


## US: A Question of Stress Test


The Federal Reserve last week released the methods used and the preliminary results in stress tests on the 19 largest US banks, which incorporated an accounting proposal that would bring about \$900 billion onto lenders' books. These banks include Citigroup Inc., Bank of America Corp., Goldman Sachs Group Inc., GMAC LLC, MetLife Inc. and other regional lenders. The accounting change suggests most of them will need to take some action to boost their capital. As a result, stronger banks are expected to keep dividend payments low or apply retained earnings, with others selling new shares to make up the amounts. In calculating the capital buffers, regulators accounted for off-balance sheet securities that banks will be incorporating in 2010 as a result of proposed accounting rules changes. Banks may bring on about \$900 billion to their balance sheets as a result of the change by the Financial Accounting Standards

Board. Supervisors boosted the risk-weighted assets in their assessments by \$700 billion, according to Bloomberg. The rationale behind the stress tests is that the deeper the downturn in GDP and employment, the worse the banks will do, as people will be less likely to pay their debts. In fact, banks constantly run good- and bad-case scenarios for budgeting purposes and share the results with the public. Meanwhile, analysts are always coming up with unusual scenarios to justify their stock price targets. But the government appears to be aiming for banks to have a Tier 1 capital ratio of 6% and a total common equity ratio of 3%. These are the baseline amounts and could be increased depending on how the financial markets react going forward. Tier 1 capital consists of common stock, preferred stock and hybrid debt-equity instruments. The

government injected tens of billions of dollars into the banks last year, in large part to increase that capital to safer levels. As of today, most large banks have Tier 1 ratios that well exceed the 6% floor. The market now seems to be fixated on the ratio of tangible common equity (TCE) to its total assets. This ratio essentially shows what common shareholders would receive if a bank were ever dissolved. Many banks - including Citigroup - have TCE ratios that are well below the 3% floor because of sharp declines in their common stock prices. If Citigroup is forced to dole out common stock to get to the 3% level, the government could end up owning 59% of Citigroup, according to Bloomberg. That is a whole lot more than the maximum 40% ownership stake of Citi that has been talked about in Washington. 



## Microscope

In February, the US government planned to end the uncertainty surrounding the solvency of banks, starting with stress tests, of which about 19 major banks with more than \$100 billion in assets would have their balance sheets scrutinized to judge whether they have enough capital to survive further economic downturn. The capital assessment covers two economic scenarios: a baseline scenario and a more adverse scenario. Under the baseline scenario, the assumptions for real growth in GDP and the unemployment rate for 2009 and 2010 are assumed to be equal to the average of several independent economic forecasts. The "more adverse" scenario reflects a deeper and longer recession than in the baseline. Both scenarios have the recession bottoming out in the 2<sup>nd</sup> quarter of 2009: the baseline sees GDP falling 2% from the second quarter of last year while the "more adverse" scenario sees it falling by 4%. The unemployment rate in the baseline scenario will peak at 9% in the first quarter of 2010 and then fall. The "more adverse" scenario will peak at 10.5% in the second quarter of 2010 and continue at that level through the rest of the year. 

### MARKET BRIEFING

#### YTD % (local curr)


<b>US DJ</b>	8,076 (-8.0%)
<b>Nasdaq</b>	1,694 (7.4%)
<b>Euro Stoxx 50</b>	2,319 (-5.4%)
<b>HSI</b>	15,258 (6.1%)
<b>Japan NK225</b>	8,707 (-1.7%)
<b>China Shanghai Composite</b>	2,448 (34.5%)
<b>Singapore</b>	1,852 (5.2%)
<b>India BSE30</b>	11,329 (17.4%)
<b>Brazil BOVESPA</b>	46,771 (24.6%)
<b>Aus All Ord</b>	3,668 (0.2%)
<b>US-10yr Bond Yield</b>	2.99%

As at 24/04/09


## Insight: "Dynamic Financial Planning"

Dynamic financial planning is based on a simple precept: Most of us change the way we manage our wealth when faced with a series of life stages, a sudden event or crisis. Our asset and investment portfolios need to be structured around the constraints and opportunities inherent within each of these stages or event. For example, it is usually the birth of a child in a nuclear family, an accident or illness that needs a sudden large sum of money or the untimely death or disablement of a family member, specially the breadwinner that makes such moves necessary. Retrospective action taken after the event may not usually give the most

efficient solutions to financial problems. A better way would be to build in the anticipated or possible events into a financial plan to be better prepared for the future. Dynamic financial-planning models can

Serve as an invaluable guideline for the preparation. The problem, of course, is that fewer and fewer clients are fitting into an established mold. Some clients are already well aware of this; others are expecting that their lives will progress down a predictable path. In either case, advisors bring an added dimension to the planning process when they point out that careers, corporations, industries, marriages, family life, health and nature often take unexpected turns. The key is to build flexibility and contingencies into the financial plan. You should plan because of uncertainties and maybe even doubts about managing your finances. 

## A-Z Financial Tools

**Quanto** is a derivative in which the underlying is denominated in one currency, but the instrument itself is settled in another currency at some fixed rate. Essentially, a quanto has an embedded currency forward with a variable notional amount. Such products are attractive for speculators and investors who wish to have exposure to a foreign asset, but without the corresponding exchange rate risk. 



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