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The Science of Insolvency

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My name is David C. John. I am a Senior Research Fellow in Retirement Security and Financial Institutions at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The stress test on the top 19 banks was a successful way to distract fearful investors from the obsession that several of those financial institutions were on the brink of failure. By promising an analysis of the most threatened banks, the Treasury and financial regulators induced investors to focus on the future, and as a result, the financial markets calmed down until the results were released. While less than perfect (as all modeling is), the results show that the largest 19 banks in the financial services industry is better capitalized than many consumers and experts feared just a few months ago.

However, the most important question is what happens next. While risks remain, the banks' gradual return to health should signal the end of government's extraordinary intervention into financial services and especially efforts to micromanage the day-to-day activities of these companies. As part of this transition, adequately capitalized banks should be not only allowed but encouraged to repay government investments in them.

Banks Healthier Than Expected

With the exception of perhaps one or two smaller banks, even those 10 banks that must increase their capital levels are not in dire shape and should be able to raise the needed capital fairly easily. The size of certain losses (especially on credit cards) will be substantial, but almost all of the major banks will be able to weather them, and those that cannot are small enough to be sold to healthier banks.

While individual consumer's accounts were never at risk because they are fully insured by the FDIC up to $250,000 per account, they can feel reassured that the worst predictions of massive bank failures are increasingly unlikely to come true. In addition, customers of smaller banks or credit unions can rest assured that, with very few exceptions, those financial institutions appear to be strong and relatively unaffected by the recession. As the recession continues, certain of these smaller banks that made commercial real estate construction loans may run into difficulty as that sector continues to slow, but none of them are large enough to cause systemic risks, and all can be resolved in the usual way.

Stress Tests Are Not New or Unusual

Major banks and bank regulators have been using stress tests--a computer simulation of what would happen to a bank's finances under certain economic conditions--for several years. The results released today are nothing more or less than a way of distracting a worried market until real information about the condition of major banks was available.

However, it is important to keep in mind that while the stress tests show that most banks are healthy stress tests are a prediction, not a guarantee. Economic and financial modeling is an approximation of real life, and it is always possible that reality will not turn out as the model expects. As a result, it is possible that one or more of these 19 banks will have problems as the effects of the recession continue to be felt.

Failure Must Be Possible

The press has loosely characterized all 19 banks that were stress tested as "too big to fail," a term meaning that their failure would have large consequences on the rest of the financial system and on the economy as a whole. Treasury Secretary Timothy Geithner added to this impression by stating that none of the 19 will be allowed to fail. This is a serious mistake.

While the failure of the largest of these banks would have serious consequences, the rest are not too big to fail and do not pose systemic risks. This includes the couple of stress-tested banks that may have trouble raising sufficient capital. Treasury decided to stress test any bank with more than $100 billion in assets. In the last year, Wachovia, which had substantially more assets than that, ran into trouble and was taken over with little problem.

By indicating that none of these 19 banks will be allowed to fail, the Obama Administration has dangerously expanded the "too big to fail" problem. As the Administration itself has indicated previously, failure must be an option for financial firms if the market is to work. Certainly not all of these 19 financial institutions are "too big" to be allowed to fail.

Going Forward

Now that there is public information about the how large banks are likely to fare in a serious recession, the information should be used to allow well-capitalized banks to be freed from government control and for taxpayers to be freed from investment in them.

- **Allow Troubled Asset Relief Program (TARP) Repayment.** Stress tests are predictors. They do not guarantee that problems with banks will not appear at a later date. But there is no reason to keep banks that did well on these stress tests under a program designed for a systemically failing financial system. Firms must be allowed out of TARP without unnecessary conditions. This will also allow these banks to end the politically motivated interference into their day-to-day activities
- **No Forced Subsidy.** Firms that do need additional capital should raise it from private sources. In no instance should these firms be forced to take taxpayer money or cede ownership rights to the federal government if it can raise capital from the private sector or meet capital standards by selling off assets. If any bank other than a select few cannot raise the needed funds from private sources, it should be merged into a healthy bank, taken over by new investors, or allowed to fail.

Time for an Exit Strategy

Six months ago, the financial services sector was in deep trouble. For the most part, that is no longer the case today. While there is still a possibility that certain banks--both large and small--could face problems, the sector is no longer in crisis. Now it is time for the Obama Administration, the Federal Reserve, and other regulators to end programs like TARP and, as credit markets continue to recover, gradually close the special financing mechanisms and other credit-assistance programs that were seen as necessary during the time of crisis.

These programs--and the micromanagement of financial institutions that came with them--should not be a permanent part of the financial landscape. Now that there is clear public information about the conditions of the largest U.S. banks, it is time to return their control to the private sector.

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