Europe’s Single Resolution Mechanism Is Creating Instability

By Jean Dermine , INSEAD Professor of Banking and Finance

Recent bank bailouts show that the Single Resolution Mechanism doesn’t work in its current form.

As of January 2016, Europe’s Single Resolution Mechanism (SRM) has been in force for banks in the Eurozone. On paper at least, the SRM is supposed to privatise risk and losses by “bailing in” shareholders, bond holders and private creditors to rescue failing banks, taking states off the hook from using taxpayer’s money to do so.

There is no doubt that the SRM fundamentally changes the way banking markets have functioned until now. In principle, the SRM can help states avoid racking up budget deficits due to costly bailouts. They can also be absolved of acting as a public backstop for any bank deemed “too big to fail”. Fully exposing shareholders, bondholders and creditors to losses should increase incentives for the industry to self-monitor.

The attempt to sever the link between bank and state, thereby holding investors accountable for risks taken by banks, is well intended. The SRM makes banks similar to companies in other industries in which private creditors bear losses if a company defaults.

However, as we can observe from recent problems in banks (Banco Popular in Spain, Banca Monte dei Paschi (MPS), Veneto Banca and Banca Popolare di Vicenza in Italy), the SRM, in its current form, is incomplete and a potential contributor to future panic and disruption in the banking system.

As I argue in a chapter in the recently published book **Monetary Economic Issues Today**, there are three main reasons.

Who gets "bailed in"?

First, the ability of the private market to bear losses is not clear cut. If the "creditors" who bear losses are "widows and orphans", pension funds or insurance companies, there are huge political ramifications. In November 2015, when the Bank of Italy imposed losses on bond holders of four small local banks, a customer of troubled Banca Etruria committed suicide after losing his life savings. He had invested all his wealth in bonds, which were wiped out.

This was why when MPS, Veneto Banca and Banca Italia di Vicenza entered difficulties, the SRM was not applied. The Italian government has since intervened to bail out MPS and provide guarantees to the two other banks at a cost to the taxpayer of €18 billion. This has opened the SRM to heavy criticism as the state and taxpayers have been put back on the hook for bank bailouts.

Preventing a run on the bank

As the case of Banco Popular in Spain showed, ambiguity around the extent to which private creditors or depositors will be wiped out when the SRM is triggered creates the risk of a bank run. The fact that the directive demands that unsecured deposits with a maturity of more than seven days are potentially exposed to losses creates significant uncertainty. While it also says in special circumstances some deposits may be excluded, there is ambiguity around which ones, leading customers of the bank and treasurers at other banks to run to withdraw funds. This ambiguity led Banco Popular to burn through €3.6 billion of emergency funding in two days as it suffered the

Eurozone's first large-scale **bank run** before it was snapped up by Santander for a symbolic €1.

Under the SRM rules, insured deposits up to €100,000 are fully protected, as are deposits of maturity of less than seven days. But all other unsecured deposits could be potentially at risk of being wiped out in a "bail in". This leads any prudent saver or corporate treasurer to make the only sensible decision in this situation: withdraw.

Will the Single Resolution Fund cover it?

Lastly, the Single Resolution Fund (SRF) can be used as a last resort to make a contribution to cover losses but only after shareholders and junior creditors have absorbed at least 8 percent of the total liabilities of the institution. Although there is some ambiguity in the implication of the fund, one wonders why such an explicit reference to a potential 8 percent cap has been made. Full exposure to losses would further increase the incentives of shareholders to monitor a bank.

Urgent need for reform

I propose several ways the SRM could be improved to meet its core objectives; ultimately ruling out state support or public guarantees of private debt.

First, the Single Resolution Board (SRB) could consider re-categorising seniority among the various debt holders in the bank. When a company goes bankrupt, senior creditors must be repaid first, followed by junior creditors. Short-term retail depositors could be considered senior and at less risk of losing everything. Shareholders and junior creditors would be bailed in first, with retail depositors a last resort. This would further reduce the risk of a run as retail debt holders and depositors will be at less risk.

Second, the SRB could exclude short-term debt with a maturity of more than seven days (up to, perhaps, one year). This type of debt is typically short-term loans provided by other banks on the interbank market. This would considerably reduce the risk of a run as information about a bank's vulnerability is unlikely to filter out 12 months ahead.

Another potential solution to ambiguity could be the creation of a private industry fund in addition to the SRF to mutualise losses among banks that back the fund. This would make the industry more likely to self-regulate and reduce the state's role in monitoring and saving failing banks. A private industry fund could also enhance deposit insurance. Currently, deposits up to €100,000 are protected by deposit guarantee schemes across the European Union. Any increase in guarantee will leave depositors feeling less worried about losing their money in a bank failure.

Last but not least, in case of a bank run with a large number of depositors withdrawing funds, authorities should have the right to close the bank and transform these short-term deposits into longer term deposits. This is the 'corralito' solution adopted in several countries in Latin America.

The urgency to fix the SRM cannot be understated. If the current policy remains in place, troubled banks are likely to cause panic and possibly more bank runs. So far the SRM has not managed to prevent this. On the contrary, it makes panics much more likely to occur. Furthermore, countries should not be allowed to bend the rules of the game. The SRM is a step in the right direction and the spirit of making the banking industry bear risk like any other industry is sound, but the SRM in its current form exacerbates instability in a very significant manner.

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