



Bank Stress Tests: How Big a Step Forward?

William R. Cline concludes that the federal stress tests on banks have brought transparency and potential for improvement in the stability of the financial system.

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Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Our guest, William R. Cline, senior fellow at the Institute, is here to discuss the US government's announcement of the results of its so-called stress test on the nation's leading banks. Thank you, Bill, for helping to clarify this very confusing situation.

Bill, what was the objective of these stress tests and why were they necessary?

William R. Cline: Fundamentally I think they're necessary to establish greater public confidence in the banking system and to make sure that those banks short of capital top up their capital so that they're robust.

Steve Weisman: The federal government projected losses for these major banks, the 19 banks, of close to \$600 billion if the economy performs worse than expected. It directed 10 of the banks to raise capital to protect themselves against future losses. Were you surprised at the extent of losses and the number of banks in need of capital?

William R. Cline: Certainly with the benefit of the last several days of information leaking into the public, it was no great surprise. Fundamentally the estimates are broadly consistent with amounts that the IMF has estimated before. The particular composition was interesting: \$34 billion for Bank of America alone; Citigroup was a fairly small figure, \$5 billion, but largely because it's already committed to have \$45 billion converted from government holdings of preferred stock to common stock; GMAC was \$12 billion; Wells Fargo was \$14 billion. So those are the principal cases in which banks are going to need to raise common equity capital.

But what's interesting was that they see a substantial amount of the capital needs over the next couple of years, even under this adverse scenario, coming from earnings. They have something like \$350 billion of earnings for these banks set against the \$600 billion in losses. The other thing that came out was that this capital shortfall was in common stock, called tangible common equity, and that there wasn't any shortfall at all in the more traditional capital, which is Tier 1 capital. But basically what they've done is—because the market was looking at the common stock and the market was saying, “Preferred shares, those are sort of like debt, let's not count them,” they said, “This is a confidence story, so

maybe we should focus on the common stock.” And at the end of the day, the basic message is: The numbers are manageable. Also this is, after all, a stress test. This is what they need if things really go bad. I mean the assumptions of the bad scenario were 3.3 percent decline in GDP this year instead of the consensus now of 2.6; almost no growth next year instead of a bounce back to a consensus of 1.8 percent. And similarly, although some people say the stress test scenario wasn’t severe enough, there will be people who will say it’s too severe.

Steve Weisman: The criticism you hear is that somehow the stress test was graded on a curve, that the scenario it asked banks to prepare for was too easy.

William R. Cline: I think there’s a prior question to ask. We’ve heard all this about “got to have regulatory reform” and “there’s got to be countercyclical capital requirements instead of procyclical capital requirements.”

What does that mean? That means, when you have a really bad time, your capital requirement should be allowed to be a bit thinner than usual. And yet, here what we’re doing is saying, “we’ve got bad times so let’s put in more capital.” The underlying premise that you should anticipate the worst possible thing in the midst of a recession and build up capital, which also tends to limit your lending. That’s procyclical if you think about it.

Steve Weisman: Is there a risk though that the effort to expand their capital will reduce lending?

William R. Cline: In some sense there is that risk. I think basically these banks are in sort of a holding pattern now. I’ve heard one comment to the effect that the problem with this is that it doesn’t address the need to increase lending. I’ve thought all along that the real need is to keep the core of the system from collapsing rather than rapidly expanding the lending. Yes, this is going to be consistent basically with shoring up, and not with a rapid expansion in lending.

Steve Weisman: If the stress test projected a fair amount of earnings, where are those earnings coming from, if not from more lending?

William R. Cline: When the Treasury bill rate is zero, then if you’re in the business of lending out money at 5 percent, you make up a nice little profit. This is sort of the classic way that we work out of these banking crises. The Fed really cranks the interest rate down. People are complaining about usurious interest rates on credit cards. Well, that gives you some opportunity for profit. So that’s where these earnings are coming from.

Steve Weisman: There is a lot of criticism of the stress test from commentators, Paul Krugman, Jeffrey Sachs, Joseph Stiglitz, even some of our colleagues here at the Institute, who feel that the banks are clearly more insolvent and that more aggressive steps should be taken. We of course have talked about this on Peterson Perspectives before. Do you think that the stress tests vindicate any particular point of view?

