

IN-DEPTH ANALYSIS

Requested by the ECON committee



# The financing of bank resolution - who should provide the required liquidity?

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Banking Union Scrutiny

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# The financing of bank resolution - who should provide the required liquidity?

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## Banking Union Scrutiny

### **Abstract**

This paper addresses two distinct yet interconnected problems. The first is whether the provision of Emergency Liquidity Assistance (ELA) on an individual bank basis should be centralised within the European Central Bank (ECB) and the second is whether existing liquidity financing arrangements are fit for the role. The paper argues that ELA centralisation would not require Treaty amendment and that a liquidity backstop is needed. However the latter cannot be provided by the ECB due to the prohibition of monetary financing and other Treaty and EU law requirements.

The choice of the EU entity which should be entrusted with the specific mandate will largely depend on the characteristics the facility would take. The paper considers such characteristics and analyses which authority may best fit that role. The paper also suggests that a well-structured facility could have a positive broader macroprudential impact, and that a fine balance needs to be struck between the risk of moral hazard and the beneficial effect this facility may have on market confidence.

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## LIST OF ABBREVIATIONS

<b>AFME</b>	Association for Financial Markets in Europe
<b>BRRD</b>	Bank Recovery and Resolution Directive
<b>DRI</b>	Direct Recapitalisation Instrument
<b>EBA</b>	European Banking Authority
<b>ECB</b>	European Central Bank
<b>ELA</b>	Emergency Liquidity Assistance
<b>ESCB</b>	European System of Central Banks
<b>ESM</b>	European Stability Mechanism
<b>NCB</b>	National Central Bank
<b>FOLF</b>	Failing or Likely to Fail
<b>HQLA</b>	High Quality Liquid Assets
<b>LCR</b>	Liquidity Coverage Ratio
<b>LOLR</b>	Lender of Last Resort
<b>NSFR</b>	Net Stable Funding Ratio
<b>SRF</b>	Single Resolution Fund
<b>SRMR</b>	Single Resolution Mechanism Regulation

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## EXECUTIVE SUMMARY

This paper addresses two distinct yet interconnected problems. The first is whether the provision of Emergency Liquidity Assistance (ELA) on an individual bank basis –currently a remit of National Central Banks (NCB) –should be centralised within the European Central Bank (ECB) and the second is whether existing liquidity financing arrangements should be reshaped and integrated to better support bank resolution.

The reason why the two problems are related is because the current legal and institutional limitations concerning the provision of liquidity in an emergency scenario may hamper the effectiveness of those arrangements and lead to a suboptimal management of the crisis.

The paper argues that ELA centralisation would not require Treaty amendment (in light of Article 18 ESCB Statute) and that a liquidity backstop is needed. The boundaries between illiquidity and insolvency are often flimsy, and the current regulatory focus on capital as a measure for failure may indeed tell only half of the story.

While an important line of defence against liquidity problems, the provision of ELA from national central banks should not be relied upon as a stable source of funding. ELA is discretionary, provided only to solvent banks and against the provision of adequate collateral. Therefore, it should not be taken for granted.

Yet, recent insolvency cases have shown how a bank needs continued access to funding even at the point of resolution. Several proposals have been brought forward from both the industry and the official sector to address this problem.

These differ in some details, but their main thrust is that the provision of liquidity in resolution should be a joint effort of the ECB (subject to the Treaty and EU legal framework that delineate the scope of its function as LOLR), the SRF (Single Resolution Fund) and the ESM (European Stability Mechanism).

One of the missing pillars of banking union is precisely the lender of last resort role of the central bank on an individual bank basis (the ECB does provide market liquidity assistance). In order to have the ECB in charge of individual liquidity assistance in addition to its existing role as provider of market liquidity assistance no Treaty revision is needed. This means that while there is a need for the centralisation of ELA within the ECB, the latter's mandate cannot, and should not in fact, be stretched to the point of providing liquidity to insolvent financial institutions. This derives from the prohibition of monetary financing (Article 123 TFEU) and other Treaty and EU law requirements. The introduction of the Bank Recovery and Resolution Directive (an instrument of secondary law that applies to all EU and EEA Member States) does not alter the primary law requirements that are applicable to the ECB and NCBs.

However, once the ECB has been ruled out as a possible provider of funds in resolution either to an insolvent credit institution or to a credit institution that lacks adequate collateral, one cannot *ex ante* decide which body is better suited to take on the role of lender of liquidity in resolution unless the aim(s) and the overall objective(s) of the facility are clear. Therefore the paper discusses the main characteristics this could take and analyses accordingly which Authority may fit that role.

Also, it is argued that –depending on how it is designed – the facility may have a macroprudential value and could potentially break the vicious loop between individual bank liquidity risk and market liquidity risk. However, the facility cannot be a wide blanket but should still be subjected to eligibility criteria that limit moral hazard.

Finally, a fine balance between moral hazard, which is inevitably created by the existence of any form of financial support, and market confidence, which can be increased by having some clarity on its functioning and access, should also be found.



## INTRODUCTION<sup>1</sup>

This paper addresses two distinct yet interconnected problems. The first is whether the provision of Emergency Liquidity Assistance (ELA) on an individual bank basis –currently a remit of National Central Banks (NCB) –should be centralised within the European Central Bank (ECB) and the second is whether existing liquidity financing arrangements should be reshaped and integrated to better support bank resolution.

The reason why the two problems are related is because the current legal and institutional limitations concerning the provision of liquidity in an emergency scenario may hamper the effectiveness of those arrangements and lead to a suboptimal management of the crisis.

