Big Brother Bank & Trust:

How the Stress Tests Will Get Government

Out of the Banking Business

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In about two hours, Secretary Geithner and Chairman Bernanke will finally release the stress tests conducted over the last three months on the nation's nineteen biggest banks. I of course can't say now what they'll tell us then about the test's results, but we already know a lot about the test and the banks on which it was conducted. Thus, we can even now assess the test's strategic impact for large and small commercial banks. In my view, the test – for all its flaws and the confusion that attends its release – is a big step forward. It for the first time sizes the real risk in the banking system, sweeping away the fiction that somehow this is just a bit of a liquidity hiccup. Knowing the size of the problem – or at least starting to size it up for real – means we can now progress to solutions that stabilize large and small banks and, thereby, get the economy back on track.

One more thing about the stress test: it will start to get the federal government out of the banking business, and a good thing too. I know this seems like an odd conclusion from a test that could put still more billions of TARP dollars in the nation's biggest banks. However, I think the banks that flub the stress test will recapitalize on their own or largely through conversion of TARP preferred into TARP common stock, essentially moving taxpayer money from one pocket to another. To be sure, this increases taxpayer risk in the banking system, but it doesn't add to the amount of dollars lent out to it – a starting point for the end of the TARP.

Even more importantly, banks will start to liquidate assets and cleanse their balance sheets – a critical step towards recovery that has taken far too long because of industry resistance and policy uncertainty. With decisions now in hand on which of the biggest banks must do what, investors know what to expect as they consider recapitalization options. It's not for nothing that one of the nation's premier private-equity investors said he sees a 35% annual return in banking – the business model is good and getting better now that the world is returning to intermediation, not securitization. With the stress test and, I hope, follow-up remedial action, banks – big and small – can get back to work.

Of course, this isn't easy. A huge outstanding question is how to recapitalize the biggest banks and apply the test's methodology to everyone else. I'll talk about that today, identifying the various ways large and small banks can recapitalize on their own and with help from Washington. Because of the federal government's huge role in this process, I'll also talk about another key strategic issue: how to get the balance back between federal regulation and private capital in a banking industry that was once and should again soon be founded on private capital at risk, not federal hand-outs, guarantees and fail-safe rescue and resolution policies. You have asked me to address the degree to which TARP could lead to long-term nationalization of U.S. banking, and the stress tests provide the first substantive indication of how this dangerous trend could be reversed.

Sizing Up the Stress Test

First, though, let's take a look at the test itself. Much has been written about it and a lot of that's wrong – wrong not because analysts goofed, but rather because the test itself changed along the way. Analysts were also taken aback because, when Secretary Geithner announced the tests in February, he and the Fed at first differed on what the results would show and on how they would be released.

And, of course, it was also unclear in February what the regulators would do with the results regardless of whether they released them or not. At first, it looked like the stress tests would be the first serious effort to separate weak from strong banks and begin meaningful resolution – not rescue – for those who flunked the test. This tough approach to the stress tests gladdened those who, like me, have long argued against propping up the biggest troubled banks instead of taking the prompt corrective action mandated even for them. But, spooked by fears of resurgent market panic, regulators quickly changed their tune and said the tests would not be a "pass-fail" one for any of the nineteen biggest banks. Parsing their words carefully, officials repeatedly said that all of the big banks are well capitalized and those that show weakness in the stress test will be given lots of time to recapitalize. If private money won't come to the table, then TARP will top it up, we are told.

From this, we conclude that it isn't the results that matter as much as the test itself. If it's a good one, banks, regulators and, I hope, the rest of us will finally see bottom for the biggest banks. With that, reasonable market participants can then step in with a clear sense of how much risk they truly run.

Is the stress test in fact one on which market actions can be founded? I think so. Critics have complained that the test takes too rosy a macroeconomic view, especially in its adverse scenario. However, the Fed never posited the test as a worst-case one – doing so would have meant subjecting the biggest banks to cataclysmic stress. Should the worst happen, the steps mandated now in the more realistic scenarios will insulate the biggest banks from harm. More importantly, though, should that evil day occur, nothing the regulators could do now for viable banks would help. None of us gets into a car and then not only straps on our seat belt, but also dons a helmet, puts on foam garments, and rigs up the escape hatch. You can't drive that way and no one can run or regulate a bank like that either.

Where the stress test got tough was not in the macroeconomic scenarios. Rather, it was in the details – some disclosed, some not. I was very encouraged to see regulators for the first time take a tough stand on market risk in the trading books for the five banks with positions of $100 billion or more. This is too little, too late, but it's better than before. Also, the test forces the biggest and more speculative banks to assume the worst on FAS 140 and move $900 billion in off-balance sheet assets on-balance sheet for purposes of the stressed calculations. Again, too little, too late – much that's off-balance sheet should have been on and all of it should long ago have been subject to more stringent regulatory capital. Again, though, a good start.

