The False Promise of Crisis-Resolution Funds

By Stefano Micossi*

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Ever since financial markets began to stabilize late last year, the idea of making the financial sector pay for the costs incurred by taxpayers to keep it afloat has gained increasing support among policymakers and the wider public. France and the United Kingdom have introduced a temporary tax on financial-sector bonuses, and the United States government has proposed legislation envisaging a “financial crisis responsibility fee” to recover the costs of America’s Troubled Asset Relief Program. There is also a discussion about how best to reform taxation of the financial sector, which is on average lighter relative to other corporate income and unduly favors borrowing over equity financing.

But a lump-sum charge to recover past costs will not change the financial sector’s incentives concerning excessive risk-taking. Furthermore, it is unclear what, precisely, the costs are that are to be recovered.

While the direct fiscal costs of supporting the financial sector were 2.5-3% of GDP in developed countries (with peaks around 4.5%), the total fiscal impact of the crisis is much larger, amounting to the total expected increase in public debt – an estimated 40% of GDP. And even larger yet is the total cost suffered by the economy – including output and job losses, and the attendant destruction of material and immaterial capital, which, according to the Bank of England’s Andrew Haldane and others, could rise to a multiple of annual GDP.

More recently, the debate has changed tack: taxing the financial sector is now seen as a convenient way to set aside sufficient resources to pay for the next financial crisis. The idea of a tax on the financial sector has become closely associated with that of a crisis resolution fund. This would pay for the residual costs of a large institution’s failure, after its capital has fallen to zero and, presumably, creditors’ claims have been wiped out (though some proposals are ambiguous, leaving room for at least some relief for creditors).

The IMF presented one such proposal to the leaders of the G-20 when they met in Washington in April. Other versions were recently put forth by the Committee on Economic and Monetary Affairs of the European Parliament and the European Commission.

To me, these proposals seem poorly conceived, for two reasons. The first is obvious: any bailout fund for financial institutions creates an implicit promise of a bailout. Sooner or later, someone will call upon that promise. If the fund is public, it will encourage private beneficiaries to free ride on taxpayers. If it is privately financed, swindlers will be encourage to free ride on honest bankers.

The only way to avoid this undesirable result is credibly to exclude all support for shareholders and creditors of a financial institution heading toward bankruptcy. They must realize that government will not ride to their rescue. Only in this manner will shareholders and creditors have a sufficiently strong incentive to monitor management and keep a tight lid on risk-taking by banks or other financial intermediaries.

Once it is accepted that shareholders and creditors deserve no relief, the resolution fund simply becomes deposit insurance. Retail depositors are the only creditors in the financial system that deserve ample, if not full, protection against the mistakes of their bankers. After all, the main source of systemic instability in financial systems is excessive leverage, and reckless lending, by deposit-taking institutions.

Deposit-insurance fees are the appropriate instrument by which to make banks pay both for their intrinsic riskiness and the risks they impose on the rest of the system. Regulation then must ensure that bankers don't abuse their charter by taking excessive risks with their depositors' money – which is precisely where regulators failed most notably in recent years, opening the way to the financial crisis.

This brings me to the second, often less readily recognized, objection to a resolution fund: banking (and quasi-banking) losses were huge in the recent financial crisis because regulators closed their eyes to misdeeds in order to ensure bankers' international competitiveness, or more simply because they had been "captured" by them. If supervisors behave as they should, large residual losses from bank failures become unlikely. So, in order to keep residual losses small, supervisors must be obliged to undertake early corrective action when a bank's capital weakens, which is how the US Federal Deposit Insurance Corporation operates.

If a bank cannot be recapitalized, it should be resolved and liquidated. This is where effective resolution procedures become important. But the key point is that no reckless exposure would possible in a system where shareholders and creditors knew that they would not be bailed out, and supervisors were not allowed to gamble on resurrection of their supervised entities, but rather were obliged to call them to account as soon as they started misbehaving.

In the effort to build a strong and coherent regulatory system for financial markets, the idea of a resolution fund is at best a distraction – and at worst a harbinger of further financial instability.

* *Stefano Micossi is director general of Assonime [, a business association and private think tank in Rome], chairman of the board of CIR Group [a blue chip company listed in Milan stock exchange], and a member of the board of CEPS [the Centre for European Policy Studies in Brussels].*