

2014 Stress Test and CCAR Summary & Analysis

On March 20, 2014, the Federal Reserve (the “Fed”) released its 2014 Dodd-Frank Act Stress Test (DFAST) results. This DFAST process tests how capital of the largest 30 U.S. banks and U.S. subsidiaries of foreign banks would respond to hypothetical “adverse” and “severely adverse” economic and market scenarios taking place over a nine-quarter horizon through the 4th quarter of 2015. The latter scenario (detailed in the table below) factored in: 11.25% U.S. unemployment rate, 4.75% drop in U.S. GDP, 25% and 35% decline in U.S. home prices and commercial real estate property values, 50% correction in equities, and an instantaneous “shock” to the global financial system (as detailed in the Fed’s release “Dodd-Frank Act Stress Test 2014: Supervisory Stress Test Methodology and Results March 2014”).

KEY ECONOMIC VARIABLES			
<i>Severely Adverse Scenario</i>			
	Stress Test 2012	Stress Test 2013	Stress Test 2014
Real GDP	-5%	-5%	-4.75%
Unemployment rate	12%	12%	11.25%
Consumer Price Index	-1%	-1%	< -1%
Equity market volatility index	21% to 70%	21% to 70%	68%
Equity prices	-50%	-50%	-50%
House prices	-20%	-20%	-25%
Commercial R/E	-20%	-20%	-35%

On a quantitative basis, 29 out of the 30 banks tested passed the stress test. We attribute these favorable test results to four years of organic capital formation, improving net earnings prospects and on-going asset divestitures. Zions Bancorp¹, a regional U.S. bank, which was one of the 12 new participants to the DFAST process this year, was the only bank to fail, probably due to a lack of fee-based revenue sources, sizable structured security holdings and commercial real estate loan exposures. Zions’ failure was not a total surprise to the market. Last year, Zions was the only regional bank that received a “Conditional” pass on the precursor exam to DFAST for largely the same reasons, while all of its regional peers “passed” (detailed in the table below). However, Zions is a credit that we’re comfortable with, as we believe the need to raise capital is fully reflected in the price of its securities. Since the Fed is now forcing the bank to raise additional capital

¹ As of 3/31/2014 Zions Bancorp comprised 1.9%, 1.9%, 1.9%, 2.0% and 1.9% of PFD, PFO, FFC, FLC and DFP respectively.

junior to the preferred, we anticipate the market's perception of Zions' credit quality will improve when the additional capital is obtained.

Related to the DFAST process, banks also submit capital plans for their upcoming year – namely their proposals for common stock dividends and share buyback programs. On March 26, 2014, the Fed released these Comprehensive Capital Analysis and Review (CCAR) results. Notably (as detailed in the table below) 25 of 30 banks received “no objection” to their proposed 2014 capital plans.

These results suggest that the Fed will permit only disciplined capital returns to shareholders. U.S. banks that “passed” the 2014 CCAR announced a median 11% increase in 2014 total capital return over 2013. Across the board, 2014 dividend increases were modest, and some banks elected to hold dividends steady and significantly increase 2014 share repurchases. Of those holding dividends unchanged and increasing share repurchases, the most significant were Capital One and PNC, who announced plans to buy back \$2.5 billion or 6% of current shares outstanding and \$1.5 billion or 3% of current shares outstanding, respectively, in order to reduce dilution from recent acquisitions.

Five banks' capital plans were rejected primarily because of the Fed's conclusions about risk management at those banks. *Although their plans were not accepted by the Fed, these banks will still be allowed to pay dividends to preferred shareholders and maintain common dividends and share repurchases at levels approved in 2013.* By not allowing any increase in shares repurchases, the Fed has maintained capital at these banks to support preferred shareholders.

The biggest CCAR surprise was the rejection of CitiGroup's request to return \$7 billion of capital to shareholders, which included raising its dividend to \$0.05 per share and a \$6.4 billion common stock repurchase program. Despite the rejection, Citi will be allowed to continue paying its \$0.01 quarterly dividend and buying back as much as \$1.2 billion of its shares through March 2015. In Citi's case, a recent \$400 million loan fraud uncovered at its Mexican subsidiary, Banamex, hurt its “qualitative” assessment and heightened regulators' concerns about the bank's global risk management and overall credit culture.

For similar reasons, we believe HSBC North America (e.g. money laundering, LIBOR-fixing, and foreign-exchange rates rigging allegations) and RBS Citizens (LIBOR-fixing and foreign-exchange rate rigging allegations and on-going restructurings) failed CCAR because of general concerns about operational lapses. In Santander Holding USA's case, an aggressive acquisition strategy focused on U.S. subprime auto lending may have given the Fed cause for concern. The two foreign-owned U.S. banks (BMO Financial and UnionBanCal) that passed CCAR have generally avoided major headline risks and continue to operate plain vanilla business models, which is what U.S. regulators seem to want all banks to do.

