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A TEST EUROPE'S BANKS MUSTN'T FAIL

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Europe is lurching toward an overhaul of its banking system. Later this year, the European Central Bank is set to assume the authority to supervise the 130 largest banks in the euro zone — a momentous process of centralizing financial regulation in Frankfurt aimed at preventing another round of the bank failures that contributed to the 2007-8 global financial crisis.

In preparation for the handoff, the E.C.B. will conduct a "stress test" to gauge how the banks would fare if economic conditions deteriorated. But the central bank's point person for these efforts, Danièle Nouy, appears to have misdiagnosed the problem, suggesting that "insufficient transparency regarding the balance sheets of the European banks" is the critical problem.

Many of the large banks own huge amounts of government bonds that were issued by countries whose ability to fully repay their debts is in doubt. If the countries default, the banks will go broke. This risk is paralyzing the banks, which consequently shy away from lending. Without lending, Europe's economies are not growing, which reduces tax revenues and makes a default on the bonds all the more likely.

To avoid such a vicious cycle, the E.C.B. should keep in mind three lessons from Japan and the United States about how to properly use stress tests to stabilize its banks.

The first is that the main reason to care about the banks is that the credit they extend is essential for growth. The point of a stress test is to make sure that banks are strong enough to lend and, if they are not, to fix the problem.

The second is that weak banks have powerful incentives to roll over bad loans (or hold on to impaired assets) to avoid taking losses. Acknowledging losses would reduce the value of shareholder equity and would expose management to criticism. The alternative is to raise more capital and hold management accountable. Absent fresh capital, attempts to protect taxpayers from having to bail out the banks mean that the banks will not extend more credit — because the new loans might go bad, too.

The third is that stress tests need to come with a plan to restore lending. Japan had a banking crisis in the late 1990s that it finally tackled in 2003. American banks were nearly broke after the 2008 crisis. In both cases, regulators used cleverly designed stress tests: They calculated potential losses by the banks and, once the results were announced, the banks had to make adjustments. In Japan, many large banks were deemed undercapitalized: Management was replaced (and managers' pay was restricted) and the banks had to raise new capital (and while doing so they could not pay dividends).

In the United States, the government offered money from the Troubled Asset Relief Program as a backstop after the Federal Reserve stress tests concluded that its 19 largest banks were at risk of losing more than $600 billion and that they needed about $75 billion in capital to survive in the worst-case scenario. The banks were given six months to plug their deficits and told if they did not do it on their own, the government would use the TARP money to invest in the banks on terms that would be attractive to the government but unattractive to existing shareholders. The result: The American banks raised more than $50 billion in new equity in one month, and another $120 billion over the next 18 months. The backstop was not needed.

Europe’s poorly conceived prior stress tests in 2010 and 2011 failed on all fronts. Most important, little capital was raised. Between 2011 and the middle of last year, European banks raised less than 75 billion euros ($103 billion), though their total assets are greater than American banks’.

Poor decisions by regulators enabled these failures. One was to allow the banks to determine their health by comparing their capital to their assets — rather than the amount needed to support the credit needs of the economy. Given the choice of raising new capital or reducing their size so that their capital base was commensurate with a smaller level of perceived risk, the banks’ shareholders and executives chose the latter, easier option. This meant less lending, and economic stagnation.

A second failure involved the government bonds held by European banks. The previous stress tests hid behind an accounting gimmick, pretending that if banks promised to hold on to the bonds, the bonds would be immune to losses. Of course, if there is a default, the losses will have to be recognized. And if default appears imminent, depositors and others who fund the banks will fear losses are coming and stop funding them. Unless the banks have an adequate equity cushion to protect them from this possibility, they will again be unable to lend.

Europe needs a credible plan to rehabilitate its banks. The most direct way would be for the governments of the euro zone to pool resources and issue the same ultimatum America did: Raise more capital or our governments will invest in your banks in ways that will benefit taxpayers and disadvantage your shareholders. The economists Viral V. Acharya and Sascha Steffen have estimated that the capital backstop needed could exceed 500 billion euros. That’s a huge number to swallow — yet it is essential for leaders to stop understating and to show the political will it takes to plug the hole.

Until now, peculiar rules have also given shareholders too much power to prevent European banks from raising new equity. For example, Italian charities have lobbied to prevent or delay plans for banks to raise new capital, with surprising compliance from regulators at the Bank of Italy. The byzantine governance structure of Crédit Agricole in France puts potential equity investors at a disadvantage, relative to the regional cooperative that controls the bank. Mr. Acharya and Mr. Steffen estimate that banks in France are the most undercapitalized of all banks in the euro zone.

With the new stress tests, the European Central Bank has a chance to change course. But to do that it needs to break with past practices and do what other countries have shown it takes to make sure that banks are no longer an obstacle to growth.