



## Market Analysis, Research & Education

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# U.S. Banks: Feeling Less Stressed?

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By one important measure, the U.S. government's financial stress tests on major banks have already proven to be a success. Since the results of the stress tests were released a few weeks ago, financial firms have returned to private capital markets at a record pace to significantly boost their capital positions.

During the first week of May, government regulators announced the results of the much-anticipated "stress tests," which were designed to rigorously examine how well the balance sheets of major U.S. banks could withstand a potentially more severe economic environment. Of the largest 19 banks, the regulators instructed 10 of them that an additional \$75 billion of capital would be necessary to adequately survive in such a scenario.<sup>i</sup>

### Stress-Test Transparency Instills Confidence

Despite the news that a majority of the nation's largest banks remained under-capitalized, investors generally greeted the results with enthusiasm. May ended up being the biggest month ever for secondary equity issuance (existing public companies issuing new shares), as U.S. companies sold more than \$50 billion of new stock to the public. Issuance was dominated by large financial firms, with roughly half issued by the 10 banks required by regulators to raise new capital (see Exhibit 1, next page). Along with asset sales and conversions

of preferred stock, banks have already raised the bulk of the capital required as a result of the stress-test results—with no additional assistance from the federal government. The ability of banks to return to access private capital markets at such a brisk pace is a dramatic turnaround from just two months ago, when new equity issuance would have been unthinkable.

### Banks Still Facing Pressures

The return of banks to the private markets does not mean they are out of the woods yet. By all accounts, their loan books continue to deteriorate, and the extra capital will be important to help absorb growing losses on mortgages, commercial real estate loans and credit cards. The Federal Deposit Insurance Corporation reported delinquency rates on the entire book of bank loans and leases already hit a record high in the first quarter of this year.<sup>ii</sup> The stress-test estimates show that loss rates on the banking industry's loan books could reach more than 9%, resulting in \$600 billion of additional losses.<sup>iii</sup> And no one can foresee whether the "more adverse" scenarios proposed by the regulators in their stress-test assessments will end up being pessimistic enough.

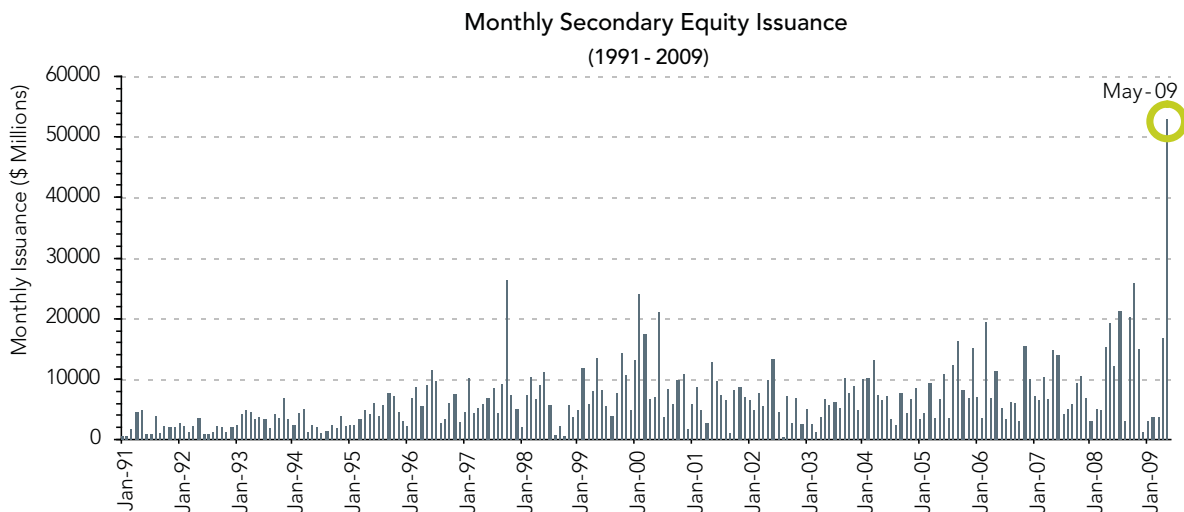
### Investment Implications

Whether the regulator stress tests end up being accurate in estimating the exact magnitude of loan losses is less important than what they have already accomplished. Due to the transparency of a standardized capital adequacy test on the nation's major banks, investors felt more comfortable with an understanding of the potential downside of loan losses going forward. The subsequent investor confidence thus has allowed banks to boost their capital positions, and at the very least they will be in a better position to withstand whatever economic environment unfolds. The stress tests already have proven to be one of the least expensive and most successful policy initiatives to start moving the financial system away from government life support. ■

#### KEY TAKEAWAYS

- Since the results of U.S. government stress tests on banks were unveiled in early May, major banks have raised capital in the private markets at a record pace to boost their capital positions.
- Banks are likely to face massive loan losses ahead, but the post-stress-test confidence boost from investors has placed them in a better position to withstand whatever economic climate unfolds.

**EXHIBIT 1**  
**U.S. companies**  
**sold a record**  
**dollar amount**  
**of new stock**  
**to the public in**  
**May, the bulk**  
**of it issued by**  
**large banks.**



Source: Bloomberg, FMRCo (MARE) as of 5/26/09.

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*Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk. Past performance is no guarantee of future results.*

[i] Source: Federal Reserve.

[ii] Federal Deposit Insurance Corp. - The federal government agency charged with maintaining stability and public confidence in the U.S. financial system.

[iii] Source: Federal Reserve.

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