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| The enigma of global financial markets: Stress testing ‘worked’ as bank failures intensify |

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| **PR exercise**Last week I pointed out that official US stress-testing of its biggest banks seemed to have ‘worked’ because a large measure of confidence has been restored in the banking system. The banks that failed the test were all able to quickly raise the needed funds from private capital markets without a government ‘bailout.’ Despite this, concerns continue to be raised in the financial media. One of these is to the effect that the test was ‘rigged.’ It has been labelled a “whitewash,” “cover-up,” and “PR” exercise conducted by the Treasury and the Federal Reserve. Some critics have claimed collusion between the authorities and the banks, criticizing the former for setting low standards and failing to publish “concrete metrics” on the vulnerabilities of particular banks. In response, the authorities published a 20 page report on the test last April (2009) to support their claim that there was no evidence indicating impending insolvency in any of the 19 banks stress-tested.Reviewing the media coverage, it seems that the authorities’ primary goal was to build confidence in the banking system at a time of dire need. Nothing short of full disclosure and transparency would have achieved this. Practically, this required testing to establish whether the banks’ common stock was adequate to quickly write down losses in an environment with so many toxic assets, and the risk of the recession being prolonged, or worse, a double-dip!The capital shortfall for the ten failed banks ranged from US$0.6 billion to US$33.9 billion; the medium loss ranged between US$1.8 billion and US$2.5 billion. As indicated in last week’s column, the total shortfall was US$75 billion.Paradoxically, the haemorrhage of US banks (other than the largest) has intensified. According to recent Federal Deposit Insurance Corporation (FDIC) data, since the beginning of 2008 as many as 273 banks have failed. So far this year the total is 108. Of more concern is that while the FDIC had reported there were 50 “troubled” banks in the US at the end of Q2, 2006; by Q2 2010 the total had grown to775. Disturbingly, the probability is that one in five of these banks would go bust each year.**EU stress-testing**It’s against the background of these experiences that recently the European Union (EU) announced the official stress-testing of its banks. Public confidence in its global banking system (both at home and abroad) was at the lowest ebb for decades, indicating the persistence of the negative effects of the global crisis. Indeed, several European economies faced severe sovereign debt issues, notably the PIIGS (Portugal, Ireland, Italy, Greece and Spain) but including Britain and Germany as well. The euro was subject to intense adverse speculation. There were even reports in some financial media of the impending break-up of the euro-zone.Similar to the US last year, there was a fear of a run on the banks, and to complicate matters the fear also of a double-dip in the economic recession.The official stress-testing was conducted by the Committee of European Banking Supervisors (CEBS). They evaluated 91 banks in 20 states. Overall these accounted for about two-thirds of the EU’s banking assets and at least one-half of each of the member states. As we have become aware since, this is the second test the authorities have conducted; the former is confidential. The report of the official stress-test was published three weeks ago (July 23).**Results**Of the 91 banks stress-tested, seven failed the test. Two of these are state-owned banks, one each in Germany and Greece; the remaining five are smaller banks in Spain. The estimated shortfall in capital holdings was 3.5 billion euros. The base year used for the scenarios in the test was 2009 and the period of the estimations covered 2010 and 2011.Basic parameters, adverse scenarioThe basic scenario assumed the probability of a severe bank crisis once in every 20 years. For the US stress test this probability was one in seven years. The banks were tested on a consolidated basis. As reported the basic parameters used were 1) the banks’ situation at the end of 2009; 2) a moderate recession over the next two years (2010 and 2011); 3) stock markets’ fall on average by 10 per cent during 2010 and 2011 (for open economies the drop was larger than average); and 4) bank liquidity levels were ignored because these were covered separately by the CEBS and the Basel Committee, as part of their development of global rules/standards for bank liquidity ratios.The threshold was the maintenance of a Tier 1 capital ratio of at least 6 per cent by the end of 2011 under the most adverse scenario utilized in the test (existing regulations required at least 4 per cent in Tier 1 capital, but several banks carry higher ratios).The adverse scenario postulated several credit and macroeconomic events, including the following: 1) a double-dip recession in Europe; 2) a cumulative fall in the rate of growth of GDP, averaging 3 per cent over this year and the next (2010-2011); 3) equities/stocks in banks portfolio marked as ‘available-for-sale’ suffer stock market declines of 20 per cent in 2010 and 2011, putting stocks into “deep bear-market territory”; 4) credit ratings on holdings of securitized products are graded down across-the-board, by as many as four notches; and 5) the yield-curve on three-months securities rise by 125 basis points and on ten-year securities rise by 75 basis points, that is, 1.25 and 0.75 per cent respectively. The latter is the equivalent of the increase in inter-bank borrowing rates since the collapse of Lehman Brothers.Although perhaps too early to tell, media reports generally indicate that stress-testing has engendered confidence in investors and traders on European and global capital markets. In this sense one may conclude that, as in the United States before, stress-testing of EU banks has ‘worked.’The aims of the EU test were broadly similar to those of the United States.As the authorities put it, the primary goal was: “to provide policy information for assessing the resilience of the EU’s banking system to possible adverse economic developments and to assess the ability of banks … to absorb possible shocks on credit and credit market risks, including sovereign risks”.Next week I shall wrap up the discussion of stress-testing in the US and EU by looking at what lessons can be learnt.  After that I will proceed with the discussion on Guyana and Caricom. |