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# The SRM and the dream to resolve banks without public money

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Every self-respecting finance minister has to pay lip service to the dictum that the sector itself should pay for any problem bank. But when the problem bank turns out to be a home bank, the tune changes immediately and excuses are quickly found why in this particular case some infusion of public money is needed. The official justification is usually that the bank has only a liquidity problem and that markets just fail to recognise that it is really solvent in the long run. In reality, there are often close ties between the holders of the bank's equity and debt and the national political class.

Moreover, the dream of resolving banks without resort to public money becomes a nightmare in the event of a systemic crisis. Experience has shown that a systemic crisis can go from bad to worse if the public sector refuses to intervene.

Hence, it does not make sense to judge the plans for the Single Resolution Mechanism (SRM) on how it would have dealt with the current crisis. The purpose of the SRM would be to create a system under which *individual* banks could be resolved without creating problems for the payments systems, the availability of credit or, more in general, problems of systemic stability. The existing national resolution procedures (to the extent that they existed at all) were in many cases inadequate for this task.

## Time inconsistency

The key economic problem is actually not how to protect the public purse, but how to create a situation in which bank managers and their investors do not count on public support *ex ante*, because this expectation of public support distorts the cost of capital.

*Ex post*, i.e. once a crisis has materialised, the rescue of some investors is often unavoidable to limit contagion or to minimise bankruptcy costs.

A hands-off policy to bank insolvency is thus not time consistent!

## Time inconsistency and credibility

On paper, the EU has imposed upon itself (and the national authorities) very strict rules under which a bank can receive any public support, unless some of its creditors have been 'bailed in'. In principle, these the rules will apply from 2016 onwards.

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But are these strict 'bail-in' rules credible? The EU Directive regulating this aspect contains a number of exceptions. The most important one allows *national authorities* to avoid a bail-in if 'systemic stability' is in danger.

This leads to the question: Who is likely to use this loophole? The track record suggests that this may well be the one country that has insisted the most on the need to protect the public purse, namely Germany, where even junior, subordinated debt was fully paid during the financial crisis and no private investor in bank debt was ever bailed in. Moreover, in 2008-09, Germany had the second-highest ratio of financial support to the banking system relative to GDP among all countries in the EU.

## How to overcome the time-inconsistency problem?

When economists diagnose a 'time-inconsistency' problem, they usually recommend delegating decision-making authority to an independent agency. This was the prescription when inflation had to be tamed. Central banks were made independent and given only one task: preserve price stability. This remedy was applied in particular to the ECB, which has been quite successful in maintaining price stability (but less successful in maintaining financial stability).

When the euro was created, it was generally agreed that those countries with the least-independent central banks and the worst inflation track records would gain the most from delegating monetary policy to an independent ECB. Similarly, one could argue that the countries likely to gain the most from delegating bank resolution to an independent EU agency should be those with the lowest cost of public funds (and hence those with the strongest temptation to save banks *ex post*) and the countries with the closest links between the banking sector and the political class.

## Cui bono?

The negotiating positions over the last months were based on the assumption that the countries under financial stress needed the SRM and that Germany made a big concession by agreeing on a common fund (SRF) and a common decision-making board. However, in reality, the time-inconsistency problem suggests that the long-run benefits might be higher for Germany than for countries with weak public finances. Germany might get a more efficient banking system if it agrees to 'bind its own hands'.

A second argument often used in Germany (and other creditor countries) is that the resources collected from German banks might be used primarily to bail out banks in the periphery. But one should keep in mind that a restructuring fund like the SRF will not bail out the bankers or the equity holders, but investors in the other assets of the bank. Many of these investors might actually be German, given that the country is running such a large current account surplus.

The popular perception that the periphery has the most to gain from the establishment of a unified resolution regime that really limits bail out in a credible way might have gotten it backwards. In reality, Germany and other surplus countries have a bigger interest in tying the hands of their national resolution authorities, which have a tendency to be too generous.