Fed Sees Goldman, JPMorgan Overvaluing Capital Strength in Slump
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March 8 (Bloomberg) -- Goldman Sachs Group Inc., JPMorgan Chase & Co. and Morgan Stanley lagged behind peers in a key measure of capital strength used by U.S. regulators to stress-test their resiliency in a severe recession.
The three firms submitted more-optimistic estimates of their capital strength and ability to avoid losses on trading and lending than Federal Reserve projections released yesterday for the 18 biggest U.S. banks. Of the three, the gap was widest for Goldman Sachs, which predicted that its Tier 1 common ratio may fall as low as 8.6 percent in a sharp economic downturn, compared with the central bank's 5.8 percent estimate.
The disparities -- including a gap of 1.3 percentage points for JPMorgan -- raise the risk that some banks may have been too aggressive while seeking Fed approval to distribute capital to investors through dividends and share repurchases. The companies must maintain Tier 1 common ratios of at least 5 percent under their capital plans. The Fed is set to release the results of those requests next week.
"If you came in with rosier assumptions than the Fed's own baseline, then you're definitely at risk of failure" in the capital request, said Christopher Whalen, executive vice president at Carrington Investment Services LLC. "The Fed is going to push back on those banks."
Spokesmen for JPMorgan, Goldman Sachs and Morgan Stanley, all based in New York, declined to comment.

Disputes Fed

Auto lender Ally Financial Inc. had a capital ratio of 1.5 percent, the lowest of the firms tested. Detroit-based Ally, which is majority owned by the U.S., disputed the Fed's results, calling the analysis "inconsistent with historical experience" and "fundamentally flawed."
The results are a prelude to the Fed's capital-plan review of the same banks scheduled for release on March 14. Yesterday's results don't forecast next week's because the first test excludes management's plans, a Fed official said yesterday on a conference call with reporters.
Banks have said they were coming into this year's process more cautious even as investors of the six biggest U.S. lenders were anticipating capital payouts that could total $41 billion.
Goldman Sachs Chief Financial Officer Harvey Schwartz told analysts in January that the firm works closely with regulators

to ensure it has a “conservative capital plan.” JPMorgan scaled back its $15 billion share buyback program by at least 20 percent and hopes to boost the bank’s 30-cent quarterly dividend, Chief Executive Officer Jamie Dimon said this year.

Brokerage Venture

Morgan Stanley CFO Ruth Porat said in January that her firm only requested approval for buying the remaining 35 percent of its brokerage venture from Citigroup Inc.
Not asking for a lot won’t help lenders if the assumptions they use aren’t appropriately cautious, said Richard Bove, a bank analyst with Rafferty Capital Markets LLC in New York.
“Even if they were conservative in their request, the capital plans will be turned down if the assumptions were too aggressive,” Bove said in a phone interview. “The Fed risks looking like it caved to pressure” if it doesn’t reject those plans, he said.
The banks probably were hurt by their risk of trading losses, analysts said. The six biggest firms were projected to lose $97 billion on trading in nine quarters through 2014, compared with $116.5 billion in losses estimated in last year’s test, the central bank said. Goldman Sachs and JPMorgan had the most such risk, with the Fed projecting losses of $24.9 billion and $23.5 billion, respectively. JPMorgan said its trading losses would be $17.5 billion.

‘Volatile Business’

“It’s a much more volatile business,” said Jennifer Thompson, an analyst at Portales Partners LLC. “In a stressed environment you will have potentially massive losses. The offset should be that they are getting better returns from those businesses. Theoretically, it should all equal out.”
Citigroup, the only U.S. bank among the six biggest to have its capital plan rejected last year, saw its Tier 1 common ratio fall to 8.3 percent under the central bank’s projections. The company sought permission to repurchase $1.2 billion of its shares without seeking a dividend increase, Citigroup said in a presentation after the Fed posted its report.
The planned buyback would “offset estimated dilution created by annual incentive compensation grants,” the New York-based lender said in the presentation.
Since the 2008-2009 financial crisis, U.S. regulators have tried to minimize the odds of another taxpayer rescue, compelling banks to retain some earnings and reinforce their buffers against possible losses. The Fed said the aggregate Tier 1 common capital ratio for the 18 banks would fall from an

actual 11.1 percent in the third quarter of 2012 to 7.7 percent
in the fourth quarter of 2014.

