

Banks face stress tests

Colin Read: Everybody's Business

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— Never before have we been required to exhibit economic literacy to the degree each of us must now.

Certainly one of the most baffling subject is the role of banks, credit and money. Why are these factors so important, and why are banks constantly in the news?

One of the real innovations of the modern economy is the ability for us all to earn buying power through our livelihood and spend that income through markets. Money, in its varied forms, is the vehicle that makes this happen. It also obviates the need for us to find someone to trade with who wants what we have produced in exchange for what they produced. Money is the oil that keeps the market machine turning.

Money comes primarily in two forms. One is cash or checks. The other, facilitating the majority of transactions, is credit, through credit cards, loans, mortgages, credit lines, letters of credit, etc. Except for cash, all these other forms of money depend critically on a well-functioning banking system. And all credit requires faith and trust in our banking institutions.

Early on in the history of banking, cash held by banks equaled credit offered. These early banks quickly realized that their customers were comfortable using the credit notes these early banks offered even if credit offered exceeded the banks' cash deposits. Essentially, banks were creating a new form of money by offering more credit than cash in their vaults.

We can see why banks like this. They earn interest on their credit extended, so the more credit they issue, the higher their profits. There is a danger, though. If every depositor came in one day and demanded cash to cancel all the credit notes the banks had offered, in loans, mortgage notes, checks, etc., the banks would not have enough hard money. They would be bankrupt.

The depression-era Roosevelt administration formed the Federal Depository Insurance Fund to lend consumer confidence in banks and avoid such runs on the bank. Nonetheless, prudent bank practices require them to hold sufficient cash reserves to ensure they don't overextend credit.

Actually, banks have to hold surprisingly little cash to cover their credit liabilities. They would prefer to hold as little cash as possible because cash does not earn them interest. If their assets must balance their liabilities, and they are required to only hold about 10 percent of their assets in cash, the rest is made up in longer term assets like mortgage liens on homes, signature loans, real estate, corporate buildings, bonds and the like.

At times like these, some of the banks' assets carry with them greater default risk. When banks' liabilities exceed the value of their assets, they are technically bankrupt. The bankruptcy of a major bank in times like these is a big concern.

To alleviate these concerns, the major national banks have been undergoing a stress test devised by the

government. The purpose is to determine if their assets are reliable, valuable and liquid enough to cover their liabilities. A bank must honor its liabilities to its depositors, but may have assets that are worth more on paper than in reality. This is especially true if the economy takes another turn for the worse, and the mortgage liens owned by banks become less valuable, or there are more defaults in the loans lent to consumers.

The stress test demonstrated that banks are sufficiently strong for current conditions and future expectations, but some are vulnerable if conditions worsen slightly. This worsening is in the range of a 2 to 3 percent GDP contraction and a 10 percent unemployment rate. The resulting increase in defaults, foreclosures and bankruptcies would threaten the balance sheet of some large banks. These banks can remedy the problem by raising some cash, perhaps through the issuance of new shareholder equity, or perhaps by converting some of its debt into shares.

The debt-to-equity solution is also the mechanism employed by Chrysler of late. Debt holders would prefer not to convert their notes to shares because they take on risk they were not expecting. However, bankruptcy risk is a much worse alternative.

This debt-to-equity conversion is also very effective because the corporation does not have to shed assets at fire sale prices to improve their balance sheet. All agree that now is not the time to try to sell major assets of almost any kind.

What debt-to-equity conversion does not give to banks, though, is more cash to work with, or more capital to lend. Banks' balance sheets are strengthened, but the economy is deprived of the new credit it so desperately needs to recover from the recession.

The other problem with the stress test and its consequences is that it is not a worst-case scenario. Rather, it is only testing how banks will manage if the recession proceeds as expected. I would be more comforted if the test were a bit more strenuous. If a bank can manage a 5 percent decline in GDP and 12 percent unemployment, I would have greater confidence in the stress test.

Of course, banks and all corporations deemed too big to fail have an insurance policy the rest of us do not have. If they struggle to cope with a greater-than-expected downturn, the Treasury and the Fed will sweep in to give them a helping hand.

In future articles, I will discuss the mechanisms the Fed can use to create cash and credit. We will see that the Fed and its central bank equivalents in other countries are taking unprecedented measures to create cash in a cash-hording economy. With this strategy comes hope for a turnaround, but also some risk of inflation. Just like life sometimes, something good comes with strings attached. Economists like to say "there ain't no free lunch." A profound and witty bunch, aren't we?

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