Currently, there are three main channels of public<sup>2</sup> provision of liquidity in a crisis: ELA, State Aid, and access to the Single Resolution Fund (SRF)<sup>3</sup>. Access to each channel is subject to strict criteria, eligibility requirements and restrictions/consequences, which is particularly true for measures that qualify as State aid.

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<sup>1</sup> Dr. Costanza Russo would like to thank Clara Barbiani, Marco La Selva and Angelo Vella for their excellent research assistance. Professor Rosa Lastra would like to thank Sara Dietz for research assistance.

<sup>2</sup> Private (internal) sources of liquidity are mentioned in Sec. 2 of this paper.

<sup>3</sup> Banks in need of recapitalisation instead could access the Direct Recapitalisation Instrument (DRI) of the European Stability Mechanism (ESM). The eligibility conditions to have access to the DRI are the following: requiring institutions “are or are likely to be in breach of the relevant capital requirements and are unable to attract sufficient capital from private sector sources to resolve their capital problems. Burden-sharing arrangements, such as bail-in (fully applicable in 2016), in the Bank Recovery and Resolution Directive, are insufficient to fully address the capital shortfall. They have a systemic relevance or pose a serious threat to the financial stability of the euro area as a whole or the requesting ESM Member. The institution is supervised by the ECB. The beneficiary Member State should also demonstrate that it cannot provide financial assistance to the institutions without very adverse effects on its own fiscal sustainability, and that therefore the use of the indirect recapitalisation instrument is infeasible”.

See [https://www.esm.europa.eu/assistance/lending-toolkit#lending\\_toolkit](https://www.esm.europa.eu/assistance/lending-toolkit#lending_toolkit) and [https://www.esm.europa.eu/sites/default/files/20141208\\_guideline\\_on\\_financial\\_assistance\\_for\\_the\\_direct\\_re\\_capitalisation\\_of\\_institutions.pdf](https://www.esm.europa.eu/sites/default/files/20141208_guideline_on_financial_assistance_for_the_direct_re_capitalisation_of_institutions.pdf).

Conditionality will also be applied. However this facility has never been used, and seems to be *de facto* superseded by the introduction of the bail-in tool and the SRF. The ESM acknowledges that: “When the instrument was first proposed, it was to cut the link between troubled banks and sovereigns. However, it soon became clear that banking union mechanisms could achieve this aim without resorting to the direct recapitalisation instrument. More specifically, the bail-in of private investors, in accordance with the Bank Recovery and Resolution Directive (BRRD), and the contribution of the Single Resolution Fund (SRF), has shifted the bulk of potential financing from the ESM to the banks themselves, along with their investors and creditors. With all the components of Banking Union operational since January 2016, the ESM direct recapitalisation instrument will only be applied as an instrument of last resort, when all other measures, including the bail-in mechanism, have been exhausted”. See ESM Explainers, “Is direct recapitalisation of banks likely to occur in the current setting?” available at [www.esm.europa.eu/explainers](http://www.esm.europa.eu/explainers).

Access to market liquidity may be difficult for troubled banks, and if/when obtained it may be insufficient to address liquidity drains on an ongoing basis; therefore alternative sources of funding play a pivotal role.

The Single Resolution Fund (SRF) was created with the specific aims of supporting the effective application of resolution tools. To this end, the SRB can use the SRF: 1) to guarantee the assets or liabilities of the bank under resolution; 2) to make loans to or to purchase assets of the bank; 3) to make contribution to a bridge institution or an asset management vehicle; 4) to make contribution to shareholders of creditors who have suffered greater losses than in liquidation; and 5) to make a contribution to the bank in lieu of the write-down or conversion of liabilities of certain creditors, when the bail-in tool is applied and the decision is made to exclude certain creditors from the scope of bail-in<sup>4</sup>. This latter case however, which is of exceptional nature, also requires that certain pre-conditions have been met<sup>5</sup>.

The conditions to access the SRF require an insolvency declaration that leads to a resolution action. The use of the fund is made directly by the SRB, in accordance with the general objectives and principles governing resolution included in the SRMR. The overall amount of available funds is also capped and the use of the SRF is subject to State aid rules<sup>6</sup>. At the Ecofin meetings of June and September 2018 it was agreed that that the ESM should provide a common backstop to the SRF<sup>7</sup>.

The provision of State aid, in the form of recapitalisation or impaired assets measures is usually granted to remedy capital shortfalls<sup>8</sup> and requires a bank restructuring plan and the prior approval of the Commission, unless there are exceptional circumstances. The Banking Communication allows the use of State aid to restore liquidity, such as liquidity support and guarantees on liabilities. These do not require prior approval (they need to be notified), but can only be limited to new issue of senior debt with a maturity of 3 months to 5 years, will have a penalty rate, and a wind down or restructuring plan must be submitted within two months<sup>9</sup>. It can be argued however that these measures do not reflect the actual needs of a bank in crisis and are in fact outdated as they do not take into account the role that the SRB plays. For instance the “restructuring problems” that the Banking Communication seems to assume are already dealt with by the SRB. Also, market funding may not be available in a crisis scenario as mentioned above.

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<sup>4</sup> Art 76 SRMR.

<sup>5</sup> Specifically, at least 8% of the bail-inable capital must have been activated and the SRF contribution cannot exceed 5% of the total liabilities including own funds of the institution under resolution. Art 27 (7) SRMR.

<sup>6</sup> See Recital (20) and art 19 SRMR.

