Financial Meltdown: How Far Will It Go? Banks Devise "Stress Tests"

Hiding the fact that the banks are insolvent

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Stress Tests: A P.R. Stunt Devised by the Banking Industry

There's a major leak at a nuclear power plant, ultimately traced to a defective design in the concrete containment shell which all of the big nuclear plants use.

The nuclear power companies had used a faulty model which showed that the containment shell would withstand an 8.0 earthquake when – in fact – it would not even withstand a 3.0 earthquake.

The nuclear industry does not want to admit how dangerous the potential problem might be, or to spend the money to fix it.

So the CEOs of the nuclear power companies call up the head of the Nuclear Regulatory Commission, the former CEO himself of one of the biggest power companies. The NRC chief himself had been under pressure from the public to crack down on the faulty shell design.

Over drinks at a watering hole for the well-heeled, the good old boys discuss their problem. They decide that what's needed is an examination to reassure the public that everything is okay.

So the power company CEOs come up with a series of test procedures – using their old models – to show that the plants could withstand a level 8.0 or greater earthquake.

After the examinations are run, the NRC announces that one-third of the power plants need to reinforce their containment shells.

The power company chieftans are furious, and engage in negotiations with the NRC to try to give more favorable results, so that they don't have to spend the money to reinforce their buildings.

Virtually all the independent (non-industry) nuclear engineers say that the containment shell at virtually every big nuclear plant is defective and is likely to lead to meltdowns. They also say that the companies' models are faulty, that the NRC is not releasing sufficient details on how the models were run, that this isn't the kind of thing you "negotiate" over, and that the potential of additional accidents from weak concrete shells could cause severe problems to the country.

This is exactly the situation occurring with the bank "stress tests" administered by the

Treasury Department, headed by consummate insider Tim Geithner.

As the New York Times pointed out in February:

> Treasury and Fed officials said they had consulted with industry executives in devising the tests.
>
> Bank executives reached over the weekend said that the tests might not produce information that is very different from what regulators already know about the banks. The Federal Reserve already has hundreds of examiners on site at the largest banks, monitoring their businesses.

The stress tests used the models created by the banks themselves:

> The banks submitted results using their own methodologies, and most important for the big capital markets players like Citi and Bank of America, their own risk models…
>
> There was no verification of underlying accounting and loan books, not even a teeny bit of sampling.

These were the models which got the banks into the financial mess in the first place.

And now, the banks are negotiating the stress test results with Treasury.

And virtually all of the independent banking experts say the stress tests are a hoax.

- PhD economist Nouriel Roubini said that the stress tests used scenarios more optimistic than what the economy is actually experiencing, saying:

  > Stress Testing the Stress Test Scenarios: Actual Macro Data Are Already Worse than the More Adverse Scenario for 2009 in the Stress Tests. So the Stress Tests Fail the Basic Criterion of Reality Check Even Before They Are Concluded…
  >
  > In other terms, the results of the stress test – even before they are published – are not worth the paper they are written on as they make assumptions on the economy that are much more optimistic –even in the worst scenarios that the FDIC has designed – than the actual figures for Q1 of 2009.

- Paul Krugman said that the stress tests are merely a "self-esteem class" for the banks
- FDIC chief Sheila Bair has said the tests are a sham
- Former senior S&L regulator William Black previously called the stress tests a sham and a hoax
- The chair of the Congressional Oversight Panel, Elizabeth Warren, is highly

sckeptical of the stress tests

- Indeed, the Federal Reserve itself has more or less admitted that the stress tests do not really measure solvency, saying:

> "Even if the tests showed a bank needs more capital, that "is not a measure of the current solvency or viability of the firm".

See also this excellent roundup of doubts about the stress tests.

Just like with the nuclear power analogy, the banks cooked up the stress tests themselves (along with good old boy Geithner), using their same old models in order to hide the fact that they are actually insolvent, and their insolvency threatens the entire economy. And just like the nuclear power analogy, the banks are now arguing about the cooked-up results, trying to avoid doing anything that would meaningfully reduce the actual risk.