



# Near-Sighted Stress Tests

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Buoyed by the results of the "stress tests" conducted by banks' supervisors, markets now appear optimistic about the capital positions of U.S. banks. Unfortunately, however, this renewed optimism has a shaky foundation. By design, the stress tests have avoided estimating the declines in the value of many toxic assets owned by banks. As a result, U.S. banks could well be in much worse shape than has been suggested by the stress tests.

The [report](#) announcing the results of stress tests stresses that supervisors conducted "a deliberately stringent test" and examined the ability of banks to absorb losses even under an "adverse" scenario with a deeper and more protracted downturn than under the current consensus estimate. The report concludes that, with a modest aggregate addition of \$75 billion in common equity, the banks will be well capitalized at the end of 2010 even under the adverse scenario.

While the focus on the "adverse" scenario might represent a conservative approach, another estimation choice led to under-counting of banks' expected losses. In reaching an estimate of \$600 billion for banks' aggregate losses, the report focuses on estimating "losses due to failure to pay obligations" rather than "discounts related to mark-to-market values."

Thus, for a bank with a \$1 billion portfolio of real estate loans due in 2010, if the supervisors estimated that only half of the face amount will be repaid, they added \$500 million to their estimate of losses. However, for a bank that has "troubled assets" with \$1 billion face value that do not become due until after 2011, supervisors did not attempt to come up with a precise estimate of the extent to which, at the end of 2010, the economic value of the troubled assets will fall below the \$1 billion face value.

This approach overlooks a substantial amount of economic damage imposed on banks by the crisis. Indeed, to the extent that the government's new program for restarting the market for troubled assets will provide market transactions for troubled assets with long maturities, mark-to-market rules might require banks to recognize this or next year the declines in economic value of their troubled assets with long maturities. But even if banks are able to avoid recognizing these declines in value on their financial

statements until after 2010, there will still be such economic losses. A bank may be an economic zombie even if its financial statements do not yet show it.

The report acknowledges this major problem in a footnote, noting that its estimated losses "are not full lifetime losses ... because the projections are for a two-year forward horizon and thus do not capture losses occurring beyond the end of 2010." Trying to defend this limitation, it notes that the profile of the adverse scenario "includes a return to positive real GDP growth within the two years," and that a two-year horizon thus "seems likely to capture a large portion of losses from positions held as of the end of 2008."

Even if positive real GDP growth resumes after 2010, however, some of the assets backing banks' 2008 positions--residential and commercial real estate, as well as the assets of nonfinancial firms--may remain far below their 2008 levels, and banks may consequently have to bear large losses on their long-maturity assets for years to come.

Furthermore, even accepting that the two-year horizon does capture a "large portion" of aggregate losses to banks' 2008 positions, it still fails to include the remainder and possibly large portion of these losses. For example, if the "large portion" happens to be 60%, then the banks' total estimated losses, and the additional capital that they need, are higher by \$400 billion than the report's estimates of \$600 billion and \$75 billion respectively.

The report also adds that the "the impact of some losses after 2010 is also captured through the calculation of the need of 2010 reserves." But without estimating the economic losses to troubled assets with post-2010 maturities, which the supervisors did not do, it is not possible to stipulate the level of reserves that will fully cover these losses.

To get a full picture of the banks' situation, bank supervisors should estimate also the decline in the economic value of banks' positions with longer maturities. Only then will the stress tests be able to deliver reliable figures for the additional capital necessary to make the [banking sector](#) healthy and vigorous. Until such an analysis is done, it would be important to avoid the premature conclusion that the U.S. banking system is largely out of the woods.

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