<sup>7</sup> See <https://www.consilium.europa.eu/media/36400/summing-up-letter-eurogroup-inclusive-format-7-september.pdf>.

<sup>8</sup> The Banking communication defines “capital shortfall” “a capital shortfall established in a capital exercise, stress-test, asset quality review or an equivalent exercise at Union, euro area or national level, where applicable confirmed by the competent supervisory authority”. See European Commission, Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis (‘Banking Communication’), 2013/C 216/01, in OJ C 216/2, 30.7.2013, at point 28.

<sup>9</sup> Sec 4 (56-61) Banking Communication.

The provision of ELA by the NCBs (with the fiat of the Governing Council and under the conditions stated in the ensuing section) allows for greater flexibility and prompt action taking into account its discretionary nature as well as its eligibility criteria<sup>10</sup>.

In the case of Banco Popular it was reported how the bank had had twice access to ELA (for an alleged total amount of €3.6bln) in the run up to the ECB decision to declare it “failing or likely to fail”<sup>11</sup>. Other reports claim ABLV instead to have received twice ELA with the last tranche received only few hours before being declared insolvent<sup>12</sup>. Should this be confirmed, it also shows how a resolution decision puts a bank under a liquidity spiral which needs to be contained by prompt liquidity provision.

Banco Popular exposed the inherent tension of maintaining a separation in the EU between the centralisation of monetary policy, prudential supervision and open market operations against the decentralisation of ELA provision when it comes to individual bank assistance<sup>13</sup>.

Research has shown that the overall lending capacity of the SRF may be insufficient in case of a systemic crisis and the Fund will need to rely on implicit support from monetary authorities<sup>14</sup>. This is reinforced by the finding that “the large majority of the more than € 2.5 trillion of public and monetary support that euro area banks received between 2008 and 2016 was liquidity support”<sup>15</sup>. The most recent estimates place the lending capacity of the SRF at approx. € 60 bln by its target date of 31 December 2023<sup>16</sup>. Currently, the SRF stands at € 24.9 bln<sup>17</sup>.

Therefore, questions arise as to whether a liquidity backstop facility should complement existing liquidity arrangements to make them more effective and, if so, which institution should be entrusted with the specific mandate.

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<sup>10</sup> Point 4 of the Agreement on ELA states that ELA can only be provided to solvent financial institutions or to those institutions which do not meet the solvency requirement yet have a “credible prospect of recapitalisation” within 24 weeks. Specifically “A credit institution is considered solvent for ELA purposes if: (a) its Common Equity Tier 1, Tier 1 and Total Capital Ratio as reported under CRR on an individual (if applicable) and consolidated (if applicable) basis comply with the harmonised minimum regulatory capital levels (namely 4.5%, 6% or 8%, respectively); or (b) there is a credible prospect of recapitalisation - in case (a) is not met”. See ECB (2017a).

<sup>11</sup> As discussed in IPOV-EGOV (2017a). It was also reported how the hefty haircut on the collateral imposed by the central bank may have contributed to the sudden dry up of liquidity. However, Authors highlight how this is not confirmed and other sources refer instead to a lack of eligible collateral. Another contributing factor was the possibly large withdrawal of deposits from local authorities.

<sup>12</sup> See Committee on Economic and Monetary Affairs (2018), p 9.

<sup>13</sup> See Hallerberg and Lastra (2017).

<sup>14</sup> See De Groen and Gros (2015).

<sup>15</sup> See de Groen (2018).

<sup>16</sup> See EP Briefing (2018).

<sup>17</sup> See <https://srb.europa.eu/en/content/single-resolution-fund>. The largest contributors to the Fund are institutions located in France, Germany and Italy. See SRB (2018).

## 1. LIQUIDITY FINANCING IN RESOLUTION: MAPPING THE TERRITORY

The immediate regulatory reaction to remedy banks' prudential deficiencies exposed by the financial crisis was to increase and improve the quality of their capital structure. Regulators also recognised the importance of strengthening banks liquidity by introducing two liquidity ratios, the net stable funding ratio (NSFR)<sup>18</sup> and the liquidity coverage ratio (LCR)<sup>19</sup>. Their main aim is to act as internal buffers against short and long-term liquidity shortages. They should also have a disciplining effect on the quality and stability of funding sought by banks, given that the assets needed for the ratios should be of a "high quality" (HQLA). These are assets that are either cash or can be easily converted into cash through sales at no –or only minimal- loss of market value. They could also be used as collateral in refinancing operations.

There is now consensus on the inefficacy of the current financing framework to withstand a liquidity crisis<sup>20</sup>. Table 1 shows aggregate data on LCR and NSFR from a sample of 138 EU banks<sup>21</sup> which depict a rosy picture in terms of compliance with liquidity ratios threshold. Yet this per se seems to be no guarantee of the resilience of the institution in case of a liquidity crisis.

In the case of Banco Popular for instance, its consolidated LCR at December 2016 was 134.8%<sup>22</sup>. ABLV was well above their regulatory requirements for LCR at both group and bank level<sup>23</sup>. Veneto Banca instead had repeated access to liquidity and capital injections before being declared insolvent<sup>24</sup>.

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<sup>18</sup> While not specifically defined at EU level, the NSFR is defined by the Basel Committee on Banking Supervision as "the amount of available stable funding relative to the amount of required stable funding. This ratio should be equal to at least 100% on an ongoing basis". See BCBS (2014) p 9.

