Greek debt is in trouble—again. After a month of dickering, it seems likely that the International Monetary Fund and the European Union will agree to roll over Greece's debt so bondholders will be paid in full. Why is Europe so terrified of letting bondholders bear some of the risk that comes with high yields?

The answer is that most of those bondholders are banks. If Greece defaults, then important French and German banks will be in deep trouble. Even a small rescheduling would force the banks to admit their losses.

If Greece is allowed to default, reschedule or abandon its restructuring, Ireland, Portugal, Spain and Italy may soon follow. This scenario is beyond the EU's bailout capability. And it would leave the European financial system in shambles, because, again, the banks are holding that debt.

There are four key facts to recognize:

First, the Greek government has borrowed more than it can plausibly afford to pay and certainly more than it will choose to pay. It now owes more than one and a half years' economic output. The reforms necessary to produce strong economic growth and drastically cut spending are very unlikely.

Keep in mind, Greece is not being bailed out. Greece's bondholders are being bailed out. Greece would rather default. Cleared of its debts, it would likely be able to borrow again soon.

Financial markets have figured this out. As of yesterday, it cost $182 per year to insure $1,000 five-year Greek debt, implying a 63% probability of total loss in five years. Yes, the write-down is inevitable.

Second, European banks are holding the bag. This week the Moody's rating agency put three large French banks under review for a potential downgrade because of their Greek exposure. Beyond direct exposure, banks throughout Europe lend to each other and write insurance against sovereign defaults. Even U.S. prime money market funds are indirectly exposed.

One would think that wise regulators would have required hefty capital against sovereign lending, or lending to other banks whose main investments are Greek debt. One would think that given a full year, those
regulators would have at least increased the capital requirements for sovereign debt, run serious stress tests against sovereign default, or forced banks to buy credit-default swap insurance from counterparties other than Greek banks. But one would be wrong. (This is a sobering lesson for the U.S.’s plan under Dodd-Frank to trust that our wise regulators will spot all dangers, require adequate capital, and keep banks from getting into trouble.)

Third, the European Central Bank (ECB) is now involved as well. It started buying secondary-market Greek debt last May. The ECB has now lent in excess of 80 billion euros to Greek banks, replacing private funding that has run away, and typically receiving Greek government debt as collateral.

If there is even a minor credit event, the ECB could no longer legally take that collateral. If Greece defaults and Greek banks fail, the ECB is stuck with junk collateral. This explains why ECB President Jean Claude Trichet insists that there must be "no credit event, no selective default."

Fourth, in the end this is all about Ireland, Portugal, Spain and Italy. If Greece were the only country in trouble, it would have been allowed to default. European governments would have plugged the holes in their banks, bailing out those deemed "too big to fail" and reorganizing the others so that deposit and lending operations continue unimpeded. After all, Greece is small.

But Spain, Portugal and Italy are also experiencing slow growth, high unemployment, and have unpopular governments with limited ability or desire to implement reforms. The banks in each of these countries are chock full of their government’s debt. Other euro-area banks are lending to them, indirectly taking on additional exposure. And the ECB is full in, holding their sovereign debt and lending vast amounts of money to their banks, taking sovereign debt as collateral.

Germany would like banks to roll over their Greek debt. But Greece cannot possibly pay 17% interest rates for 10 years. So if banks roll over debt at market rates, Greece's eventual default is ensured. Banks cannot roll over at low rates without enduring huge losses. Thus, the only way to get banks to "voluntarily" roll over the debt is by letting them carry the debt at artificial "hold to maturity" valuations, which leaves the danger to the financial system.

Germany knows it’s likely to bear the brunt of bailouts. The German sentiment that bondholders should bear risk is nice. Alas, the chance to do that is passing quickly. All the private bondholders will soon have cashed in their debt, and only the ECB, IMF, governments and government-guaranteed banks are left.

So what to do? Prepare for the worst. Europe needs to expunge the rot from its banks so that the inevitable write-downs do not imperil its financial system. Sovereign debt and sovereign exposure must face large capital buffers. Sovereign debt must be marked to market. Banks must run serious stress tests to find implicit sovereign exposure. Banks with inadequate capital must raise it, find buyers, or reorganize. If that means bailouts of "systemically important" banks, then governments must do so, face their taxpayers, and make their regulators explain how they let this happen.

Sovereign defaults often follow financial crises. But with a more proactive policy, any European sovereign defaults need not create a second financial crisis.

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