BusinessWeek

February 25, 2009

A Stress Test Every Bank Can Pass?

Details are emerging of Treasury's "stress tests" for failing banks it may rescue—but regulators may be willing to lend a hand to banks even if they flunk

By Jane Sasseen and Theo Francis

On Feb. 25 regulators laid out details on how they will run the "stress tests" that Treasury Secretary Timothy F. Geithner has promised on the biggest banks. Now those tests, designed to judge whether the banks have the capital to keep lending and absorb losses in a severe recession, face an exam of their own.

Much of the credibility of Geithner's struggling bank bailout program hinges on what Treasury does with the test results. Many investors believe the banking system is drastically undercapitalized. While no one expects regulators to declare the money center banks insolvent, they are watching to see whether Geithner will allow the weakest of the examined banks to fail. "If everyone passes the test, it won't provide [investors] any comfort," says Andy Laperriere, a Washington-based policy analyst with the research firm International Strategy & Investment Group.

Regulators say they plan on more rigorous, more forward-looking versions of the computer simulations that the banks themselves have conducted to project how their capital would hold up through a variety of worst-case scenarios. While the banks' own tests often focused narrowly on issues such as interest rates, inspectors will consider two other prospects. First, they'll see what would happen to loan defaults and bank revenues if GDP falls by 2% this year and grows 2.1% in 2010, which is the consensus forecast.

Then they'll look at what would happen should things get dire: if GDP falls 3.3% in 2009, say, and remains flat after that. The feds are projecting home prices will slide 14% this year, and will look at the impact of unemployment at 8% or even 10%. Regulators may also be more skeptical than the banks about the impact of a prolonged recession on the values of mortgage-backed securities, derivatives, and other assets.

WHAT "CAPITAL" COUNTS

A key consideration will be the kind of capital that regulators place the most confidence in. Bank executives fought to get regulators to focus on the traditional measure of solvency known as "Tier 1" capital, a broad measure that counts intangibles such as some deferred tax assets as well as preferred shares with debt-like qualities. But while the intangibles might have some future value to banks, investors have discovered just what a misleading barometer of a bank's health they can be. Washington Mutual and IndyMac had high Tier 1 ratios when regulators seized them.

So investors and bondholders have focused on tangible common equity, in which preferred stock and intangibles are stripped out. Senior government officials say they will focus primarily on Tier 1 capital in the stress tests, although they have also specified that the "dominant element" of Tier 1 capital should be common equity. But Karen Shaw Petrou, managing partner of Federal Financial Analytics, says regulators have signaled that banks won't be sanctioned if they can't meet that "dominant" standard. "If they don't pass key aspects and there are no sanctions, what's the point?" she asks.

IS FAILURE POSSIBLE?

The tests, which should be complete by late April, will give regulators a better idea of the hole that needs filling before the banks get more money. In theory, Treasury officials say any bank found lacking in capital still will first try to tap the markets. But few private investors want to invest in the banks.

"It's a bit of hope over reality," says Daniel Alpert, managing director of Westwood Capital.

So the Treasury may be the only option for any bank needing capital.

Should Treasury recapitalize the underwater banks, force them into a merger, or put them under the control of the Federal Deposit Insurance Corp.? Investors say the FDIC option—basically receivership—is necessary to avoid a Japan-like "zombie bank" scenario.

But it looks like flunking out is not in the cards. Speaking before Congress on Feb. 24, Fed Chairman Ben Bernanke said "the outcome of the stress test is not going to be pass or fail." A senior Administration official adds, "There is no explicit cap on the amount of capital we will provide." Investors are worried. "It's like a test you get to do again if you didn't do well," says Donald J. Rismiller, chief economist of institutional broker Strategas Research Partners. Adds Petrou of Federal Financial Analytics: "The fear is that the tests will simply set the price tag for how much more taxpayers have to put in."