<sup>19</sup> The LCR "requires internationally active banks to hold a stock of HQLA at least as large as expected total net cash outflows" over a 30 days stress period. "The LCR became a minimum requirement for BCBS member countries on 1 January 2015, with the requirement set at 60% and rising by 10 percentage points annually to reach 100% on 1 January 2019 to avoid disruption to the orderly strengthening of banking systems or ongoing financing of economic activity". See BIS (2018).

<sup>20</sup> See Lehmann (2018) ; de Groen (2018); Konig (2018); Konig (2017); Mersch (2018)

<sup>21</sup> See EBA (2018). The average LCR was 143.1% at end June 2017 (139.5% as of December 2016), and all banks in the sample show a LCR above the full implementation minimum requirement applicable from January 2018 (100%). In addition, data show that the weighted average LCR has increased since June 2011, mainly due an increase in banks' liquidity buffers.

<sup>22</sup> See IPOV-EGOV (2017), p 4.

<sup>23</sup> In their 2016 Annual Report, the holding reported that "As at 31 December 2016, the liquidity coverage ratio (LCR) of the group and the bank was 398.0% (448.0%) and 375.0% (437.0%). According to the Regulation, as at 31 December 2016, the group and the bank were required to maintain an LCR of at least 70%". See ABLV (2016).

<sup>24</sup> However, Veneto Banca did not meet the LCR requirements in several occasions. Specifically, "the Liquidity Coverage Ratio (LCR) fell below the minimum requirements set by Article 38 (1a) of the Commission Delegated Regulation (EU) 201/61 for three consecutive months from December 2015 to February 2016 and then again in May 2016. The liquidity position has temporarily improved only as a result of the capital increase (EUR 1 billion) subscribed entirely by Atlante Fund in June 2016". See ECB (2017b).

Lehmann (2018) noted how liquidity coverage ratios “rely on inevitably ad-hoc assumptions of outflows, and will not shelter banks from acute funding crisis” and that – while a needed measure – this is “by no means a fail safe mechanism in case of a crisis affecting an individual bank”<sup>25</sup>.

**Table 1:** EBA aggregate data on EU banks' capital, leverage, and liquidity ratios assuming full implementation of the CRD IV-CRR/Basel III framework

	CET1	Tier 1	Total	LR	LCR	NSFR
<b>Group 1</b>	<b>13.5</b>	<b>14.5</b>	<b>17.5</b>	<b>4.9</b>	<b>137.6</b>	<b>111.1</b>
<b>Group 2</b>	<b>15.0</b>	<b>15.3</b>	<b>17.4</b>	<b>5.6</b>	<b>178.5</b>	<b>117.5</b>
Large Group 2	14.6	15.0	17.2	5.7	184.7	116.2
Medium Group 2	15.7	16.1	18.1	5.8	184.8	120.7
Small Group 2	15.7	15.9	17.4	4.7	150.6	118.3
<b>All banks</b>	<b>13.8</b>	<b>14.7</b>	<b>17.4</b>	<b>5.0</b>	<b>143.1</b>	<b>112.3</b>
G-SIIs and O-SIIs	13.8	14.7	17.6	5.0	139.8	111.8

Source: EBA

The well-known concern is that in many cases of financial difficulties, the dividing line between illiquidity and insolvency is flimsy and the two are often a continuum. This is traditionally attributed to the maturity transformation banks undertake<sup>26</sup>.

Therefore, on the one side an excessive regulatory focus on capital as the main yardstick for solvency may be ill placed, on the other the existing tools on liquidity financing in resolution are limited in what they can achieve because they are simply not sufficient.

Bank liquidity seems to be the financial measure which is heavily exposed to the first wave of losses and to the emergence of a loss of confidence in the ability of the institution to fulfil its debt obligations. Therefore, in considering how to devise a possible backstop facility, the importance of the positive effect this could have on market confidence should not be underestimated. Figure 1 shows a simplified representation of banks sources of liquidity in going and gone concern<sup>27</sup>.

Recently, suggestions on how to improve the current arrangements have been brought forward by both the private and the official sector, specifically the Eurogroup<sup>28</sup>. As the latter proposal has been extensively discussed elsewhere<sup>29</sup>, here we wanted to give a snapshot of those from the private sector, namely the one from the Association for Financial Markets in Europe (AFME) which advocates the introduction of a European facility to finance resolution.<sup>30</sup>

<sup>25</sup> Lehmann (2018), p 7-8.

<sup>26</sup> Diamond and Dybvig (1983); Allen and Gale (1998); ECB (2009).

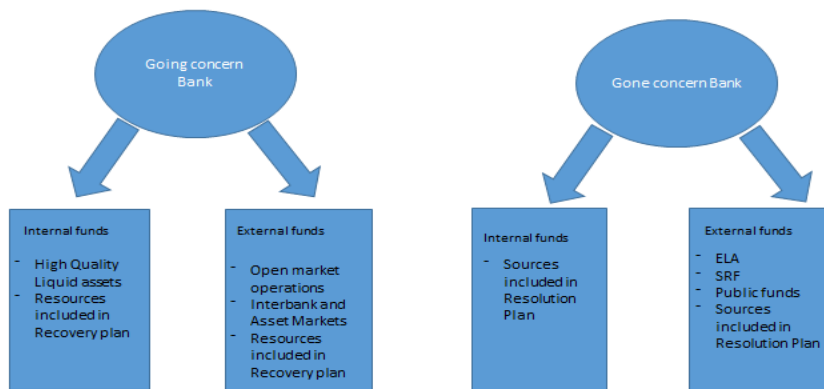
<sup>27</sup> TLAC, equity and bail-inable instruments have not been included as these are capital instruments.

<sup>28</sup> Eurogroup (2018).

