

Europe's Ungainly Banking Revolution

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Late last year, eurozone finance ministers reached a compromise on the basic elements of the Single Resolution Mechanism (SRM) – that is, how to deal with banks in difficulty. It looks ugly, but it also appears likely to work.¹

The main ingredient of the compromise is to use, at least initially, separate national funds in case a bank needs to be saved while also creating a common Single Resolution Fund (SRF) of up to €55 billion (\$75 billion) over the next ten years, which is to be financed by contributions from the banks themselves. The entire SRM would be run by a collection of national supervisors and representatives from the European Central Bank and the European Commission.

The European Parliament's initial reaction to this scheme was highly negative, because this initial proposal is far from ideal from a pan-European point of view. But the European Parliament has little power to change any of the current proposal's main elements, because it is the finance ministers' governments, not the European Union, that will ultimately have to put up the money.

The defects of the finance ministers' proposal are apparent. First of all, the SRM will not, at least at the beginning, be a 'single' mechanism at all. National funds – and thus national authorities – will continue to be responsible for 'their' banks' problems, with the SRF's contribution to any rescue operation rising only gradually. It will be at least a decade from now – roughly the year 2025 – before the SRM is really 'single', with the use of separate national funds ending.

This is of course a long transition period. But since the ECB is in the process of conducting a special in-depth examination of the banks' balance sheet called AQR (Asset Quality Review) there is actually little danger that there will remain too many skeletons in the banks' cupboards. Moreover, after five years (meaning by 2020), the SRF could already contribute one-half of the funding that might be needed to finance the resolution of any of the 120 banks covered by this scheme, thus providing an important backup should the national funds be insufficient.

¹ MEP Sven Giegold has posted on twitter a humorous but instructive flow chart showing the complexity of the process (see https://twitter.com/sven_giegold).

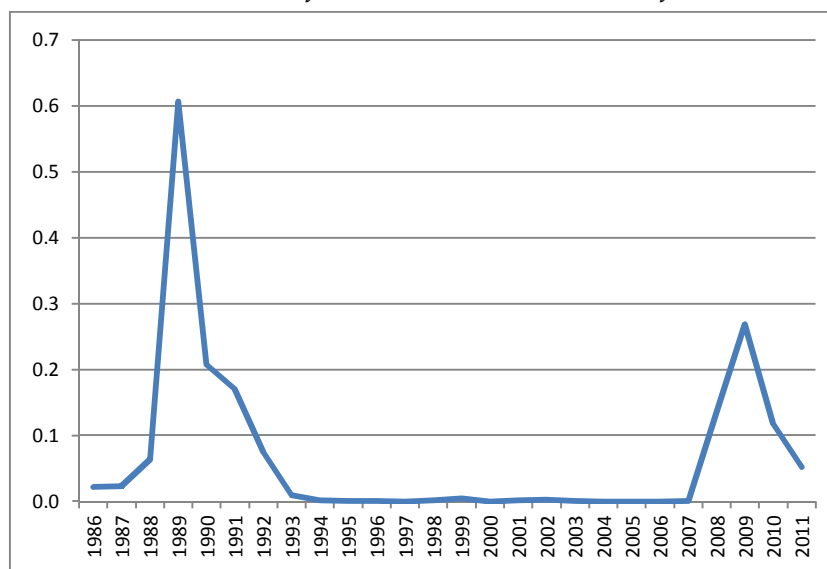
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The experience of the US shows that banking crises tend to come in bunches, at the end of long credit booms. The figure below shows the losses of the Federal Deposit Insurance Corporation (FDIC), the US institution responsible for restructuring banks and protecting depositors. It is apparent that before the present crisis, losses of a significant scale occurred only during the early 1990s in the context of the so-called 'savings and loan crisis'. During the 15 years between these two major systemic crises, hardly any bank failed. It is likely that in Europe as well there will be a period with few banking problems once the legacy of the current crisis has been dealt with. The long transition period should thus be manageable.

Estimated losses of the US FDIC over time (% of GDP)



Sources: FDIC and IMF.

To be sure, it is not ideal that the SRM will cover only those 120-plus banks that will come under the ECB's direct supervision at the end of this year. But this makes sense at the beginning, when the ECB will have its hands full getting a grip on the banks under its direct control (which, in any case, constitute about four-fifths of the eurozone's banking system). Theoretically, the ECB is also the indirect supervisor of all the thousands of smaller banks in the eurozone, but it will take some time before this becomes effective.

Another inelegant part of the proposed arrangement is that the SRF will not be part of the EU machinery; instead, it will be created by an intergovernmental treaty (now being rapidly negotiated among eurozone member countries). But this intergovernmental agreement is likely to be only a transitory solution. There have been other cases of major initiatives that started outside the legal framework set by the EU treaties, but that were later incorporated into the *acquis communautaire* (the body of EU law), thus bringing them under the control of the European Commission and the Parliament. This is how the Schengen free-travel zone evolved. The same is likely to happen with the SRF.

The incredibly complicated decision-making process that has been proposed for the SRM, which, on paper at least, would involve more than 100 individual officials and many committees, is also unlikely to represent a real obstacle, as bank restructuring usually has to happen in a matter of days, typically over a weekend. The few individuals who know the details of a case will take the key decisions, while the rest, with little knowledge of or stake in the matter, will be politely asked to agree. When the SRM and the SRF are brought back into the EU system, the decision-making mechanism will need to be revisited.

The size of the SRF has often been criticised as being insufficient. But this is wrong: €55 billion would be enough to deal with all but the very largest banks in Europe. It would also be sufficient to deal with even a systemic crisis in small- to medium-sized countries like Ireland or Portugal. Even Spain needed 'only' €60 billion from the European Stability Mechanism at the peak of its crisis.

In any event, a restructuring fund can only be a first-aid kit to deal with an isolated accident (or two). Systemic crises always require a fiscal backstop. On this account, the SRM proposal is also incomplete.

In any event, the euro area has now a permanent mechanism to support governments in difficulty. While there is no explicit agreement, there can be little doubt that if a major crisis erupts that threatens to overwhelm the SRF, the funds necessary to save the euro-area's banking system from collapse will be found, given that all the member states participating in the SRM will have an incentive to back up their common investment.

The plan for the gradual constitution of a common resolution fund constitutes an awkward step in the right direction as it leaves as many problems unresolved as it addresses. But the end result is likely to be quite strong, because it establishes a key innovation: a common fund that effectively mutualises much of the risk resulting from bank failures.