AMERICAN BANKER
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Stress Test Has Industry Stressed Out

Results could fuel nationalization talk, add to uncertainty

American Banker | Friday, April 3, 2009

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WASHINGTON — No matter what information regulators reveal on the stress tests of the largest banks — and what they will say is a mystery — the results are likely to renew calls to nationalize some institutions, and could further complicate efforts to stabilize the industry.

Since the stress tests were first announced two months ago, the industry has become increasingly anxious about what will be made public when they are completed at the end of this month. Regulators have sent mixed signals on the issue, and options range from declaring the results confidential to detailing which institutions need capital and how much.

With either option, or one of the host of those in between, the public's confidence in at least a few institutions likely will be damaged.

"For banks who it's believed failed the exam, I think we are going to see that cycle all over again with the downward cycle of the stock price and repeat speculation of nationalization," said Kevin Jacques, the Boynton D. Murch chairman in finance at Baldwin-Wallace College.

Some of the uncertainty reflects continuing debate over the cost of "failing" the stress tests, where the definition of failure is itself unclear. If a bank is perceived to need more capital if economic conditions worsen, does this automatically mean it failed the stress test? How large must the shortfall be before regulators take other actions other than requiring it to raise more capital? What would those actions be?

The number of questions greatly exceeds current agency guidance; they have said only that some information will be made public, and that banks will be given six months to raise additional capital from the private sector, with possible government assistance if they are unable to do so.

Unless regulators say exactly which institutions failed the tests, how badly and what the remedial steps will be — all unlikely given their behavior to date — the result is likely to be more confusion, observers said.

"They've created a real problem that was totally unnecessary," said Robert Clarke, a former comptroller of the currency and now a partner at Bracewell & Giuliani. "There's just going to be an endless series of speculation and we are going to be back where we were when we were speculating if banks are going to be nationalized."

The other extreme — attempting to keep all data from the stress tests under wraps — is destined to fail, observers agreed. Those institutions that passed the test are likely to try and find ways to communicate it.

At the very least they will emphasize they have no plans to raise additional capital, which, by the guidance offered so far by regulators, will effectively mean they passed.

The rest, meanwhile, will look as though they failed the test.

"It might be in the best interest of some of the banks if they do pass to spill the beans," said Chris Low, the chief economist for First Horizon National Corp.'s FTN Financial. "It could be the ones who don't pass that we don't hear from, and that may be a tip-off."

Wayne Abernathy, executive director, financial institutions policy, for the American Bankers Association, said bankers may feel pressure to disclose their performance to dispel rumors about the results.

"Analysts will be trying all sorts of ways to guess what the results of the tests were," he said. "If there is so much speculation out in the market that's affecting their operations, they might want to make some disclosure to clarify their record."

Several observers expect regulators to try and keep as much data as they can confidential — only to be undermined by banks that passed.

But keeping it quiet and letting banks indirectly offer clues to the results will just make the situation worse.

"The regulators will treat the stress test under the same procedures of the supervisory exams, but the good banks will look for indirect ways to hint at the results," said Karen Shaw Petrou, managing director of Federal Financial Analytics.

"But it will remain a situation where better banks are undermined by weaker ones, because nothing in the stress test results will be transparent enough to clear up the gloomy cloud of uncertainty hovering over everyone."

For banks that fail, a key question remains what additional actions regulators may take beyond requiring them to raise more capital.

One likely scenario is that those institutions will be forced to sell toxic assets through the Obama administration's legacy loan program.

"One hint that a bank may have failed may be sudden PPIP participation or other moves to sell assets," said Joseph Mason, a professor at Louisiana State University and a former OCC economist, referring to the Public-Private Investment Program.

Federal Deposit Insurance Corp. Chairman Sheila Bair hinted as much in an interview with CNBC last week, saying it was a step regulators were considering.

"This program is interrelated with the stress test, and depending on how strong the banks are given the stress test, they may be encouraged to use this facility as part of their recapitalization efforts," Bair said.

Management changes loom as another possibility for those institutions that fail the test. The stakes for bank chief executives went up this week after the government ousted the CEO of General Motors.

"Investors are already drawing their own conclusions, and after the GM news broke," Low said, "there's some speculation CEOs may be asked to leave if a bank fails" the stress test.

Then there are remaining doubts about the validity of the stress tests in the first place. Regulators have damaged their credibility by repeatedly vouching for institutions only to see a government takeover or bailout shortly thereafter, including Fannie Mae and Freddie Mac.

Many analysts already doubt the conditions of the stress tests. Under the tests, the performance of the top 19 banks, each holding more than $100 billion of assets, is tested under two scenarios: a baseline reflecting consensus expectations, and a more adverse scenario. Both would specifically project gross domestic product, the unemployment rate and changes in housing prices.

Under the more adverse scenario, the test assumes a GDP of negative 3.3% in 2009 and a gain of 0.5% in 2010; an unemployment rate of 8.9% in 2009 and 10.3% in 2010; and house price declines of 22% in 2009 and 7% in 2010.

But soon after the release of that information, some analysts were already suggesting those numbers were not dire enough. At least one bank in the United Kingdom has already run into this problem.

Last month England's Financial Services Authority said Barclays had passed its stress test, which measured the company's condition under an extreme housing price decline. Barclays publicly declared it did not need additional capital.

This did little to satisfy analysts who questioned the validity of the test and speculated that Barclays may still need additional funds. Analysts said the criteria for the tests were not tough enough.

Such a scenario is possible in the United States, observers said.

"The investors and the analysts disregard Treasury and regulators' statements now anyway," Petrou said.