<sup>29</sup> See Deslandes and Magnus (2018). Other proposal from the official sector comes from the IMF (2018), p 17 and the FSB (2018), p 15.

<sup>30</sup> AFME (2018); See also the proposal European Banking Federation (2018).

**Figure 1:** Banks’ main resources of liquidity



Source: Authors

### 1.1 AFME

AFME’s proposal focuses on the creation of an “effective temporary public sector backstop mechanism” to support the implementation of the resolution tool.

The Association envisages a joint effort between the SRF and the ECB. The rationale behind this specific choice lies in the need to have a substantially large financial capacity for the facility and for the necessary rapidity of action. The terms of funding should also be as such as to allow the bank in resolution to return to market funding. While there should be a fiscal backstop possibly provided by a newly established “European Monetary Fund”, the funds borrowed should enjoy the guarantee of the SRF. In this way, the burden is shared with the private sector<sup>31</sup>.

AFME is also supportive of a high degree of transparency around the policies that govern the use and the conditions of the facility. In terms of conditions and eligibility criteria, these should include: (a) the inability of the bank to have access to market funding, (b) the bank is, or has been, recapitalised through bail in or the use of other resolution tools; (c) the bank will have to be subjected to enhanced supervision or scrutiny from resolution authorities; (d) the liquidity is exclusively functional to the execution of the resolution strategy; (e) the financing is temporary and will have to be replaced by private funding as soon as possible; (f) the liquidity is provided at a penalty rate and against some collateral. The possibility of creating creditors “super-priority” for the liquidity providers should be considered as well.

Of essence will also be the cooperation between home and host authorities in case of cross border institutions, to address currency mismatches and to be able to lend in different denominations.

<sup>31</sup> The proposal does not address the issue of whether the fees for the guarantee would also be repaid by the private sector. It is likely to imagine that the cost of accessing the guarantee is included in the overall amount of funds requested.

## 2. SHOULD THE PROVISION OF LIQUIDITY FINANCING IN RESOLUTION BE COUPLED WITH CENTRALISATION OF ELA<sup>32</sup>?

Central banks provide liquidity not capital. Any discussion about resolution and fiscal backstops need to consider this reality. Central banks are liquidity providers of last resort. Governments can be – under certain circumstances anchored in public interest considerations and safeguard of financial stability – capital providers of last resort.

In the Eurosystem, LOLR or Emergency Liquidity Assistance (ELA) comes in two forms. The 1<sup>st</sup> is market liquidity assistance typically in the form of Open Market Operations, which is the competence of the ECB (thus centralized) and forms part of its monetary policy responsibilities in accordance with Article 18 of the ESCB Statute and Article 127 TFEU.<sup>33</sup> The 2<sup>nd</sup> is individual liquidity assistance. Though the ECB is competent to provide liquidity assistance to “financially sound” banks as part of its regular discount policies, the provision of ELA to troubled illiquid but solvent banks in an emergency situation is a national competence of the National Central Banks (thus decentralized), performed on their own responsibility and liability, in accordance with Article 14.4 ESCB Statute subject to the fiat of the ECB’s Governing Council.

When euro area credit institutions receive central bank credit through regular Eurosystem monetary policy operations in accordance with Article 18.1 of the ESCB Statute, the rules that govern the eligibility criteria of the counterparties and the collateral framework (lending should be based on adequate collateral) are determined by the ECB.<sup>34</sup> In these standard monetary operations the nineteen NCBs of the Eurosystem share the risk of any losses in proportion to the size of their economies and populations (Article 33.2 of the ESCB Statute). But when banks run out of acceptable collateral for regular monetary policy operations, they may request ELA, which is provided by the NCB at its own risk and at a higher interest rate (though ELA still needs to be approved by the Governing Council).<sup>35</sup>

Article 14.4 of the ESCB Statute<sup>36</sup> assigns the Governing Council responsibility for restricting ELA operations if it considers that they interfere with the objectives and tasks of the Eurosystem, for example if there is a threat to the singleness of monetary policy or an obvious concern about a possible breach of the monetary financing prohibition. If the Governing Council finds such interference, by a

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<sup>32</sup> See generally Hallerberg and Lastra, (2017).

<sup>33</sup> The CJEU in the *Gauweiler* case confirmed that the role of ELA at a macro-level “is part of the ECB’s monetary policy, as the objective of safeguarding an appropriate transmission of monetary policy is likely both to preserve the singleness of monetary policy and to contribute to the ECB’s primary objective to maintain price stability”. See Case C-62/14 Peter Gauweiler and Others [2014] OJ C129/11.

<sup>34</sup> These rules are included in the so called “General Documentation” which has been updated and revised by ECB Guideline (EU) 2015/510 of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (ECB/2014/60). The implementation of the Eurosystem’s monetary policy framework should ensure that a broad range of counterparties participate under uniform eligibility criteria for the counterparties and that lending should be based on adequate collateral.

<sup>35</sup> See Praet (2016).

<sup>36</sup> Article 14.4 of the ESCB Statute reads as follows: “National central banks may perform functions other than those specified in this Statute unless the Governing Council finds, by a majority of two thirds of the votes cast, that these interfere with the objectives and tasks of the ESCB. Such functions shall be performed on the responsibility and liability of national central banks and shall not be regarded as being part of the functions of the ESCB.”



majority of two thirds of the votes cast, it has a veto right over such operations. Failure of an NCB to comply with the Governing Council's veto under Article 14.4 ESCB Statute can result in an infringement action being taken against them by the ECB before the Court of Justice under Article 271(d) TFEU. If there is no objection and ELA is provided, responsibility for the provision of ELA lies with the NCB concerned. Thus, any costs of, and the risks arising from, the provision of ELA are incurred by the relevant NCB and are not shared by the Eurosystem as a whole.

