

## Do we need a resolution fund paid for by financial institutions?

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**E**ver since financial markets appeared to stabilise, the idea of making the financial sector pay for the costs incurred by taxpayers to keep it afloat has gained increasing support among policy-makers and the general public. France and the United Kingdom have introduced a temporary tax on management bonuses paid to executives in the financial sector, and the US government has proposed legislation envisaging a Financial Crisis Responsibility fee to recover the costs of its Troubled Assets Relief Programme (TARP). There is also discussion among tax experts on how best to reform taxation of the financial sector, which is on average lighter than on other corporate income and unduly favours borrowing over equity financing.

However, a lump-sum charge to recover past costs does not change the financial sector's incentives to take excessive risks. Furthermore, it is unclear precisely what costs should be recovered: while the direct fiscal costs of supporting the financial sector were some 2.5% to 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 of public debts, or according to available estimates some 40% of GDP. Even larger yet are the total costs incurred by the economy – including output and job losses, and the attendant destruction of material and immaterial capital – which according to some authors could rise to a multiple of annual GDP.<sup>1</sup>

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 becomes closely associated with that of a crisis resolution fund – and attendant crisis resolution procedures – which would

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pay for the residual costs of failure of large institutions, once capital had fallen to zero and, presumably, creditors' claims had been wiped out (on this, some proposals are ambiguous, leaving room for at least some relief for creditors). One such proposal was presented by the IMF to the leaders of the G-20 when they met in Washington in April;<sup>2</sup> another was recently put forth by the Committee on Economic and Monetary Affairs of the European Parliament.<sup>3</sup> These proposals seem ill-conceived.

Two main objections apply. The first one is quite obvious: any fund set up *ex-ante* to pay for failing financial institutions creates an implicit promise of a bail-out that sooner or later someone will call upon. If the fund is public, it will encourage the private beneficiaries to free ride collectively on the taxpayer, as indeed happened with the recent crisis; if it is privately funded, it will encourage the swindlers to free ride on honest bankers. The only way to avoid both of these undesirable results is to credibly exclude all support for shareholders and creditors of a financial institution going bankrupt. They should harbour no illusions that anyone will come to their rescue. Only in this manner will shareholders and creditors have sufficiently strong incentive to monitor management and keep a tight lid on risk-taking by their bank or other financial intermediary. Merciless behaviour by public authorities on this score is the first requirement to overcome the too-big-to-fail affliction.

Once it is accepted that shareholders and creditors deserve no relief, the resolution fund simply falls back to deposit insurance. Retail depositors are the only creditors in the financial system that deserve if not full, at least ample protection against the mistakes of their bankers; 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 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 depositors' money – which is precisely where regulators most notably failed in recent years, opening the way to the financial crisis.

Which brings me to the second objection to the idea of a resolution fund, often less readily recognised: the reason why banking (and Wall Street quasi-banking) losses got so big in the recent financial crisis was that supervisors closed both eyes to the misdeeds of their regulated bankers in order to let them compete successfully in international markets, or more simply because they had been 'captured' by them. If supervisors behave correctly, then large residual losses from bank failures become unlikely: to this end, supervisors must be obliged to take early corrective action when capital of a bank under their supervision weakens, much as happens under US prompt corrective action by the Federal Deposit Insurance Corporation (FDIC).

If the ailing bank cannot be recapitalised, then it should be resolved and liquidated: which is where effective resolution procedures become important. But the key point to retain here is that no reckless exposure is possible in a system where shareholders



and creditors know with certainty that they will not be bailed out, and supervisors are not allowed to ‘gamble for resurrection’ of their supervised entities, but rather are obliged to call them to order early as soon as they start misbehaving.

In the several recent endeavours to build a stronger and more coherent regulatory system for financial markets, the idea of a resolution fund is at best a distraction and at worst a harbinger of renewed financial instability.

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<sup>1</sup> See “The \$100 Billion Question”, comments by A. G. Haldane, Executive Director, Financial Stability, Bank of England, at the Institute of Regulation & Risk, Hong Kong, 30 March 2010.

<sup>2</sup> “A Fair and Substantial Contribution by the Financial Sector”, Interim Report for the G-20, International Monetary Fund, 23 April 2010.

<sup>3</sup> See their revised proposal on a European Securities and Markets Authority (ESMA) legislation, Article 12d establishing a so-called ‘European Stability Fund’. For more information, see EP press release of 10 May 2010 ([http://www.europarl.europa.eu/news/expert/infopress\\_page/042-74361-130-05-20-907-20100510IPR74360-10-05-2010-2010-false/default\\_en.htm](http://www.europarl.europa.eu/news/expert/infopress_page/042-74361-130-05-20-907-20100510IPR74360-10-05-2010-2010-false/default_en.htm)).