CEPS COMMENTARY
Thinking ahead for Europe

Europe's Ungainly Banking Revolution

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Early in the morning of March 20th, delegates from the European Parliament, eurozone finance ministers and the Commission reached a compromise on how to deal in future with banks in difficulty in the eurozone. It took over 16 hours of a final 'sprint', but the outcome is typical for the EU: it looks ugly, but appears likely to work.

The key ingredient of the compromise, which is now certain to be formally translated into EU law, is to create over the next eight years a common Single Resolution Fund (SRF) of up to €55 billion ($75 billion, or about 1% of bank deposits) financed by contributions from the banks themselves. This fund would be run by an elaborate structure under the 'Single Resolution Mechanism' (SRM), which will involve national supervisors, representatives from the European Central Bank and the European Commission.

Compared to initial proposals by the finance ministers, the major change is that the SRF will already after two years contribute 60% of the cost of saving any of the banks covered by the scheme. This means that the transition period has been considerably shortened. The contributions of national resolution funds, which will continue to exist for eight years, to any rescue operation will thus be already residual after two years and will then fall gradually to zero over the following six years. This means that de facto the transition period has been considerably shortened. This was made possible by the fact that the ECB is in the process of conducting a special in-depth examination of the banks' balance sheets, called AQR (Asset Quality Review), and that even the most sceptical countries have to admit that the ECB is likely to do a thorough job so that there is actually little danger that there will remain too many skeletons in the banks' cupboards.

Moreover, 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, over the period 1986-2011. 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 banks failed.

It is likely that there will be a period in Europe as well with few banking problems, once the legacy of the current crisis has been dealt with. The transition period should thus be manageable.

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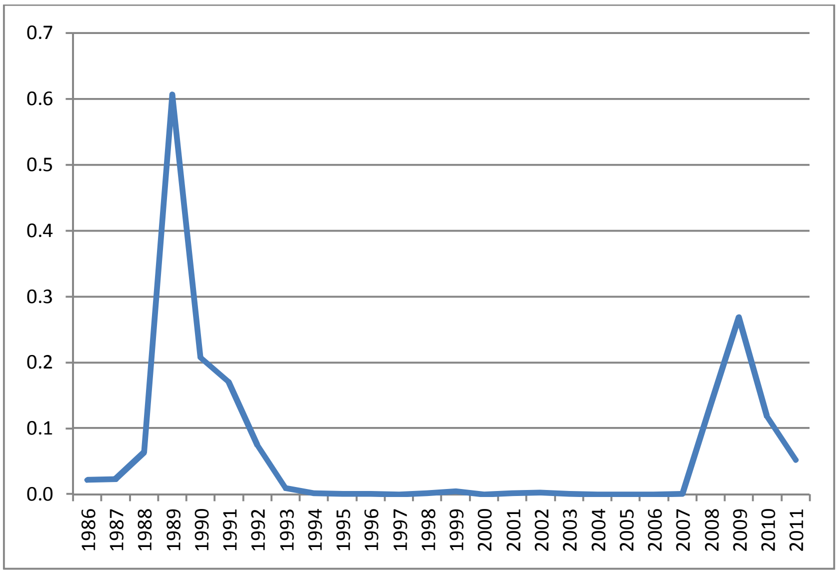
Estimated losses of the US FDIC, 1986-2011 (% of GDP)



Data 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. But this intergovernmental agreement is likely to be only a transitional 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 had been proposed initially for the SRM, which, on paper at least, would have involved more than 200 individual officials and many committees, has now also been streamlined.[1] But the formal decision-making mechanisms were never likely 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.

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.

[1] MEP Sven Giegold had posted on twitter a humorous but instructive flow chart showing the complexity of the process as initially proposed by the Finance Ministers (see https://twitter.com/sven_giegold).

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 indeed incomplete. But 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 represents an awkward step in the right direction in that 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.

Most commentators have focused on the key macro elements discussed here, namely the length of the transition period for the creation of the common fund, its size and its governance. But the fine print of the agreement might be even more important for the future of the European banking system.

These important details have not yet been made public. But it is this fine print that will give answers to key questions, such as: Under what condition will a bank be resolved? Who bears the losses? All of the participants in this process have underlined the principle that from this point onwards, creditors will have to 'bailed in' and that the industry (not the public purse) should bear the cost of any rescue operations. However, the finance ministers have inserted once again some loopholes in the fine print allowing them to deviate from these principles. The crisis has shown that when push comes to shove finance ministers almost always choose to save any bank in difficulty. On paper, the EU now has thorough rules that would not allow this practice to continue, but unfortunately the fine print of the SRM agreement might have opened some new loopholes for them. Europe will get a banking system that does not depend on continuous public support only if the rules on bank restructuring are rigidly adhered to.

This is now more likely to happen than earlier, because any European authority will be much less likely to cave in to the political pressure to save a bank (or its creditors) just because the bank plays an important role at the national level. In many member countries the largest banks have a balance sheet that is larger than their GDP, but even the largest banks are small when viewed in relation to the GDP of the entire euro area. The real importance of the SRM could thus be that the political economy of bank restructuring changes radically.