Why European Banks Are Stressed Out

Markets need answers to two questions: How much money is needed, and where will it come from?

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Europe seems determined to repeat its mistake and undertake a second round of ineffectual stress tests on its banks. The 2010 version did little to alleviate banks' spiraling funding costs or to restore confidence in European markets. Unless the design of this year's tests is fundamentally different from last year's, Europe's crisis will persist.

Insufficient capital, combined with volatile financing, makes the European banking system prone to a run. Unlike banks that rely on retail deposits only, banks that depend on short-term borrowing from financial intermediaries or large corporations in competitive money markets must meet a much higher standard of solvency to prevent runs. When bank equity falls short of this "run point," getting money from private markets becomes difficult. In Europe, some banks have turned increasingly to borrowing from the European Central Bank, while paying higher premiums to borrow in private markets to compensate for their risk of default. The results from our research with Morgan Stanley's David Greenlaw, commissioned by the University of Chicago Booth School of Business's Initiative on Global Markets, suggest that two things must occur to end the lingering financial crisis in Europe.

First, private lenders must be confident that there is a ceiling on European banks' potential losses. A competent stress test could provide this information. To be credible, the test would have to anticipate likely bank losses in truly adverse conditions. Because European banks own large amounts of sovereign debt issued by countries that might not be able to pay in full, the possibility of a government-debt restructuring must be considered in the stress scenario. Realistic growth prospects and losses on housing loans also must be examined. That the Bank of Spain and Moody's differ by roughly €100 billion on their worst-case scenarios for Spanish banks' capital shortfalls (below existing requirements) demonstrates how far European authorities will need to go to be credible in this respect.

The second necessary ingredient is a credible plan to recapitalize Europe's banks that are found to have inadequate capital to forestall runs. Pronouncements of solvency are not enough. European policy makers would do well to remember that creditors' 2010 run on Irish banks came after these institutions received clean bills of health in last year's stress test.

By far the preferred arrangement would be a mandate that compels weaker European banks to raise additional equity from private sources. A sign of the impotence of the first round of European stress tests is that, of the 90-plus banks that underwent the tests, only Deutsche Bank raised significant new equity in their aftermath, while the others continued to operate without improving their capital. This time for the
banks that fail to attract private capital, there must be a credible back-up plan for what comes next. A rapid closure might be one option, but if bungled, it risks triggering a run that could be contagious. Another option might be to prop up weaker banks temporarily with taxpayer support until they can be sold or liquidated in an orderly fashion. It should be clear that the only justifiable reason for such support would be to forestall a damaging run.

The U.S. stress tests in 2009 came with such a back-up plan. The extent of the loss scenarios examined in these tests were important, but they were supplemented with the big stick of serious government intervention for banks that failed to raise private capital. This stick concentrated minds wonderfully. Of the 19 banks examined in the U.S. stress tests, 13 raised at least $1 billion in new equity within one month of the results' publication.

As clear as all this seems, European politicians are largely unwilling to admit that their banks may be short of capital. Economists and other observers have realized all along that the true reason for (temporarily) offering aid to Greece was to protect banks in other countries (including Germany and France) from losses on their holdings of risky euro-area sovereign debt. The policy community downplayed this fact—until Ireland. By then, the game was up. It became clear last fall that the true objective of the euro "bailouts" was to buy time for European banks to rebuild their capital so that they could endure eventual losses from debt restructurings.

Markets are not fooled by policy rhetoric or by ineffective stress tests. Consequently, banks in some countries have had chronic problems in borrowing privately. Ironically, to protect itself, the banking system has sought to buy protection against the defaults of governments. But this hedging, using credit default swaps, drives up the cost of the insurance, so that CDS spreads have widened. In response, some politicians argue that buying protection should be banned or insist that more stringent fiscal consolidation is the answer. But these diagnoses miss the point: Europe's sovereign-debt problems cannot be separated from its banking problems. If the banks were better capitalized, then sovereign spreads would be narrower, and the banks could withstand a government-debt restructuring needed to put budget deficits on a sustainable path. Repairing Europe's banks would help end the financial crisis, even if large economic adjustments would still be needed in the euro area to promote convergence and growth.

For now, the situation in Europe is fragile and potentially dangerous. The wholesale funding that banks rely on is subject to rapid withdrawal. The potential triggers for such a run are numerous, including policy talk of haircuts for debtors, the elimination of implicit government support, or rising fear that likely government support may be inadequate. The last point is especially important because the longer the situation festers, the greater the chance that public outrage will constrain government policy.

Ultimately, the crisis in Europe will continue until we have answers to two critical questions: How much money is needed to stabilize the banks, and where will it come from?

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