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BAIL-IN: Useful in Normal Times, Risky in a Crisis

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"BAIL-IN": a new word has recently entered the public consciousness, one that is not yet present in Merriam-Webster. In Italy, the crisis of four small banks has introduced the new European banking "resolution" regime (SRM) to many who would otherwise have never paid attention to the issue. So, now we know what it is, but what are the pros and cons of the new regime that, on the heels of the Single Supervisory Mechanism (SSM), makes up the second building block of the Banking Union (while we are still missing the third—a single deposit guarantee scheme)?

The main objectives of the Single Resolution Mechanism (SRM) are: to enhance trust in the banking sector, prevent bank runs and contagion, minimize (decouple) the dangerous link between banks and sovereign debt, and reduce the fragmentation in the internal market for financial services.

Are these objectives conducive to economic growth and stability? There are good arguments for saying the new regime could be useful in "normal times." A significant portion of shareholders, bondholders, and depositors, all holding assets with credit institutions, would need to be more careful in risk-taking, knowing that the government will not be on standby to bail them out. Economists rightly assume that closer attention paid by shareholders, bondholders and depositors to bank management could result in a stronger and more stable banking system. With normal-sized waves (perfect calm is a rare occurrence), the new regime, if well-managed, could fill the ship's sails, allowing for swifter and more tranquil navigation while giving the crew time to prepare the vessel for the inevitable storm.

The new regulations are not, however, fit for meeting the perfect storm such as what Europe faced in 2008-9, or in the 1930s. There are several reasons for that, the most important of which are: (i) as history shows, rigid regulations, crafted from the experience of the previous crisis, are ill-suited for meeting new systemic challenges and (ii) only the State has the necessary tools and firepower to successfully avoid or mitigate major financial crises that impact the real economy (i.e. consumption, investment, and employment). In 2008 and 2009, the treasuries and central banks of the United States and United Kingdom worked successfully to keep the system afloat, employing an incredible array of traditional and hitherto unknown tools. Public funds were funneled to save banks, in the end without losses to taxpayers. The complexity of European institutions and the monumentally high level of public debt in countries such as Italy did not allow such a timely and flexible response. The results were more disappointing.

Likewise, in the 1930s, the crisis was met, admittedly less successfully, with a panoply of instruments unthinkable before that time: monetary, fiscal, and administrative. Disregarding the gospel of "true central banking" it preached in the 1920s, the hyper-orthodox Bank of England, supported by the Treasury, stepped in directly to rescue and manage non-financial businesses, undertaking long-term investments that theory, practice and statutes until then regarded as unfit for a central bank portfolio. When the very survival of the economic and social fabric is at stake, using all available tools, as would be the case in times of war, is not only legitimate, but necessary. We don't know when the next financial crisis will occur and what features it will have. Therefore, it is crucial that the EU, ECB, national governments, and central banks be able to step in swiftly with any available weapon, and these tools should remain available even after the worst is overcome.

Enforcing constraints from the outset, at the very least, makes the necessary state intervention slower and less efficient. It is true that the SRM could be suspended in an emergency, allowing the European Stability Mechanism to step in, but the legal and political constraints to the implementation of recue packages are such that uncertainty over whether a bail-in or bailout will occur is likely to precipitate bank runs and contagion to the healthy parts of the financial system.

It is unthinkable that European leaders did not ponder the lessons of recent and past crises. Why, then, did they design a "resolution mechanism" that is bound to, at the very least, delay action and multiply legal contention in a systemic crisis?

The answer lies in the lack of reciprocal trust, which had long since lurked under the surface until it exploded during the 2008-14 crisis. Government intervention in a banking crisis is ruled out not only to avoid unfair competition (the standard argument against state aid), but more so because of the lack of trust in the fiscal prudence of the more indebted countries, Italy in particular.

If we want a Banking Union, with risk shared and managed by all member states, along with a common deposit insurance scheme and a revision of the SRM, all reasonable goals, we need to rebuild trust between members of the EU from the ashes of the banking crisis. It is a task for which Italy has both a vested interest and decisive role to play, first and foremost by showing she is serious in her commitment to reduce her public debt.