CEPS COMMENTARY
Thinking ahead for Europe

Will the Single Resolution Fund be a 'baby tiger' during the transition?

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Our short answer is no! Even during its early years, the Single Resolution Fund (SRF) should be sufficient to deal with almost any crisis scenario imaginable. The funding for the SRF will be built up only gradually over the coming decade, however, and there is thus a legitimate concern that it will not be sufficient to deal with a major crisis.

How much does the SRF need?

To address this concern, the European Parliament asked us to perform an exercise that is straightforward in principle, but fiendishly difficult in reality: to calculate how much funding would have been needed from the SRF during the last banking crisis. We thus took all the balance sheet data from all euro-area banks that had received state aid since 2007 and assumed that the new rules on bail-in – the Single Resolution Mechanism (SRM) and bank recovery and resolution Directive (BRRD) – were already in force.

We then calculated how much funding would have been required from the SRF to keep these banks afloat. The result was that a total of about €72 billion would have been sufficient in a central case. Under a more stringent assumption about the capital requirements for the resolved banks, the sum might go up to €102 billion, or down to €54 billion under more optimistic assumptions.[1]

How much can the SRF get?

The central case of €72 billion in funding requirements from the SRF should be compared to its target size of 1% of covered deposits, or approximately €55 billion. Moreover, the SRF would be able to impose ex-post contributions of 3/8 of the total, thereby increasing the total funding at its disposal to over €75 billion.

The SRF would thus have had enough funding to deal with the biggest banking crisis in European post-war history. But how is this surprising result possible?

The surprise, including to ourselves, was that the SRF would have been sufficient to deal with such a major, indeed systemic crisis. The first reason for this sufficiency is simple: bail-in. The SRF can intervene only after a bail-in of 8% (of liabilities) has taken place. The second reason is that there is a limit to the funding the SRF is authorised to provide: it can extend only up to

[1] For the full study, see De Groen & Gros (2015).

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5% (of liabilities including own funds). We thus find that for the largest banks (those in difficulties during the first leg of the crisis), the 8% bail-in took care of most of the losses, leaving little need for funding from the SRF. During the second leg of the crisis, the 8% bail-in was usually not sufficient, but here the SRF would often have been limited by the 5% ceiling. In these cases additional bail-ins might have been needed. (For the cognoscenti: what matters here is the ratio of risk-weighted assets to total assets. A corollary of this technical point is that bail-in reduces the funding needs from SRF mainly for large banks.)

A second question arises from the fact that the funding at the disposal of the SRF during the transition would be much lower: Would it not surely be insufficient?

The answer to this question is simple: no banking crisis erupts at a single point in time; rather, the losses arise over a longer period of time during which the crisis affects the economy. The banking crisis in Europe that started in 2007 is no exception: the losses arose over a period of eight years, which happens to coincide with the time period needed to fully 'load' the SRF. It is clear that an SRF in the building-up phase would not have been sufficient if all the losses that arose over the past eight years were to materialise again in a single year. But this is extremely unlikely. The central scenario would thus be that the gradual build-up of the SRF should be sufficient to deal with a major crisis, even one of similar proportions as the last one. Some limited bridge funding might be needed in case the next crisis is very much 'front-loaded', but our paper shows that the necessary mechanisms exist, or could be mobilised on short notice.

The need to ensure the credibility of bail-in

The upshot of this research is thus that applying the new rules on bail-in will be crucial when the next crisis arrives. But bailing-in on a large scale will be possible only if this does not lead to contagion. Care should thus be taken to maintain the credibility of the bail-in procedures during good times and to limit cross-holdings within the banking sector of the capital instruments potentially subject to bail-in.

If these two objectives can be achieved, the SRF should be sufficient.

P.S.

The subtitle of our submission to the European Parliament ("How expensive is it to resolve a bank?") is wrong. The purpose of a resolution fund is to finance investment in a new bank (to be carved out of the failing one) – not to give money away. A well-run resolution fund should thus be profitable. By contrast, a deposit insurance fund can only make losses, as it is deployed only once a bank has failed and the losses are so large that depositors cannot get their money out. In short, a resolution fund invests in the future, whereas a deposit insurance fund pays for losses incurred in the past. Hence, it should never be expensive to resolve a bank, but it might be expensive to protect depositors. (See Gros, 2015, for a critique of the Commission's proposal on deposit insurance and how this burden could be better distributed.)

References

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