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Fed Research Praises Stress Tests

Real estate loans have caused more than half of U.S. banks' loan losses during the financial crisis — far more than the 40% they caused in the last banking crisis in the 1990s, and far more than banks had reserved for during the boom years.

But bankers couldn't have set aside enough money to cover those losses before the Great Recession, says a research report from the **Federal Reserve Bank of San Francisco**, because they never could have seen them coming.

The study goes on to endorse a long-term fix: The Obama administration's call for higher capital at lenders, as determined by the stress tests given to banks last year.

Over the past year — with the benefit of hindsight — a number of bankers, economists and investors have lined up to praise the U.S. Treasury's stress tests of banks last year.

"Even if banks had better forecasts and more discretion in setting reserves, they would probably still be unable to adequately provision against unexpected large economic shocks," Fed researchers **Fred Furlong** and **Zena Knight** wrote in the report released Monday.

By contrast, they wrote, "the stress tests focused on what would happen in cases of significant unexpected losses."

Early last year, as the financial crisis raged, the Obama administration moved to calm spiralling fears that more unnamed U.S. banks could fail, especially since lenders' loan losses were soaring past historical levels.

To ease fears among banks' customers and investors, the Treasury said it would step in and test the biggest 19 banks' balance sheets to see what would happen if the economy and financial system deteriorated beyond forecasts.

As a result of the stress tests, regulators required a number of the tested banks to raise more capital.

The stress-test measures were initially received with heavy skepticism; bank stocks initially fell on the announcement of the tests, and some analysts and economists even said the administration was using rose-tinted scenarios.

Now, the stress tests are often compared to President Roosevelt's famous "bank holiday" in 1933, which is credited with restoring the public's trust in the banking system.

"The lesson of the financial crisis," wrote the Fed researchers, "is that the buffer against downside risk must come in the form of higher bank capitalization."

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