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What Stress Tests Did and Didn't Accomplish

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Even before the results of the stress tests of the country's largest banks are released, a debate over what the exercise accomplished has begun.

Verdicts run the gamut, with some arguing the results will reassure investors and a nervous public about the health of the banking industry, give the Treasury Department valuable time and help the government prevent future problems.

But others insist the tests exacerbated the crisis by confusing people and delineating which institutions are "too big to fail."

"We didn't get anything out of the tests except a lot of unnecessary anxiety and speculation and worry about what's going to happen to some of these banks, all of which could have been avoided," said Robert Clarke, a former comptroller of the currency, and now a senior partner at Bracewell & Giuliani LLP.

Since the Treasury first announced the tests would be conducted, speculation has raged over which of the 19 institutions tested would need additional capital, how much they would need and where would they get it.

Speculation will turn to fact on Thursday afternoon when the results will be made public. Whether investors, analysts or the public will be satisfied remains to be seen — but many have their doubts.

"They raised expectations very high in the beginning," said Cornelius Hurley, a professor at Boston University School of Law and former Federal Reserve Board lawyer. "I don't think they fully appreciated how much they were raising the expectations when they announced it in February. I think they created a monster they had to tame. On the eve of the release, I think a lot of people are skeptical about the results, and I think that's the opposite effect they wanted to have."

To be sure, many contend the tests accomplished their objective by providing a measuring stick for building market confidence and reassuring the public at large.

"I absolutely think the test was worth it," said Terry Moore, a managing director of North America banking for Accenture. "It's not the final word on the health of the banking industry," but "it does provide an outside view of the top 19 banks rather than an inside out view. It's a consistent measure against those top 19."

Dwight Smith, a lawyer with the law firm Alston & Bird in Washington, said the tests may even succeed where many have thought they would fail — in helping banks attract private capital.

Until recently, many thought such an idea was implausible, and that the banks would eventually have to seek government funds. But the very promise of government funds may be enough encouragement.

The tests "will encourage new investors to come in … because there does appear to be a Treasury backstop for the investors," Smith said. "In the best scenario, the stress tests and the results actually bring the crisis to a conclusion for the largest banks. They, in theory, will know how much capital they need to get through the worst possible time."

The tests also bought Treasury more time to implement other parts of its recovery program, and made it clear that the government is committed to fixing the industry's problems, some argued.

"The expectations in February that the tests may somehow make everyone feel comfortable about" Citigroup Inc. were "never going to occur," said Karen Shaw Petrou, the managing partner of Federal Financial Analytics Inc. "The goal, I think, is to make sure the government has a handle on the systemically important banks and has the means" to restore their health.

"I hope Thursday night we will walk away with no loss of market confidence and some improvement in it."

William Mutterperl, a lawyer at Reed Smith and a former vice chairman for PNC Financial Services Group Inc., said the tests "will be a bit of a road map as to which banks are in better shape than others."

"This is very unique, because we have always operated under the premise that a lot of this information is very secret … so this is a sea change," he said. "It's never happened before."

These somewhat positive voices are offset by a chorus of critics who see the stress tests as a mistake.

Paul Miller, an analyst at Friedman, Billings, Ramsey, said investors are more confused than ever as a result of the stress tests.

"Treasury didn't think this would get out of hand," Miller said. "They will never do it again, because it became confusing to the Street. When all is said and done, companies will have to raise capital, but they were going to have to raise capital anyway."

Whether banks will be able to raise private capital is an open question. Though Fed Chairman Ben Bernanke expressed confidence that they could Tuesday, many said fears that the government will eventually step in and wipe out shareholders could keep private investors at bay.

"I wouldn't put money in if I was private capital…. If [the bank] raises only half capital and government puts in the other half, what happens when you get diluted?" said Mark Calabria, director of financial regulations studies at the Cato Institute and a former senior staffer for Sen. Richard Shelby, the top Republican on the Senate Banking Committee.

Kip Weissman, a partner at Luse Gorman Pomerenk & Schick PC, said the stress tests have only fed the rumor mill about banks' condition when the goal was to provide clarity.

"It literally had the opposite effect," Weissman said. "It was hoped it would reduce the rumors on the confidence of the banks, and it made it worse. It was intended to limit the ability of the stronger banks to differentiate themselves from the weaker banks, but that hasn't happened."

The tests may also reinforce that the largest institutions are backed by the government. "We've got government reiteration of the approach that it is going to protect top banks from failure," said Moore.

The tests examined banks with more than $100 billion in assets under two scenarios — one a baseline and the other more negative — to see how much more capital they would need over the next two years. But critics claim the slumping economy has already made those assumptions too rosy.

Under the more adverse scenario, the test assumes a GDP of negative 3.3% in 2009 and a gain of 0.5% in 2010, an unemployment rate of 8.9% in 2009 and 10.3% in 2010 and house price declines of 22% in 2009 and 7% in 2010.

But many think that scenario is not dire enough. "Some are saying 'I'm not sure you can take assumed unemployment numbers and assumed GDP numbers and apply that to a bank,' " Clarke said.

Mark Flannery, banking chairman at the University of Florida, said the tests also do not tackle other, critical issues.

"We still haven't overcome the 800-pound gorilla, which is what are the subprime, so-called toxic assets really worth," Flannery said. "I'm not sure what the stress tests say about that."