richard Batley  
+ 44 20 7753 1576

Jean-Maurice Ladure  
+ 44 20 7753 1469

Henry Lancaster  
+ 44 20 7957 2426

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