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Stress Test

Before it became a financial phrase, "stress test" referred to a medical procedure. This particular assessment deals with the health of the heart and is an integral part of a medical check-up that the conscientious executive is required to undergo, especially when he turns forty-five and the body starts showing signs of sub-prime performance in all areas.

The treadmill test which is a big part of the medical check-up requires the patient (usually healthy, or thinking he is) to bring a towel and wear shorts and rubber shoes for the treadmill. This is the same machine one finds in a fitness center in front of a TV monitor. Before he steps on the treadmill, the patient's bare chest is attached with suction cups wired to a monitoring machine to track his heart rate, breathing, and blood pressure as he walks on the treadmill. The doctor puts his patient at ease as he undergoes the stress test on the machine by asking him irrelevant questions (have you read "War and Peace"?) mainly to check if he is still capable of speech or breathing as the speed and incline of the treadmill is raised.

Why are we wasting two paragraphs on a medical procedure? And what does this have to do with the title of this piece which you, dear reader, expect to be related to the financial markets?

As the treadmill checks the state of the patient's heart, principally its ability to function under different stress levels, so too does the US treasury undertake to check the financial health of that country's biggest banks.

Shortly after the brouhaha on the AIG bonus where critics started raising questions on why the Troubled Asset Relief Program (TARP) set at 700 Billion Dollars was also providing relief to executives in the form of bonuses. Wasn't it these same bankers who brought on the financial Chernobyl? This anger expressed even by the President may have required the communications experts of the administration to quickly change the topic and move on to something else. Hence was born the stress test. This was announced with very few details to stroke the curiosity and exercise the jaws of the talking heads and launch them into a full-tilt explanatory mode.

The stress test, we are informed, is to be applied to nineteen of the largest banks in the States which also operate globally (including here in our blessed isles), hence the international interest in this process. These banks are already recipients of TARP funds and categorized as "too big to fail", which really means that they *cannot* be allowed to do so if the end of the world is to be avoided.

The stress test is designed to see how strong this patient is and what maximum speed and incline it can take in the financial treadmill. The external blows the banks are being tested to survive are mainly two—a 10% unemployment rate and a further 20% drop in housing prices. These two factors will cause the credit crisis to worsen. The test then is designed to see how much losses a particular bank can absorb.

Unlike the usual tests which students undergo to validate what knowledge or skills they have learned and to come out with either a passing or failing grade, these financial stress tests are designed *not* to give out grades. They are intended to indicate how much additional tutoring the student requires in order to pass.

The reason for the initial hesitation in declaring how each of the nineteen banks fared in the test is that such a "grading" may worsen the liquidity crisis of the failing banks and trigger a loss of confidence followed by a bank run. Instead, either of two things will be done. The grading system will be adjusted for the poor student so no one fails. Or a remedy is already announced, such as converting the bailout money now in preferred shares to common to boost the bank's capital adequacy ratio.

It is clear from such a flexible stress test that the objective is not to stress any of the banks further and make them more vulnerable. The objective is to see how to keep all of them healthy. In this sense, the so-called "stress test" is not a test at all. It does not aim to differentiate the nineteen banks between the strong and the weak, or, as in the last judgment, separating the sheep from the goats, the chaff from the grain. It is instead a diagnostic tool to decide what form of intervention is appropriate for a bank that cannot withstand the designated stress in its present state.

A better version of a stress test is the congressional grilling that bankers whose organizations have received TARP funds and then doled out executive bonuses. Such bankers used as they are to being lionized as philanthropists, art patrons, and collectors of vintage cars had to be subjected to verbal abuse and contempt by certain congressmen whose idea of liquidity surely related more to bodily fluids than cash flow.

It is this grilling and the legislative threats of confiscatory taxes on executive bonuses that prompted many of the rescued banks to opt for prompt payment of their bailout funds, even if this may later lead to failing the stress test that was only then in the works.

When the loss in value of US homes has reached ten trillion dollars from their peak prices and the value of world equities lost twice that amount, it is not really the big banks that need to be tested for stress. Clearly, it is the investors and the bank's customers that need to withstand the stress they are undergoing without prospect of any bailout.

The investors are still on that proverbial treadmill unable to get off. True, the machine's speed seems to be slowing down. The incline is leveling off to a flatter angle. And the doctor by the side is still calmly keeping the patient talking—are you still feeling fine? The patient on his own stress test is too out of breath to give an intelligible reply.

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