**06 05 2009 Insolvenza delle Banche Usa, Stress test e disciplina del mercato**

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Joseph Schumpeter famously argued that the essence of capitalism was creative destruction, by which new economic structures are born from the rubble of older ones. The government stress tests on the 19 largest US banks, the results of which are due be announced on Thursday, could have facilitated this process. The opportunity looks likely to be missed.

The tests, which measure how viable banks are under adverse economic conditions, have no "failed" category, even if as many as 10 are reported to need additional capital. But, given that the economic environment already reflects the tests' worst-case scenario and that recent estimates by the International Monetary Fund of financial sector losses have doubled in six months, the stress test results will not be credibly interpreted as a sign of bank health.

Instead, market participants will conclude that banks requiring extra capital have, in fact, failed. As a result, these institutions will not be able to raise outside capital and will immediately require government help.

Once again, the question will be how the near-insolvent banks can be kept afloat, to avoid systemic risk. But the question we really should be asking is: why keep insolvent banks afloat? We believe there is no convincing answer; we should instead find ways to manage the systemic risk of bank failures.

Schumpeter's biggest fear was that creative destruction would lead capitalism to collapse from within, because society would not be able to handle the chaos. He was right to be afraid. The response of governments worldwide to the financial crisis has been to give the structure of private profit-taking an ever-growing scaffolding of socialised risk. Trillions of dollars have been thrown at the system, just so that we can avoid the natural process of creative destruction that would take down these institutions' creditors. Why shouldn't the creditors bear the losses?

One possible reason is the "Lehman factor" – the bank runs that would occur as a result of a big failure. But we have learnt from the Lehman collapse and know not to leave the sector high and dry when a systemic institution fails. Just being transparent about which banks clearly passed the stress tests would alleviate many of the fears.

Another reason is counterparty risk, the fear of being on the other side of a transaction with a failed bank. But unlike with Lehman, the government can stand behind any counterparty transaction. This will become easier if a new insolvency regime for systemically important financial institutions is passed on a fast-track basis by Congress. Problem nearly solved.

That leaves the creditors – depositors, short- and long-term debt-holders and preferred shareholders. For the large complex banks, about half are depositors. To avoid runs on these deposits, the government has to provide a backstop. But it is not clear it needs to cover other creditors of a bank, as the failures of **IndyMac** and **Washington Mutual** attest.

Even if systemic risk were still present, the government should protect the debt (up to some level) only of the solvent banks, not the insolvent ones. That way, the risk of the insolvent institutions would be transferred back from the public to the private sector, from the taxpayer to the creditors.

The government may be able to avoid the mess by persuading long-term creditors to swap their debt for equity, at a loss. The recent failed effort with Chrysler suggests this will not be easy. But a credible threat of bankruptcy could scare creditors into negotiation, to avoid bigger losses.

Suppose the systemic risk problem is solved. The other argument against allowing banks to fail is that after a big loss by creditors, no one would be willing to lend to banks – which would devastate credit markets. However, the creative-destructive, Schumpeterian, nature of capitalism would solve this problem. Once unsecured debtholders of insolvent banks lose, market discipline would return to the whole sector.

This discipline would force the remaining banks to change their behaviour, probably leading to their breaking themselves up. The reform of systemic risk in the financial system would be mostly organic, not requiring the heavy hand of government.

Why did creditors not prevent the banks taking excessive risks before the crisis hit? For the very same reason creditors are getting a free pass now: they expected to be bailed out. For capitalism to move forward, it is time for a little orderly creative destruction.