

Where is MacArthur when we need him?

The details regarding the procedures employed in the so-called “stress tests” were released today. Under the Supervisory Capital Assistance Program (SCAP) bank regulators have undertaken a “what if” analysis regarding potential future losses, revenues and reserve needs for bank holding companies over the next two years under different economic scenarios. The results will be made public next Friday, but we can already tell that there are three serious problems with the SCAP. These shortcomings involve the starting point, the ending point and the paths assumed in the exercise.

First, the SCAP premise is that banks currently are all viable because they meet the regulatory definition of being solvent. The fact that some banks have market values of equity that are tiny and debt that is trading below its face value suggests that this is far from clear. And the fact that all the banks that have had to be taken over (or merged) passed the regulatory minimums also suggests this starting point is too generous. Like it or not, we need to prepare for the possibility of winding down a large institution. Talking about it in advance is irresponsible, but preparing is wise. However, fast track legislation to permit the efficient resolution of complex bank-holding companies died this week. So, the chances that we will be stuck keeping a wounded bank alive are quite high.

Second, the benchmark for what constitutes passing this test is too weak. The presumption behind the tests is that if banks have a big enough capital buffer to absorb potential losses and still have enough capital to stay above a regulatory minimum that is all that should be required. Technically, banks in this condition would be able to legally operate. But banks in this condition will not be in a position to continue lending to support economic recovery. The reason for assisting banks is so that they can lend, not so that they can hunker down and hope that the economy recovers and pulls them along. We want banks to have enough lending capacity to bring the cost of borrowing down to more normal levels.

Third, the economic scenarios themselves are no longer sufficiently grim to inspire confidence. Unfortunately, the economy has deteriorated sharply while the exercise has been underway. The adverse scenario this year now looks like an underestimate for where the economy will land and giving an all-clear signal based on these assumptions will not instill confidence.

If you search for SCAP using Google, one of the top hits on the list is the “Supreme Commander of Allied Powers.” We need MacArthur-like resolve to settle this banking crisis. The first step will be to hold the banks to a much higher standard and insist that they add enough capital to start lending even if the economy continues to deteriorate. Absent this kind of approach, the banking system will continue to operate with many walking wounded and the recovery will be delayed.

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