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ECONOMIC VIEWPOINT

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Why Do Governments Have So Much Difficulty Dealing With Troubled Banks?

The latest spate of banking problems in Italy highlights the rather remarkable truth that governments have enormous difficulties dealing with banking crises. This situation prevails despite decades of experience on what not to do and what works in terms of bailouts. The Italian crisis has all the classic symptoms of poor banking practices, weak supervision and uncomfortable options when things go bad.

The most recent problems at Banca Monte dei Paschi di Siena mirror those experienced weeks earlier in a smaller Milan bank, namely, bad assets that currently exceed the level of provisioning; this has sent tremors through the banking system. Attempts to use emergency means outside of the Eurozone's new best practice approach, the Bank Recovery and Resolution Directive, were rejected by the powers that be in Europe. This reaction may well be justified, but certainly is at odds with the approach taken in the first two Greek bailouts that favored the lenders, especially German banks.

The Italians first attempted to spread the losses within the banking system by asking other healthier banks to buy impaired assets. This is foolhardy, suffers from moral hazard consequences, and in fact does what the European Central Bank (ECB) as the lender of last resort should have considered doing. Now that the extent of the problem has grown and has affected the third largest bank in the country, a new approach is needed, but the authorities find themselves between a rock and a hard place. No one will willingly add capital to an impaired bank, since that equity will be the first casualty of any bank failure. The preferred Euro-approach of forcing banks to borrow subordinated debt that can be considered equity if circumstances warrant is unlikely to work. Moreover, in the case of Italy, since bank ownership is widely held, it is also difficult to assign losses without a public outcry. Some have argued that another government financial institution should be the bailout instrument, but this runs the risk of continuing to hide the extent of the damage. The preferable approach is to separate good from bad assets, namely, serious bank restructuring in which the owners are first loss-takers.

Regardless of what the Eurozone rules dictate, what we have learned from the TARP, in the case of the U.S. financial crisis, is that bailouts should not be given on easy terms. The fact that the U.S. Treasury earned a "profit" of $ 15 billion on its actual lending of $ 442 billion implies that the interest rate charged was approximately 3.3 percent, far from the distress rates normally associated with lenders of last resort. Without dramatic write-downs that will hit bank balance sheets, the structural problem of bad bank portfolios cannot be tackled. Once depositors have been protected up to a certain level, it behooves authorities to force effective restructuring, intervening as needed. To ignore the problem in the interest of protecting the system actually does the exact opposite, namely, it weakens the system even further.

Throughout this entire process, it seems inconceivable that the ECB would remain above the fray for one of its members, in this case the fourth largest economy in the EU. The similarity to the case of Greece is the mistaken view in Berlin that punishing members for bad behavior will lead to a stronger union. As long as national authorities are the primary instrument for bank supervision, yet cannot offer serious lender-of-last-resort support for large or systemic problems, the misalignment of policy responsibilities will persist. The weaknesses of the Italian banking system could not have come at a worse time for the Eurozone, just barely out of recession and now reeling from the Brexit vote. Some commentators, like Reza Moghadam, have noted that the banking problems of Europe are more widespread and that an emergency asset management company is needed. One thing is clear: fixing banks is not rocket science, but it is politically difficult and it incurs an economic price. The trick is to limit the cost by acting forcefully and not sweeping the problem under the rug.

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