The ECB has emphasised that the provision of ELA must be at the discretion of the NCB, and that a credit institution cannot assume automatic access to this liquidity. This discretionary approach reflects the need to address moral hazard concerns. Because the NCB bears any potential losses of ELA, each NCB has discretion (subject to the fiat of the ECB Governing Council) both as to the actual decision to grant or not ELA and as to the criteria that it uses to evaluate requests for ELA, which includes the determination of solvency and adequate collateral.

Though the content of the decision to grant or not grant ELA (assessing the risks involved in order to act accordingly in each case) is discretionary and falls squarely upon the NCB concerned (which will bear any potential risks, costs and losses), there are parameters or contours that must be observed from a procedural perspective for NCBs in the Eurosystem. The discretion that national central banks have in the provision of ELA is thus framed within a system of rules. National practices on ELA must be consistent with EU law and ECB requirements, in particular the relevant provisions in the Treaty and in the ESCB Statute, the ELA procedures, first published in 2013 and recently revised again in 2017<sup>37</sup> (but in existence since 1999), the ECB doctrine and guidance and the EU rules on State aid.

The ELA procedures aim to ensure that ELA operations do not interfere with the single monetary policy, since there are risks that might result from ELA for the monetary policy objectives of the Eurosystem.<sup>38</sup> That is why the ECB's Governing Council may object or restrict the provision of ELA by the NCB, why there are caps or limits on the amount that can be lent or the length of the assistance and why a special information sharing framework is applicable to any institution receiving ELA.

Article 130 TFEU protects the independence of both the ECB and the NCBs when exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the ESCB Statute. Given the close interaction with the single monetary policy, the NCBs must be independent from government instruction in decisions concerning ELA.

Furthermore, the principle of financial independence means that NCBs are required to have sufficient financial resources to perform their tasks, including the provision of ELA, since losses could have a knock-on impact on the exercise of ESCB-related tasks. Indeed, by providing ELA to an insolvent bank, an NCB could compromise its capacity to carry out monetary policy operations effectively. Any recourse to taxpayers' money is a decision for the fiscal authority (state task, not a central bank task). ELA cannot

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<sup>37</sup> See ECB Decision of 17 October 2013 on ELA (Emergency Liquidity Assistance)

[https://www.ecb.europa.eu/pub/pdf/other/201402\\_elaprocedures.en.pdf](https://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf).

The most recent version of the ELA procedures was published under the title of "ELA Agreement" on 17 May 2017 [https://www.ecb.europa.eu/pub/pdf/other/Agreement\\_on\\_emergency\\_liquidity\\_assistance\\_20170517.en.pdf?23bb6a68e85e0715839088d0a23011db](https://www.ecb.europa.eu/pub/pdf/other/Agreement_on_emergency_liquidity_assistance_20170517.en.pdf?23bb6a68e85e0715839088d0a23011db).

<sup>38</sup> For example, where the government of a Member State could instruct an NCB to provide a large amount of ELA, it could indirectly influence the Eurosystem's monetary policy and the Eurosystem would be forced to neutralise the effects of ELA on the monetary base in order to maintain price stability. See Zilioli (2017).



be granted to insolvent institutions, but only to temporarily illiquid ones on the basis of adequate collateral.

The prohibition of monetary financing of Article 123 TFEU is considered essential to build central bank credibility, which is necessary to achieve monetary policy effectiveness. Indeed, the central bank's ability to withstand government pressure to finance government deficits via central bank credit is considered as the "economic test of central bank independence."<sup>39</sup> For the purposes of ensuring compliance with the prohibition on monetary financing, the following criteria – under which a NCB may engage in lending to a solvent credit institution on the basis of collateral in the form of a State guarantee – apply. First the lending should be as short as possible. Secondly there must be systemic stability aspects at stake. Thirdly the central bank needs to independently exercise full discretion regarding the decision to extend ELA or not. Fourthly there must be no doubts as to the legal validity and enforceability of any State guarantee under applicable national law. And, finally, there must be no doubts as to the economic adequacy of any State guarantee, which should cover both principal and interest on the loans, thus fully preserving the financial independence of the NCB.<sup>40</sup>

The provision of ELA must also comply with the EU rules on State aid, since an inherent subsidy exists whenever a central bank lends to an insolvent bank. State aid measures must be approved by the European Commission, which has delineated in a number of decisions and communications the contours of ELA activities that are compatible with the internal market. For ELA not to fall under the ambit of state aid, among other things, (1) the measure must be taken - in the words of the Commission's communications - "at the central bank's own initiative" and (2) the institution receiving ELA must be solvent.<sup>41</sup>

A final element in the discussion concerns the relationship between micro-prudential supervision and Lender of Last Resort (LOLR). As evidenced by the Northern Rock crisis in the UK, which caught the Bank of England by surprise, having timely information is crucial during financial crises.<sup>42</sup> Assistance on a rainy day requires surveillance on a sunny day.

The question arises: Is it appropriate to keep the existing decentralised arrangement when no Treaty amendment is needed but merely a change in interpretation, is it practical to follow the existing practice? One of us (Lastra) has advocated elsewhere that the missing pillar of banking union is lender of last resort and that in order to have the ECB in charge of both market liquidity assistance and individual liquidity assistance no Treaty revision is needed. Article 18 ESCB Statute and the principle of

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<sup>39</sup> See Lastra (2015) para. 2.130.