William R. Cline: I think probably those critics would still maintain critics because the principle of cash flow evaluation was used, instead of a mark-to-market standard, and thus in their view, the banks are in much worse shape. I have thought all along that the cash flow evaluation is the right way to look at these things.

Steve Weisman: When you say these things, you mean the...

William R. Cline: The evaluation of the assets.

Steve Weisman: Of the loans. Right.

William R. Cline: Yes. One of the things that's very useful about this exercise is its transparency. For each of these banks, you've got a breakdown of about 10 categories of the assets that they hold. The test results show an assumed loss rate under the stress scenario. So anybody who doesn't like these results and thinks they're too rosy, should go through and place what their own loss rates are and justify why those higher rates are warranted. They do point out that the overall loss rate under the stress test is 9 percent of the loans and they point that that's a higher rate than occurred in the 1930s.

So it's not exactly, at least at first blush, a rosy scenario. On the contrary, it's a fairly conservative, rigorous test. So I think it has legitimately given a sort of breath of fresh air to the market. Obviously, the financial market has responded. The stock market is back in the black for 2009 for the first time for a while.

And I think there's legitimacy there. There are those who think that the whole exercise is a charade, a Potemkin's Village, a kicking the ball down the road so that you can avoid dealing with the problem now because Congress is so angry that they wouldn't give you enough money to deal with it. Time will tell whose diagnosis was the correct one. But I guess my money is on the diagnosis that the stress test is meaningful and that the banks, in a fundamental sense, are solvent and that we can start to turn this thing around.

Steve Weisman: Bill, you've also analyzed the public-private partnership schemes of the federal government on legacy loans and legacy securities, as they call them. How important is it for that exercise to succeed? How do you assess the public-private partnership faring right now in the current climate?

William R. Cline: I think in principle, it would be highly desirable to have a lot of these assets sold off. I think it's going to be difficult for this to move very fast.. I mean a lot of the commentary by leading economists when this was announced, was: "This is terrible because the government is going to overpay for these assets." Some analyses said, it'll pay \$2 for an asset that's only worth \$1. And I actually had a piece that's on our website [link here: <http://www.petersoninstitute.org/publications/papers/cline-emmons20090401.pdf>] demonstrating that if there's some overpayment, it's more on the order of 10, 15, 20 percent, not 100 percent, and that that might be salutary because the whole concept is that the stuff is at

fire-sale prices now and that a more meaningful long-term price would be higher. All that being said, I think the problem is going to be that a number of the banks are not going to be interested in what they are offered. Even if the entity comes in trying to buy up the asset and, let's say, it offers 50 percent more than you can get for the fire-sale price, that still may be too low in terms of what the bank thinks it's worth. And again, it does its own cash flow evaluation.

Steve Weisman: Is there some extent to which the somewhat favorable results of the stress test will even embolden the banks to say, "we're okay, we don't have to sell this stuff now"?

William R. Cline: I think that's right. I'm not sure why that would be the wrong conclusion actually. If the value of what they can expect from the continuing payments on those assets exceeds what this market is still willing to offer, then it's a little bit difficult to fault that logic.

Steve Weisman: President Obama a week or so ago blasted the hedge funds that were holding some of the bonds for Chrysler and said they were speculators because they were unwilling to accept write-down to those assets. But now the administration is hoping that these same speculators will come in and take some of these toxic assets off the books of the banks. Is there a difference between the two kinds of speculators?

William R. Cline: Well, whenever you get to a debt workout, there's a question of whether there are so-called rogue creditors who don't cooperate in the workout. I think some would argue that the particular divvying up of the pie in this case, where the union is getting a large chunk of the stock...

Steve Weisman: In Chrysler's case.

William R. Cline: Yes, was not as evenhanded as it might have been. I've also heard, by the way, that a number of those holdout creditors had decided to cooperate. I'm not sure exactly where that stands. I think that the more fundamental problem we're facing here is that because the government has become involved in the salvage efforts, there's a certain expansion of fundamental property rights. There's a sense that, "you don't have that right anymore because there wouldn't be anything there if the government hadn't come in." And we're in a very murky period now where it's unclear what the property rights are. There is some risk that there is a politicization that goes on and it gets eroded. And the problem, then, is the confidence in the system down the road.

Steve Weisman: Bill, thank you very much for talking about the stress tests and a lot of what you said raises more questions. We'll just come back to them also down the road. Thanks for doing this.

William R. Cline: Thank you.

