Toxic Tests

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The United States government is now permitting ten of America's biggest banks to repay about $70 billion of the capital injected into them last fall. This decision followed the banks having passed the so-called "stress tests" of their financial viability, which the U.S. Treasury demanded, and the success of some of them in raising the additional capital that the tests suggested they needed.

Many people have inferred from this sequence of events that U.S. banks—which are critical to both the American and world economies—are now out of trouble. But that inference is seriously mistaken.

In fact, the U.S. stress tests didn't attempt to estimate the losses that banks have suffered on many of the "toxic assets" that have been at the heart of the financial crisis. Nevertheless, the U.S. model is catching on. In a meeting this month, finance ministers of G-8 countries agreed to follow the U.S. and perform stress tests on their banks. But, if the results of such tests are to be reliable, they should avoid the U.S. tests' fundamental flaw.

Until recently, much of the U.S. government's focus has been on the toxic assets clogging banks' balance sheets. Although accounting rules often permit banks to price these assets at face value, it is generally believed that the fundamental value of many toxic assets has fallen significantly below face value. The Obama administration came out with a plan to spend up to $1 trillion dollars to buy banks' toxic assets, but the plan has been put on hold.

It might have been hoped that the bank supervisors who stress-tested the banks would try to estimate the size of the banks' losses on toxic assets. Instead, supervisors estimated only losses that banks can be expected to incur on loans (and other assets) that will come to maturity by the end of 2010. They chose to ignore any losses that banks will suffer on loans that will mature after 2010. Thus, the tests did not take into account a big part of the economic damage that the crisis imposed on banks.

Although we don't yet have an estimate of the economic losses the stress tests have

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chosen to ignore, they may be substantial. According to a recent report by Deutsche Bank, for example, borrowers will have difficulty refinancing hundreds of billions of dollars of commercial real estate loans that will mature after 2010.

Rather than estimate the economic value of banks' assets—what the assets would fetch in a well-functioning market—and the extent to which they exceed liabilities, the stress tests merely sought to verify that the banks' accounting losses over the next two years will not exhaust their capital as recorded in their books. As long as banks are permitted to operate this way, the banks' supervisors are betting on the banks' ability to earn their way out of their current problems—even if the value of their assets doesn't now significantly exceed their liabilities.

But doesn't the banks' ability to raise new equity capital indicate that, regardless of whether the stress tests are reliable, investors believe that their assets' value does significantly exceed their liabilities?

Not at all. Consider a bank with liabilities of $1 billion. Suppose that the bank has assets with long maturity and a face value of $1.2 billion but whose current economic value is only $1 billion. Although the value of the bank's assets doesn't exceed its liabilities, depositors won't flee as long as the government backs the bank by guaranteeing its deposits. If in two years the bank's assets have a 50–50 chance of appreciating to $1.2 billion or declining to $0.8 billion, the bank will be able to raise new equity capital: new investors will be willing to pay for the prospect of sharing in the excess of the value of assets over obligations if things turn out well.

To get a good picture of banks' financial health, estimating the value of their toxic assets is unavoidable. Regulators could encourage each bank to sell part of its toxic portfolio and extrapolate the portfolio's value from the price obtained in such a sale, or they could attempt to estimate the portfolio's value as well as they can on their own.

Either way, the true value of banks' toxic assets must be estimated before concluding that banks are armed with sufficient capital to carry out their critical roles. The kind of stress tests that the U.S. conducted, and that other countries are being urged to emulate—and the ability of banks to raise additional equity capital—cannot provide a basis for such a conclusion.

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