Europe's Single Resolution Mechanism is a recipe for instability

Jean Dermine

The Bracken column is named after Brendan Bracken, the founding editor of The Banker in 1926 and chairman of the modern-day Financial Times from 1945 to 1958. This column reflects his enormous contribution to the open discussion and understanding of international finance and banking. It focuses on providing views and perspectives on how to improve the global financial system.

RECENT BANKING TROUBLES IN EUROPE have exposed significant inadequacies in the EU's Single Resolution Mechanism (SRM). Designed to absolve states of the responsibility to bail out banks, the SRM is supposed to bail in shareholders, bondholders and private creditors to protect taxpayers and promote financial stability. However, far from being a cure-all, in its current form it has proven itself the opposite: a potential cause of panic and disruption in the banking system.

The first reason for this is that the SRM is unclear about precisely who gets bailed in when a bank is about to fail. While in principle it is apparent that shareholders and bondholders lose their money before anybody else, in practice, bondholders are very often 'mom and pop' investors who stand to lose everything. This presents serious political challenges for activating the SRM. We saw this in November 2015, when the Bank of Italy imposed losses on bondholders of four small local banks and 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 Monte dei Paschi (MPS), Veneto Banca and Banca Popolare di Vicenza hit difficulties, the SRM was not applied. The Italian government intervened to bail out MPS and provide guarantees to the two other banks at a cost to the taxpayer of €18bn, exactly what the SRM was supposed to avoid.

DEPOSITOR FEARS

Another reason is that the legislation lacks clarity in another crucial area. The SRM essentially says that losses might be imposed on depositors and that only under special circumstances can deposits be left completely off the table. This arguably led to Europe's first large-scale bank run in June as depositors ran to withdraw their funds from Banco Popular in Spain, fearing that they might be bailed in as it struggled under €37bn in toxic property debt. While retail deposits of more than €100,000 are protected by deposit insurance, unsecured deposits – retail or wholesale – with a maturity of more than seven days are potentially exposed under the SRM.

Any prudent treasurers will retrieve funds that are in any danger of being wiped out. Deposit withdrawals by small and medium-sized enterprises were the source of the liquidity crisis at Banco Popular, which was then bought up by Santander for €1. While shareholders and junior bondholders were wiped out, the driving force of the bank run was corporate customers who feared losing their money.

ROOM FOR IMPROVEMENT

I propose several ways the SRM could be improved to meet its core objective, ultimately ruling out state support or public guarantees of private debt. In general, the SRM is a noble idea. It makes banks similar to companies in other industries, where private creditors bear losses if a company defaults. But in my opinion, it does not go far enough.

First, politically sensitive retail depositors should have more protection in the event of a bank failure. The Single Resolution Board (SRB) could consider recategorising the seniority of banks' deposits, such that retail depositors become senior depositors. When a company goes bankrupt, senior creditors must be repaid first, followed by junior creditors. Under this arrangement, shareholders and junior creditors would be bailed in first with retail depositors as a last resort.

Second, the SRB could exclude short-term debt with a maturity of more than seven days (up to, say, one year) from exposure. This type of debt typically consists of short-term loans provided by other banks on the interbank market. The fact that such deposits are currently exposed creates the risk of a bank run. This would considerably reduce the risk of a run because information about a bank's vulnerability is unlikely to filter out 12 months early.

Third, the creation of a private industry fund to mutualise losses among banks that back the fund could further relieve states and savers from risks. This would also make the industry more likely to self-regulate.

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 temporarily and transform these short-term deposits into longer term deposits. This is the so-called *corralito* solution adopted in several countries in Latin America.

The SRM is a step in the right direction and the intention of making the banking industry bear risk like any other is sound. In its current form, however, the SRM significantly exacerbates instability. It needs urgent amendments to increase the onus on the banking industry to keep its own house in order. TB

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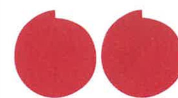

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