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NO ONE FAILS (REALLY)

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… **Because they shouldn't at this point!** The results of the Comprehensive Capital Analysis and Review (CCAR) have quickly become yesterday's news, largely (and incorrectly) dismissed as another unrealistic and awkward attempt by regulators to grade-on-a-scale and ultimately endorse most of our financial institutions while marginally winging a handful.

Particularly disturbing are the pundits bemoaning any softening in stance on capital restoration or return, as they remain convinced that severe balance sheet damage lurks hidden and unaddressed. We think they are poorly informed, and we think this deserves a second look, based on quantitative historical context.

We view this CCAR (which is to be repeated annually) as further vindication of US banking sector balance sheet integrity. It also removes another layer of regulatory uncertainty. **Given time, this should enhance sector confidence, valuations and impetus to consolidation.**

Late last year we turned positive on financials, particularly banks, for 1) top line revenue promise from early-stage loan growth, 2) increasingly heavy capital and 3) receding credit problems. Lending momentum appears less due to cyclical economic fundamentals and more due to share recapture and re-intermediation factors (see "The GREAT CREDIT DISTRIBUTION" – December 19th.) Last week's CCAR news bolsters our more sanguine view on credit.

Compared to previous exercises, the CCAR was less about stress testing and more about future use of capital. In that sense, no one really "fails" in a second Great Recession, even if it were worse than the last one, and it were to have unknowingly begun five months ago.

Unlike US Treasury's initial Supervisory Capital Assessment Program (SCAP) results released 34 months ago -- which gave the largest 19 bank holding companies one month to announce a plan and six months to raise nearly $185 billion in "capital buffers" for a uniformly consistent range of future loan losses under a set of very adverse economic assumptions – this time the Federal Reserve set minimum capital hurdles without a one-size-fits-all range of embedded credit losses, while still assuming the equivalent of another Great Recession replete with another global crisis in the financial sector.

While there has been a wide range of commentary, criticism and reaction, we view the hypothetical stress scenario as quite serious and, frankly, realistic. Those who habitually take the cynical side of such exercises probably need to reconsider the degree of charge-offs, write-downs, reserve and capital builds that have been accomplished over the last three years.

The media has immediately centered on the four that "missed" certain of the minimum capital hurdles by the end of next year. By then, only three of these intend to be bank holding companies, and two other "misses" were quite moderate, and only occur if they were to raise payouts. This basically indicates the US financial system carries hurricane-proof levels of capital at current payout rates. At worst some might be unable to raise dividends or buyback stocks, but would not need to cut dividends.

1) While both approaches to future stress are completely dependent on realistic revenue and credit loss projections, the CCAR left each financial institution to project both before regulatory response, while the SCAP initially herded all FIs into a common range of credit losses.

2) Stress projections were again based on serious, but incalculably broad distress in macroeconomic variables. Too few appreciate that this approach is not only hypothetical but extremely hard to translate into actual credit losses or marks, let alone be reflected in future revenues. There is no algorithm that swallows a peak 13% unemployment rate, a 21% decline in home prices, an 8% fall in GDP and then spits out net charge-off ratios delineating numbers for home equity loan damage in Duluth and credit demand weakness in Dallas businesses. Never has been and never will be.

3) The resultant, bottoms-up CCAR loss ratios were strikingly similar to the top-down ranges in the SCAP. More importantly, they were again realistically

extreme. In the following exhibit we go beyond the top 19 and compare both stress loss scenario projections if applied to the entire banking system, as well as the actual, post-SCAP losses and those from the previous recession.

All FDIC-Insured Institutions	Historical 5 yrs 1990-95 Cumulative	*SCAP 2-Yr Mid-Point Adverse 2009-10 Cumulative*	Actual 2-Yr 2009-10 Cumulative	*CCAR 2-Yr Adverse 4Q11-13 Cumulative*
1-4 Family Residential	0.9%	*6.9%*	5.2%	*7.4%*
Non Residential (CRE)	5.1%	*8.0%*	2.1%	*5.2%*
Construction & Development	5.8%	*16.5%*	11.4%	
Home Equity	1.2%	*18.0%*	5.5%	*13.2%*
Multifamily	4.4%	*11.0%*	2.4%	
Real Estate - Other		*5.0%*		
Commercial & Industrial	5.3%	*6.5%*	4.2%	*8.2%*
Noncard to Individuals	4.0%	*10.0%*	5.0%	*5.9%*
Credit Cards	21.1%	*19.0%*	19.3%	*17.2%*
Other		*7.0%*	1.9%	*2.5%*
Total Loans	4.5%	*9.6%*	5.1%	*8.1%*

It is important to reflect that under the 2009 SCAP "adverse scenario" loss expectations were excessively high. Considering how lengthy the GR was and how disappointing the subsequent recovery has been, the regulators proved to be widely off-the-mark in over estimating damage. The 2009 assumptions were supposed to provide "a deliberately stringent test … more stringent than a solvency test" - and they did.

SCAP losses were based on a 10.3% unemployment rate peak (the actual peak was 10%) and a further 3.3% real GDP drop during 2009 (actual drop was 3.5%). These "adverse" macroeconomic assumptions proved eerily correct.

However, this was to produce direct loan losses of 9.1% over the two-year period for the top 19. The actual losses were barely half that. Applying their theoretical loss ratios by loan categories to all banks, we found that the system-wide predicted loss

ratio would have been 9.6%, equivalent to the 1930s Great Depression. In actuality they were 5.1%, slightly higher than the five-year cumulative loss experience spawned after the 1990 recession. The recent CCAR considers another 8.1% cumulative two-year loss ratio for the top 19 financial institutions. We sincerely doubt that.

Implications for industry consolidation may be a little less clear. Another 11 have undergone a "less intensive" Capital Plan Review (CapPR), giving them time to build more data. It should therefore be no surprise that regulators will consider similar stress loss ratios for banks below $50 billion in assets, as they often prefer quantitative consistency. But this sector remains on an inexorable path to massive consolidation. One of the frustrating restraints has been regulatory deliberation and delay. Having updated worst-case markers, however arbitrary, should contribute to greater regulatory approval predictability and, possibly, speed.

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