THE WALL STREET JOURNAL.
WSJ.com

MAY 9, 2009

Banks Won Concessions on Tests

Fed Cut Billions Off Some Initial Capital-Shortfall Estimates; Tempers Flare at Wells

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The Federal Reserve significantly scaled back the size of the capital hole facing some of the nation's biggest banks shortly before concluding its stress tests, following two weeks of intense bargaining.

In addition, according to bank and government officials, the Fed used a different measurement of bank-capital levels than analysts and investors had been expecting, resulting in much smaller capital deficits.

The overall reaction to the stress tests, announced Thursday, has been generally positive. But the haggling between the government and the banks shows the sometimes-tense nature of the negotiations that occurred before the final results were made public.

Government officials defended their handling of the stress tests, saying they were responsive to industry feedback while maintaining the tests' rigor.

When the Fed last month informed banks of its preliminary stress-test findings, executives at corporations including Bank of America Corp., Citigroup Inc. and Wells Fargo & Co. were furious with what they viewed as the Fed's exaggerated capital holes. A senior executive at one bank fumed that the Fed's initial estimate was "mind-numbingly" large. Bank of America was "shocked" when it saw its initial figure, which was more than $50 billion, according to a person familiar with the negotiations.

At least half of the banks pushed back, according to people with direct knowledge of the process. Some argued the Fed was underestimating the banks' ability to cover anticipated losses with revenue growth and aggressive cost-cutting. Others urged regulators to give them more credit for pending transactions that would thicken their capital cushions.

At times, frustrations boiled over. Negotiations with Wells Fargo, where Chairman Richard Kovacevich had publicly derided the stress tests as "asinine," were particularly heated, according to people familiar with the matter. Government officials worried San Francisco-based Wells might file a lawsuit contesting the Fed's findings.

The Fed ultimately accepted some of the banks' pleas, but rejected others. Shortly before the test results were unveiled Thursday, the capital shortfalls at some banks shrank, in some cases dramatically, according to people familiar with the matter.

Bank of America's final gap was $33.9 billion, down from an earlier estimate of more than $50 billion, according to a person familiar with the negotiations.

A Bank of America spokesman wouldn't comment on how much the previous gap was reduced, though he said it resulted from an adjustment for first-quarter results and errors made by regulators in their analysis. "It wasn't lobbying," he said.

Wells Fargo's capital hole shrank to $13.7 billion, according to people familiar with the matter. Before adjusting for first-quarter results and other factors, the figure was $17.3 billion, according to a federal document.

"In the end we agreed with the number. We didn't necessarily like the number," said Wells Fargo Chief Financial Officer Howard Atkins. He said the company was particularly unhappy with the Fed's assumptions about Wells Fargo's revenue outlook.

At Fifth Third Bancorp, the Fed was preparing to tell the Cincinnati-based bank to find $2.6 billion in capital, but the final tally dropped to $1.1 billion. Fifth Third said the decline stemmed in part from regulators giving it credit for selling a part of a business line.

Citigroup's capital shortfall was initially pegged at roughly $35 billion, according to people familiar with the matter. The ultimate number was $5.5 billion. Executives persuaded the Fed to include the future capital-boosting impacts of pending transactions.

SunTrust Banks Inc. also persuaded the Fed to significantly reduce the size of its estimated capital gap to $2.2 billion, after identifying mathematical errors in the Fed's earlier calculations, according to a person familiar with the matter.

PNC Financial Services Group Inc., saw a capital hole materialize at the last minute. As recently as Wednesday, PNC executives were under the impression they wouldn't need to find any new capital, according to people familiar with the matter. Thursday morning, the Fed informed PNC that it had a $600 million shortfall.

Regulators said other banks also were told they needed more capital than initially projected.

The Fed's findings were less severe than some experts had been bracing for. A weeklong rally in bank stocks continued Friday, with the KBW Bank Stocks index surging 10%. Investors were especially relieved by the relatively small capital holes at regional banks. Shares of Fifth Third soared 59%, while Regions Financial Corp.'s $2.5 billion deficit led to a 25% leap in its stock.

With the stress tests, government officials were walking a fine line. If the regulators were too tough on banks, they risked angering their constituents and spooking markets. But if they were too soft, the tests could have lost credibility, defeating their basic confidence-building purpose.

All the back-and-forth is typical of the way regulators traditionally wrap up their examinations of banks: Regulators often present preliminary findings to lenders and then give them time to respond. The process can result in changes to the regulators' initial conclusions. Some of the stress-test revisions, for instance, were made to account for the beneficial impact of the industry's strong first-quarter profits.

On Friday, some analysts questioned the yardstick, known as Tier 1 common capital, that regulators chose to assess capital levels. Many experts had assumed the Fed would use a better-known metric called tangible common equity.

According to Gerard Cassidy, an analyst with RBC Capital Markets, the 19 banks' cumulative shortfall would have been more than $68 billion deeper if the government had used the latter metric, which accounts for unrealized losses.

Federal officials said their projections reflected the most comprehensive analysis ever conducted of the industry.

The test results showed that the 19 banks faced a total of $599 billion in losses over the next two years under the government's worst-case, Depression-like scenario. The Fed directed 10 banks to add a total of nearly $75 billion to their capital buffers to insulate themselves from potential losses.

Banks pressed ahead on Friday with plans to fill their capital holes by tapping public markets. Wells Fargo raised $7.5 billion in stock through a public offering. The bank originally planned to raise $6 billion, but expanded the offering, which was valued at $22 a share, due to robust demand. Shares of Wells Fargo rallied $3.42, or 14% to $28.18.

Morgan Stanley, which is facing a $1.8 billion capital hole, raised $4 billion by selling stock. Shares of Morgan rose $1.06, or 4%, to $28.20.

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Printed in The Wall Street Journal, page A1