<sup>40</sup> ECB Opinions CON/2008/46, paragraph 4.3 and CON/2008/48, paragraphs 3.9 and 4.3. See also Zilioli (2017).

<sup>41</sup> The Commission 'Banking Communication' of July 2013 on state aid support measures for banks <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013XC0730%2801%29&from=EN> states in Paragraph 62: The ordinary activities of central banks related to monetary policy, such as open market operations and standing facilities, do not fall within the scope of the State aid rules. Dedicated support to a specific institution (commonly referred to as 'emergency liquidity assistance') may constitute state aid rules unless the following cumulative conditions are met: (a) the credit institution is temporarily illiquid but solvent...; (b) the facility is fully secured by collateral...; (c) the central bank charges a penal interest rate... (d) the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the state.

<sup>42</sup> See Goodhart and Schoenmaker (1995).

subsidiarity provide sufficient legal basis, in particular in the context of the SSM/Banking Union.<sup>43</sup> LOLR/ELA links monetary policy and supervision. The restrictive interpretation by the ECB of the ESCB Statute preventing it from acting as a lender of last resort to individual banks should be revisited, in particular with the advent of Banking Union since the ECB at the helm of the SSM is in charge of the supervision of significant institutions.<sup>44</sup>

### **3. TO WHICH INSTITUTION SHOULD THE MANDATE OF RESOLUTION FINANCING BE ENTRUSTED?**

Given the legal impediments for the ECB to provide a financial backstop in the light of the prohibition of monetary financing and other Treaty and EU Law requirements, we need to consider which existing EU institution would be best placed for this purpose, as the creation of a new ad-hoc body is not necessarily needed as the legal bases of the SRF/SRB and the ESM allow them to operate for resolution purposes.

In principle, the attribution of a new responsibility may not require an overhaul of the current legal framework, but adjustment will be needed to the BRRD, the ESM Treaty and the SRMR. In light of the need to guarantee a rapid response, and to have access to a larger pool of funds if needed, the governance and borrowing criteria for the ESM will have to be revisited.

However, we believe that the correct identification of a suitable body may be largely dependent on the form the facility should take. Therefore, in what follows we will consider some of its main characteristics and then we will draw some conclusions.

The first aspect to consider is what the final aim of the facility should be. This in turn has an impact on the triggering event.

#### **3.1 Final aim and triggering event**

While it is clear that an arrangement is needed to facilitate the resolution phase, one needs to ascertain whether the final aim of the instrument should (or should not) be targeted to specific resolution objectives.

The BRRD and the SRMR both indicate that authorities “shall have regard” to (or “shall take into account” in the wording of the SRMR) resolution objectives<sup>45</sup> in applying the resolution tools and powers. Resolution objectives have all equal ranking but authorities need to balance them on a case-by-case basis. As we have seen in the past, the result of this balancing exercise determine whether there is a public interest in resolution or not. In this latter case, the bank will be liquidated under national

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<sup>43</sup> See Lastra (2015), chapter 10.

<sup>44</sup> Ibid.

<sup>45</sup> Namely: (a) to ensure the continuity of critical functions; (b) to avoid significant adverse effects on financial stability, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline; (c) to protect public funds by minimising reliance on extraordinary public financial support; (d) to protect depositors covered by Directive 2014/49/EU and investors covered by Directive 97/9/EC; (e) to protect client funds and client assets. See art 31 BRRD and art 14 SRMR.

insolvency proceedings. This in turn means that if no resolution tool is going to be used, there may be no intervention of the SRF, which would create possible tensions should the facility be administered by the Fund.

This notwithstanding, the actions taken by the Italian government in the Veneto Banca case showed how the risk of a severe disruption of critical functions can be independent of the existence of a threat to financial stability. This means that while “a high bar of resolution has been set”<sup>46</sup>, the need to protect critical functions justifies a financial backstop even in absence of a resolution action. However, this in turn tips the balance in favour of public funds, as those provided by ESM lending facilities (given that ESM market-based funds are guaranteed by Member States).

In light of what discussed above in relation to the overarching importance of providing liquidity funding, it can also be argued that the aim of the backstop is to reassure the market and to avoid dangerous illiquidity spiralling. This means that it may not necessarily have to be linked to a resolution action.

The current narrative on the creation of such a backstop (described above)<sup>47</sup> may recognise the importance of market confidence but is specifically focused on resolution. On the other hand, the ECB is clear in saying that “whilst the provision of central bank liquidity should not be ruled out in resolution, it should not be assumed either”, that “resolution financing is a government task” and that “funding gaps that cannot be addressed by the industry or through the SRF should be filled, ultimately, by Member States”<sup>48</sup>. Besides, we should be mindful of the fact that ELA is discretionary, and also that a possible move from backward to forward looking assessment of banks’ solvency<sup>49</sup> may jeopardise the provision of ELA.

This brings us to the core of the problem, that is that the “failing or likely to fail” evaluation is mostly based on capital, which may skew the assessment of the actual financial capabilities of a bank<sup>50</sup>. Liquidity risk is the third aspect to consider<sup>51</sup> but the relevant judgement takes a microprudential perspective. Yet, because of information asymmetries and market imperfections, market risk in the form of a widespread drying up of liquidity in interbank and other markets, may arise. As a consequence to that, the individual liquidity risk of the single institution propagates to other entities before any official FOLF declaration, spiralling into a systemic liquidity risk. Finally, the information asymmetries

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<sup>46</sup> As said by Andrea Enria, Chairman of the EBA, and reported in IPOL-EGOV (2017b) at p 7.

