

## **US Bank Stocks – Timothy Geithner To Become XLF's Largest Shareholder in 2009(Or the coming Financial Stock Market Crash)**

First some numbers on US Banking Capital

Tangible Common Equity of all US banks/thrifts pre-crisis - **\$844B 6.8% TCE ratio**

Tangible Common Equity Q42008 - **\$872B 6.3% ratio**

Tangible Common Equity of US Banks(more \$10b in assets) Q4 - **\$550B\* 5.0% ratio**

Danger zone(3% ratio) - \$324b, **Surplus over danger \$226B**

Total losses taken by US Banks so far - \$700B

Capital Raised \$500B

Deficit - \$200B

The deficit was made up mostly by the pre-tax pre-provision income which increased the TCE of the system

Total losses left to go IMF **\$200B**(\$900b total) Goldman **\$300B**(\$1T total) Roubini

**\$1,000B**(\$1.8T total)

These totals are for US banks and ignores losses taken outside the US banking system

Lets assume total losses left to go fall between Goldman and Roubini numbers(Given that the IMF is not exactly known for their forecasting abilities)

so **\$650B left to go** over the course of probably 2 more years. Those losses will fall mostly in the US largest banks as they control almost 80% of banking assets, so you would have \$520b(80%, a very optimistic assumption given that big banks have lower 'earning' assets than smaller ones, their portfolios are worse) in losses against \$550b in TCE for the largest banks. This is more than twice the surplus TCE of big banks

This also wipes out the majority of TCE of the big banks. Now its true that the pre-tax pre-provision income of the US banking system

runs at around \$200b(this number should be roughly \$160b for large banks), this number will be lowered if the Geithner bad asset program is used widely as that facility will decrease bank profitability to the benefit of Pimco and Blackrock(Large asset sellers simply cant be expected to get the better end of the deal when trading against large savvy bond firms in this type of environment). But \$400b can be 'raised' that way over the next two years.

Of course the problem is, the market is forward looking and it will simply not tolerate to let banks 'earn' their way out of this problem without EXPLICIT guarantees on bank liabilities so this means that equity capital needs to be raised to fill the deficit(deficit over danger TCE zone) **immediately**. Actually its possible that the 'deficit' understates the amount of capital needed given that the market might still consider a 5% TCE ratio as not enough. Indeed Alan Greenspan says banks will need well north of \$750B to recover

\*Rough Estimate

That's what the current Geithner plan seems to be doing, the stress test is likely to show a deficit of similar magnitude(although only firms with more than \$100b in assets are in) that will be filled through convertible preferred stock. He will also try to lure in private equity capital by hurting the solvency/profitability of banks by making them sell assets to bond firms at attractive prices. If private capital is not lured in, Geithner will have to sink at least another \$500-\$750B of common equity capital to fill the gap. Its just not reasonable to expect more than half a trillion in private equity capital to step in and **take risks in bank stocks in this type of environment, so its quite likely the Geithner plan will not 'work'**, indeed if Pimco, Blackrock and other make money on this(after paying interest, fees and loans to the government) and **they are saying they will**, the banks will be left less solvent and less profitable since there is no such thing as a free lunch and the income to the US best bond funds needs to come from somewhere

The total market cap of US financial stocks is roughly about \$800B against \$500-\$700B of common equity that needs to be raised, this means that Geithner will become the largest shareholder of bank stocks in the US after he realizes private equity capital will not save the day. Indeed he will have to hire a whole new team to file SEC 13gs forms

### Conclusion

This suggests XLF is currently having a sucker rally and it will tank then break its lows this year. The trade is to short US bank stocks/buy puts with low TCE ratios(the big ones) and collect the check perhaps after the stress tests show the size of the deficit or when the market realizes the degree of dilution on low TCE banks is much bigger than expected The 'risk' to this is a change of plans by Geithner, however if he does change plans it will be to favoring nationalizations and forcing conversions of debt to equity(in an effort to 'create' capital), however that does not present a risk to shorting financials since the uncertainty and the low TCE ratios will guarantee the common stocks of large banks will become options and trade close to \$1

A different risk is explicit guarantees of large banks and permission for them to play accounting games and 'earn' their way out of the problem, this is however a Japanese type solution that is not likely to be favored by US authorities



Most of the data was obtained from the FDIC quarterly banking profile and bloomberg

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