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Brussels looks to bank investors not taxpayers

By Alex Barker in Brussels and Brooke Masters in London

Reforms to force investors rather than taxpayers to pay for rescuing failed banks will be up to four times more positive for the European economy than the latest Basel bank capital overhaul, the European Commission has concluded.

The upbeat assessment, published on Wednesday, underlines the importance Brussels places on its plan to prevent the next crisis by providing a subsidy-free solution for winding-up struggling banks that are too big to fail.

Michel Barnier, the European Union commissioner overseeing financial services, hailed the proposal as a way to remove the implicit state guarantee for the financial sector. “Banks should pay for banks,” he said. “We are going to break the link between banking crises and public budgets.”

The reform blueprint gives national regulators summary power to write down unsecured creditors in failing banks and establishes a network of national funds to cover resolution costs, guarantee deposits and lend to each other in an emergency.

While Mr Barnier describes these as essential steps to a more ambitious EU banking union, he admits the measures are not relevant to immediate crisis-fighting in the eurozone. Those on forcing losses on private investors, known as “bail-in”, would to be phased in around 2015 and 2018.

Publication of the plan was delayed for almost a year over fears that it would make it even harder and more expensive for banks to raise funding. In the event, the proposal came when funding markets were already largely frozen and EU leaders were debating more ambitious integration of banking rules, particularly for the eurozone.

The Commission impact assessment concludes the reforms will raise bank funding costs by about 15 basis points, or 0.15 per cent. But the net benefits to EU economic output will be up to 0.62 per cent in the long term, through more stable growth and fewer crises.

This is four times the positive impact estimated from the Basel III global bank reform agreement, which forces banks to shore up buffers of equity, cash and liquid assets.

The introduction of writedown powers – which the Commission believes would have avoided Lehman Brothers bankruptcy – has been long flagged to investors and banks.

But extreme sensitivities remained about the details and whether the proposal will in practice ensure investors receive as much as they would have from a bankruptcy. The British Bankers' Association, the European Banking Association and the Association for Financial Markets gave the proposal a cautious welcome.

Some experts argue the impact of the reforms is hard to predict.

"Quoting figures to two decimal places is ridiculously precise. We can't possibly know to that degree of accuracy. And there's a range of outcomes. In some cases the measures may well have a major positive effect on GDP [gross domestic product]. In other circumstances, for instance if there is a loose end somewhere, the benefits could vanish," says Clifford Smout, co-head of Deloitte's European centre for regulatory strategy.

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Bob Penn, a partner at Allen & Overy, points out that the negative impact on funding is reduced by assuming investors will still be able to buy debt that converts to equity.

"They have assumed away the additional costs associated with the likely narrowing of the market as organisations which cannot invest – because they cannot have equity exposures or invest in embedded equity derivatives – leave it," he said. "This is the unknown quantity, which could have a major macroeconomic cliff effect on implementation."

Some regulatory experts said the proposal makes clear where the Commission wants to go but may be too late.

"The real agenda is now out in the open ... but the timetable is way out in the future, 2015, 2018 for bail-in. What happens in the meantime? If banks need support before then, it looks as if taxpayers are still on the hook," said Jon Pain, a former UK regulator now with KPMG.

The measures must be agreed with EU member states and the Parliament to become law.

Sharon Bowles, who chairs the Parliament's economic and monetary affairs committee, said the proposal was "useful for the future" but too late for the current crisis. "We cannot wait an extra two and a half years for the crisis management legislation to be negotiated and implemented," she said.

EU member states are broadly supportive of so-called "bail-in" measures, but have long opposed more burden sharing on deposit guarantees.

What the proposals mean