

Have You Survived Your Stress Test?



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It wasn't long after I found myself on the back nine of life that my physician directed me to a cardiac stress test. On his little scorecard, I had chalked up two points (the mere presence of the Y chromosome contributing half of the total) and that was enough to call for the test. Off I went to the treadmill, a 10 lead EKG attached, thallium injected, and attended to by staff with up-to-date CPR certifications in case I was to code as the exercise progressed. Today I cannot recall specifically what we learned from the endeavor, but I probably pledged to eat more vegetables. I exited confident that my heart would never attack me and get back to business.

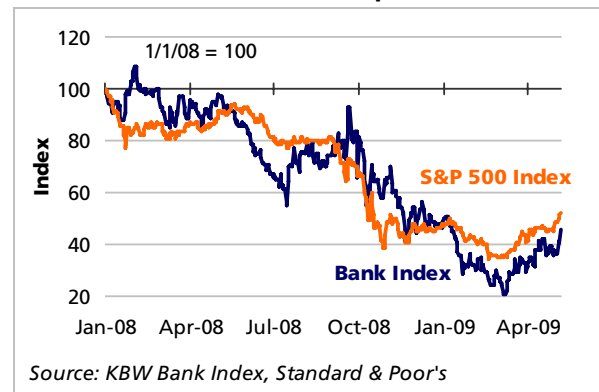
While I write, the results of the stress tests designed for our banks have been leaking out at a disconcerting rate. As you read this, the results are probably clearer, though the design and stringency of the tests themselves may never be. The requisite level of tangible common equity was shifted mid-stream. The requirements were also different depending on each bank's book of business. These are bendy rules for sure. Yet the markets have responded well: bank shares and spreads are much better.

At the risk of looking more foolish than I did on that treadmill, a few comments on this bank stress test process are in order. Having watched the proverbial cow leave the barn, regulators have now examined the gate and determined that banks are undercapitalized. This exercise occurs in the midst of a financial crisis when it is really expensive, if not impractical, to raise capital. As banks seek to restore their health through a process of massive deleveraging, they are also now required to add additional capital, in case the economy gets worse. Mark this down as a coincident indicator of the low point in the recession.

Clearly, if a bank is insolvent, the FDIC should take it over, and we see some of this happening each week. But these tests have nothing to do with insolvency and the officials have been clear on this. The amazing failure of the regulatory structure to recognize the necessary amount of capital — given leverage in the system, the poor lending strategies,

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Banks Absorb Knockdown, Get Up Off The Canvas



the alchemic securitization processes, and the impact of the shadow banking system — was spectacular. But there is little to gain from forcing further restructuring of balance sheets right now.

From my jaded position inside the bond market, it was always clear that the banks and the financial system are the WD-40 of the larger economy. For that reason, restoring the health and functionality of lending markets has always been critical. Broken? Yes. Under repair? Very much so, and as a matter of fact there is good reason to believe that financial conditions are getting better. Are banks facing *über alles* utility-like regulation going forward? Yes. But the purpose of the stress tests was to raise confidence in the health of the banking system. Instead we now have to understand the ability of these already impaired institutions to coerce security holders higher up the capital structure to convert to straight equity, or calculate whether banks would actually be able to raise sufficient new common stock in the next six months. If these tasks prove difficult in this environment, the banks get to be wards of our government for some time longer, which is not likely good for them or the economy.

There is sufficient evidence that the worst of the declines in economic activity have been witnessed. Climbing back on the treadmill and increasing speed is going to be another story. It would be helpful to have untethered banks participating. ■