Where the Test Bites Smaller Banks

Finally, there's one key aspect of the stress test with significant implications for the 8,000 or so banks that weren't subjected to it: the loss-given-default or LGD assumptions. These affect each of the loan books the examiners kicked – mortgages, commercial real estate, commercial loans, and so forth. LGD means how much collateral is left to offset losses and here the bank regulators took a very dim view of troubled assets. Some have said that the LGD assumptions are Depression-tough, although no one knows for sure because the LGD details haven't yet been made public. In their push-back on the stress tests, the biggest banks have been allowed to demonstrate why their underwriting, specific exposures or credit enhancements counter the regulators' LGD assumptions. Even so, though, it's clear that LGD tests are among the toughest part of the stress scenarios.

What does it mean for community and regional banks? Trouble when your examiners come calling, I think. The LGD assumptions will apply not just to the biggest banks, but also to others holding comparable assets. I know the regulators won't directly stress-test anyone but the big 19, but I expect the LGD criteria to be used on an increasingly routine basis in examinations to judge capital adequacy. We're a long way from revisions to the Basel II rules, especially for smaller institutions. But, the LGD assumptions – a critical part of the revised risk-based capital rules – are now a fact of life on which examiners will base their assumptions of capital adequacy regardless of the nominal numbers banks of any size can post.

Reading the Report Card

Now that I've talked about the test and how tough it truly is, let's turn to what the biggest banks must do with the results. For all the talk from banks that think themselves in good shape, I doubt anyone is giving back any TARP money anytime soon. The regulators are on to one interesting arbitrage play: attempting to give back TARP money while doubling down in the FDIC's temporary liquidity guarantee program (TLGP) that guarantees debt. With Treasury now conditioning TARP repayment on TLGP abstinence, it will take longer to wean even the strongest banks from the TARP.

This isn't to say, though, that showing capital short-falls under the stress test will mean that still more TARP or TLGP funding will have to flow into the banking sector and, with it, still more hands-on government control over compensation, lending, loan modification and business in general. For one thing, banks will have at least six months to address the stress test's findings, time in which the glimmers of market recovery could brighten and private capital flows restart. The hints of market optimism will also make it far easier for banks – and not just the big ones – to convert private preferred stock into common equity – a big move in bolstering regulatory-capital ratios and market confidence. For the weakest big banks, TARP remains an option, of course, either through conversion of Treasury's preferred into common or, if that isn't enough, use of what's left of the TARP.

With the glimmers of hope also will come better asset disposition opportunities in private markets and, perhaps, through the public-private investment program or PPIP and the asset-backed facility at the FRB, called the TALF. So far PPIP is still on the drawing boards and TALF is a slow-starter, in large part because of the complexities of the programs and the political risk attendant to them. The prospects for PPIP and TALF remain uncertain. Should they take off, they'll prove a mixed blessing for the industry because the huge amounts of government support in them will exacerbate demands for government control of the banking system. Best for the industry would be for PPIP and TALF to do a fade-out and private capital to come back in to support asset-disposition activities. Should progress prove uncertain, however, then both the PPIP and TALF offer significant opportunities for asset sales that will support recapitalization across the industry.

Big Brother Bank & Trust?

So, on balance, I think the stress test is a good start on getting government out of the banking business. I know this is counter-intuitive – maybe I say this because I'm just so hopeful events will turn out this way. But, I really do think that, through the stress tests, Treasury and the FRB have taken the first disciplined look at the solvency crisis that has gripped the industry since at least August of 2007. Recognizing this isn't a liquidity problem, but rather a profound loss of asset values that erode bank capitalization isn't fun, but it's critical.

The sooner hard decisions start about recapitalization, the quicker government gets out of the way. To be sure, TARP will be with us for a while at large and small banks. PPIP and TALF too may be market presences for some time to come. With them comes profound political risk because none of this is free and taxpayers, understandably, want something back for their billions. But, had Treasury and the Fed not started the hard task of recapitalizing the biggest banks, market confidence would be even more fragile, private capital still more elusive and the crisis would go on still longer.

The stress tests will help us find bottom at the biggest banks. That's not fun for them, nor will it be for you. The stress test's stringent capital methodology will come down through the industry and stress community and regional banks, forcing some of them to the hard decisions now evident at the nation's largest institutions. It won't be fair, since some of the smaller banks will be forced to fail while the bigger ones are propped up. That's a matter regulatory policy can and should fix in the next rewrite on which Congress is already hard at work. But, the sooner we clear out weaker institutions throughout the industry, the sooner survivors can re-establish themselves without a pall of doubt hanging over them or Big Brother telling them what to do at every turn.