Overall, the 2014 Stress Test and CCAR results highlighted:

- Continued improvement in overall capital levels for U.S. banks.

- Sufficient capital and earnings at U.S. banks to permit a median 11% increase in 2014 total capital return over 2013.
- Much higher than previously assumed regulatory “qualitative” hurdles for larger banks.

Importantly, the benchmark Tier 1 common equity ratios of U.S. banks withstood a stress test based on 2008-2009 crisis-era market corrections, maintaining capital levels (i.e., bank peer average of 8.5%) well above the Fed’s 5% minimum threshold. In other words, even though a repeat of the 2008-2009 financial crisis is unlikely, banks are better prepared today to withstand similar losses.

For large and complex financial institutions, U.S. regulators sent a clear message this year: all of them will have to (1) maintain high levels of capital and (2) develop enhanced risk management practices. In our view, these developments generally represent credit positives for preferred investors in U.S. banks and U.S.-based operating subsidiaries of foreign banks. Of course, individual credits require ongoing rigorous case-by-case analysis, which we will continue to perform as we have been doing since our firm’s inception.

Flaherty & Crumrine Incorporated
April 1, 2014

2014 Stress Test and CCAR Results²

U.S. Banks	Minimum Tier 1 Common Ratio under "Severely Adverse" Stress Scenario > 5%	Minimum Tier 1 Common per "Severely Adverse" Stress Scenario through Q4 2015	2014 Share Repurchase Request	2014 Share Repurchase Request as % of 4Q13 Avg Diluted Shares	2014 Quarterly Dividend per Share	4Q13 Quarterly Dividend per Share	Pro-forma Dividend Yield 4/1/14
Ally	Passed	6.3%					
American Express	Passed	12.1%	\$4.4 billion	4%	\$0.26	\$0.23	1.14%
Bank of America	Passed	5.9%	\$4 billion	2%	\$0.05	\$0.01	1.15%
Bank of NY-Mellon	Passed	13.1%	\$1.74 billion	4%	\$0.17	\$0.15	1.92%
BB&T	Passed	8.4%	\$0	0%	"conservative increase"	\$0.23	2.27%
BBVA Compass	Passed	8.5%			\$102MM annual dividend to BBVA		
BMO	Passed	7.6%					
Capital One	Passed	7.8%	\$2.5 billion	6%	\$0.30	\$0.30	1.56%
Citigroup	Passed	7.2%	\$1.2 billion	1%	\$0.01	\$0.01	0.08%
Comerica	Passed	8.6%	\$236 million	3%	\$0.20	\$0.19	1.55%
Discover	Passed	13.2%	\$1.6 billion	6%	\$0.24	\$0.20	1.62%
Fifth Third	Passed	8.4%	\$669 million	3%	\$0.13	\$0.12	2.25%
Goldman Sachs	Passed	6.9%	not disclosed		not disclosed	\$0.55	1.33%
HSBC North America	Passed	6.6%					
Huntington	Passed	7.4%	\$250 million	3%	\$0.06	\$0.05	2.36%
JPMorgan Chase	Passed	6.3%	\$6.5 billion	3%	\$0.40	\$0.38	2.64%
KeyCorp	Passed	9.2%	\$542 million	4%	\$0.065	\$0.06	1.81%
M&T Bank	Passed	6.2%	not disclosed	0%	\$0.70	\$0.70	2.30%
Morgan Stanley	Passed	6.1%	\$1 billion	2%	\$0.10	\$0.05	1.28%
Northern Trust	Passed	11.7%	\$425 million	3%	\$0.33	\$0.31	2.01%
PNC	Passed	9.0%	\$1.5 billion	3%	not disclosed	\$0.44	2.02%
RBS Citizens	Passed	10.7%					
Regions Financial	Passed	8.9%	\$350 million	2%	\$0.05	\$0.03	1.78%
Santander Hlds USA	Passed	7.3%					
State Street	Passed	13.3%	\$1.7 billion	5%	\$0.30	\$0.26	1.72%
SunTrust	Passed	8.8%	\$450 million	2%	\$0.20	\$0.10	1.99%
US Bancorp	Passed	8.2%	\$2.3 billion	3%	\$0.245	\$0.23	2.28%
UnionBanCal	Passed	8.1%					
Wells Fargo	Passed	8.2%	\$16.975 billion	7%	\$0.35	\$0.30	2.81%
Zions	FAILED	3.6%	\$0	0%	\$0.04	\$0.04	0.51%
Peer Average		8.5%		3%			1.76%

² Data compiled from "Dodd-Frank Act Stress Test 2014: Supervisory Stress Test Methodology and Results March 2014" and bank press releases.

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