Global Guidelines

The Tier 1 common ratio measures a bank's core equity, made up of common shares and retained earnings, divided by its total assets adjusted for risk using global banking guidelines.
JPMorgan, the biggest U.S. bank, projected that its key capital ratio wouldn't fall below 7.6 percent, compared with 6.3 percent estimated by the central bank. The lender said pretax losses through 2014 would total $200 million while the Fed said they would be $32.3 billion. JPMorgan also was more optimistic than the Fed in estimating net revenue, loan losses and provisions it would need to cover those losses.
Morgan Stanley estimated its Tier 1 common ratio could fall to as low as 6.7 percent, 1 percentage point higher than the Fed's projection. The bank's estimate for net revenue in the stressed period was $5.1 billion higher than the Fed's.

'More Optimistic'

"Managements probably need to be a little bit more optimistic, the Fed's a regulator," Stifel Financial Corp. CEO Ronald Kruszewski told Matt Miller in an interview on Bloomberg Television's "Fast Forward" program. "That's not unusual."
The Fed's minimum projected ratio for Bank of America Corp., which didn't request buybacks or a dividend increase last year, would drop to 6.8 percent in the most adverse scenario while Wells Fargo & Co.'s would be 7 percent.
Losses for the 18 firms, which represent more than 70 percent of the assets in the U.S. banking system, would total $462 billion over nine quarters, according to the Fed.
Under the Fed's worst-case scenario -- where U.S. gross domestic product doesn't grow or contracts for six straight quarters, unemployment peaks at 12.1 percent and real disposable income falls for five consecutive periods -- the 18 companies would lose $316.6 billion on soured loans, led by Bank of America. The Charlotte, North Carolina-based firm would lose $57.5 billion, followed by $54.6 billion for Citigroup and $54 billion each for Wells Fargo and JPMorgan.

Mortgage Losses

Home loans were the largest source with $60.1 billion in projected losses on first mortgages and $37.2 billion on junior liens and home-equity loans. Bank of America would face $24.7 billion in losses, as San Francisco-based Wells Fargo would

incur $23.7 billion, the Fed estimated.
The next-largest source of bad debt was credit cards, which the Fed estimated would cost banks $87.1 billion. Citigroup, the world's biggest credit-card lender, led loss estimates with $23.3 billion. Capital One Financial Corp., which gets more than half its revenue from credit cards, would lose $16.4 billion.
"The stress analysis and underlying assumptions are informed by a number of factors, including our experience in the 2008 financial crisis and subsequent recession," McLean, Virginia-based Capital One said in a presentation on its website.
As a share of a company's loans, Capital One's portfolio performed worst, with losses amounting to 13.2 percent of its holdings, according to the Fed. That compares with 6.9 percent for Bank of America and 7.7 percent for JPMorgan.
Dimon, 56, expressed confidence about the outcome of the stress test when he spoke to analysts and investors last week.
"Whatever happens, the company will be fine, as long as we can freely compete with everybody else in the world," Dimon said Feb. 26 at the company's investor day. "That, to me, is the most important thing of all."

The following shows how the 18 biggest U.S. banks performed under the Fed's preliminary stress test results, which didn't take into consideration new capital proposals. They are ranked by their lowest projected minimum tier 1 common ratio under the Fed's severely adverse economic scenario:

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Ally Financial Inc. 1.5
Morgan Stanley 5.7
Goldman Sachs Group Inc. 5.8
JPMorgan Chase & Co. 6.3
Bank of America Corp. 6.8
Wells Fargo & Co. 7.0
SunTrust Banks Inc. 7.3
Capital One Financial Corp. 7.4
Regions Financial Corp. 7.5
KeyCorp 8.0
Citigroup Inc. 8.3
U.S. Bancorp 8.3
Fifth Third Bancorp 8.6
PNC Financial Services Group Inc. 8.7
BB&T Corp. 9.4
American Express Co. 11.1
State Street Corp. 12.8
Bank of New York Mellon Corp. 13.2
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