Bloomberg

# Europe's Banks Need a TARP of Their Own

By Thomas Cooley, Matthew Richardson and Kermit Schoenholtz -
Jun 18, 2012

In spite of Sunday's victory of pro- bailout parties in the Greek election, the European Monetary Union remains in a battle for its survival. What began as a debt predicament is now compounded by a rapidly expanding banking crisis and growing political instability that threaten European integration.

Recent European backing to stem the run on Spanish banks was a welcome step away from the prevailing position that fiscal and banking problems aren't candidates for coordinated action. Unfortunately, the details of the support for Spanish banks are vague, and were insufficient to calm the financial markets. Instead, the yield on Spanish 10-year government bonds has risen above 7 percent to a euro-era high.

There is a good reason -- vague solutions that don't address the integrity of the entire European banking system won't work. Restoring confidence will require a full-fledged euro-area banking union, including common mechanisms to backstop bank liabilities and to resolve or recapitalize failed lenders. A common set of rules as the European Commission recently proposed isn't enough.

With bank runs already under way, the immediate requirement is a euro-area Troubled Asset Relief Program like that used in the U.S. to clean up the banks during the 2008 financial crisis. The existing European Financial Stability Facility and the anticipated European Stability Mechanism aren't up to the challenge. Both mechanisms provide funding to recapitalize banks through their sovereigns -- reinforcing the links between the banks and their sovereigns in a vicious cycle of declining creditworthiness. It also is unclear that they will have sufficient resources to meet the growing challenge.

## Triple Threat

Why does the euro region have such difficulty confronting these problems? In part, it faces a classic policy "trilemma." Euro members aim to encourage a robust and stable cross-border banking system, prevent runs on banks in particular countries and preserve national sovereignty. Over time, you can choose any two of these, but not all three. A robust cross-border banking system requires euro-wide regulation, deposit insurance and resolution mechanisms for insolvent banks. These are inconsistent with strict preservation of national sovereignty.

The runs reflect doubts about the capacity of national governments to recapitalize their banks, fear over the fiscal consequences of loans as a solution and the lack of a credible euro-wide backstop.

In the U.S. we have witnessed such instability only recently. After the collapse of Lehman Brothers Holdings Inc. in 2008, there was a run on major U.S. banks and securities firms. However clunky the Treasury's response -- the TARP program that Congress eventually approved -- it had one great virtue: It worked.

Is TARP a model for the euro nations? TARP worked because it helped to take the critical issue of solvency of the banking system off the table, creating breathing room for other solutions to emerge.

By itself, TARP would have been insufficient. But putting TARP capital into the major banking institutions set the stage for a round of well-organized, transparent stress tests. Perhaps most important, TARP served as a potential backstop to resolve any systemic institutions that proved unable to raise private capital after the publication of stress-test results. The credibility of the tests facilitated a wave of private-equity capital flows into the financial system, making additional TARP injections unnecessary.

In Europe, the lack of TARP makes it unrealistic to conduct credible stress tests. No policy maker will announce the insolvency of a bank without being prepared to resolve it. Consequently, no bank creditor will believe any stress test if the public backstop is unavailable.

## TARP Worked

The details of the implementation of TARP were important to its success. The U.S. Treasury provided additional capital in exchange for preferred stock and warrants. The debt could only be paid back by raising additional capital, and the use of warrants meant the banks sold off the upside of any rebound, decreasing the incentives to take big risks to recover. So far the details of the Spanish bank rescue make it sound more like a targeted loan to the government rather than a recapitalization.

We have no illusion that a TARP combined with credible stress tests will be sufficient to address the problems of the euro area. Ultimately, the region needs a new treaty or a constitutional-level commitment that buttresses the credible rules for monetary policy with equally credible rules for fiscal and prudential policies.

Naturally, today's European creditor nations want to ensure that there are sufficient guarantees for their continued solidarity and largesse. Achieving such a sustainable arrangement will take considerable time -- far more than policy makers have to halt the bank runs that threaten the monetary union’s survival. If any country exits the euro, the difficulty of halting bank runs elsewhere will increase.

Decisive collective action can get a financial system through a crisis, and there is no alternative consistent with preserving the euro. Letting market discipline weed out the banks, though attractive in principle, could weed out the banking systems of entire nation states -- a choice that no nation can tolerate. Moreover, euro-area banking systems are inherently interconnected and particularly fragile because of the monetary union’s inconsistent objectives.

If it’s not too late for collective action to halt the systemic runs, time is certainly running out. The question is whether the euro’s members are up to the task.

(Thomas Cooley, Matthew Richardson and Kermit Schoenholtz are professors at New York University’s Stern School of Business. They are contributors to Business Class. The opinions expressed are their own.)

To contact the authors of this article: Thomas Cooley at tcooley@stern.nyu.ecu; Mathew Richardson at mrichar0@stern.nyu.edu; Kermit Schoenholtz at kschoen@stern.nyu.edu

To contact the editor responsible for this article: James Greiff at jgreiff@bloomberg.net.