<sup>47</sup> Sec. 2.1.

<sup>48</sup> Mersch (2018). However, opposite signals came from the ECB only few months later when the financial press reported rumours of internal discussions related to the set up of a resolution facility. See <https://www.bloomberg.com/news/articles/2018-04-09/ecb-considers-proposal-for-new-cash-line-to-aid-bank-rescues> and <https://www.reuters.com/article/ecb-banks-cash/update-1-ecb-could-provide-cash-to-failing-banks-if-conditions-met-coeure-idUSL8N1S05CQ?feedType=RSS&feedName=companyNews>. This is also reported in Deslandes and Magnus (2018).

<sup>49</sup> Mersch (2018).

<sup>50</sup> The recent decision of the Luxemburg Commercial Court which refused to place the ABLV subsidiary into liquidation based on, amongst other considerations, “the very strong financial standing of ABLV Bank Luxembourg, S.A., a result of its sound management”, epitomises the fluidity behind the assessment of “insolvency”. See ABLV press release <https://www.ablv.com/en/press/2018-03-09-the-court-recognises-the-soundness-of-ablv-bank-luxembourg-s-a-which-can-now-be-sold-to-new-investors>.

<sup>51</sup> Art 32 (BRRD). On the limits of the FOLF assessment, see Olivares-Caminal and Russo (2017).

argument applies to the ECB as well in its evaluation of the degree of financial soundness of the bank, because it is difficult to evaluate assets in a crisis scenario within a very limited timeframe and because even information exchange among all relevant parties involved may not be smooth or timely. This in turn may hamper the validity of their judgement.

In a sense, disentangling the provision of a backstop funding facility to resolution actions allows it to have a macroprudential value and to potentially break the vicious loop between individual bank liquidity risk and market liquidity risk.

Once the triggering event (FOLF or illiquidity) has been established, it is possible to discuss the relevant funding body (SRF which however can only provide funds for resolution purposes, ESM or national governments). This would also lead to further analysis as to whether, or under which conditions, the rules on State Aid should apply.

The problem of moral hazard that this facility may create is addressed in the sec 4.5

### **3.2 Eligibility Criteria**

As mentioned above, different suggestions have been brought forward on the eligibility criteria. The question of the provision, quality and type of collateral as well as other eligibility criteria is determined by the facility offered.

ELA is always granted against the provision of adequate collateral. The latter fulfils a double aim: it acts as a guarantee for the lender and contributes to the reduction of moral hazard.

### **3.3 Type size and length**

As discussed above, ELA on an individual bank basis provides short term funds to an illiquid but solvent bank, against the provision of good quality collateral and generally at a penalty rate or high rate of interest. The ESM can extend precautionary financial assistance via credit lines in certain circumstances. It would normally attach a conditionality requirement to its main lending facilities.

Unlike the ECB, both the SRF and the ESM have a limited amount of funds at their disposal and experience shows that the funding needs of a bank in resolution may be large. This, coupled with a possible medium-term funding need of the troubled bank, highlights the need to have either bridging facilities provided by a public body (especially in the case of the SRF) or bonds issue to fill that gap in light also of the nature of LOLR.

Equally important is that the funds are in the immediate availability of the relevant body. In this respect, it should be noted that since 2017<sup>52</sup> SRF funds are gradually being invested “in obligations of the Member States or intergovernmental organisations, or in highly liquid assets of high creditworthiness”<sup>53</sup>. This in turns means that the investment, while safe and prudent, would still need to be liquidated at a short notice<sup>54</sup>.

Finally, if the provision of funds is guaranteed or otherwise sees the involvement of the official sector it carries the risk of (re)creating a doom loop between (insolvent) banks and sovereigns. This could be

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<sup>52</sup> See [https://srb.europa.eu/sites/srbsite/files/\\_def\\_srb\\_fund-web.pdf](https://srb.europa.eu/sites/srbsite/files/_def_srb_fund-web.pdf)

<sup>53</sup> Art 75(3) SRMR.

<sup>54</sup> The SRB has also the power to ask for loans to resolution financing arrangements of non-participating member states, but this is an extremely exceptional case. Art 72 SRMR. Alternative source of funding can be available too, art 73 SRMR.

avoided with the imposition of strict conditionality and realistic exit strategies, however it is a risk that needs to be taken into account in the design of the facility.

### 3.4 Timing and information exchange and access

Ideally, liquidity provision should be prompt. In this respect, the governance and the decision making process of the candidate body plays an important role.

The SRB owns the Fund<sup>55</sup> and manages it accordingly to its own governance rules. So the decisions related to its use follow SRB's ones. The SRB has so far a proven record of acting promptly during emergencies. The ESM is governed by the Board of Governance of the 19 euro area finance Ministers and decisions related to lending are taken by unanimity. It is likely therefore to be slower in decision-making.

Equally important however is the exchange and flows of information among the ECB and the funding body. This also implies access to recovery and resolution plans, which would tip the balance towards the SRF.

### 3.5 Addressing the tension between moral hazard and market confidence

Inevitably, the existence of a publicly known facility which can be accessed in case of crisis may create moral hazard. However, all forms of financial support can create moral hazard and financial support is objectively needed in case of crisis. Also, moral hazard may still arise because of the expectation of receiving assistance, irrespective of the formalisation of the instrument.

The classic way to reduce it is to build up penalty incentives in the eligibility criteria as well as to have a feasible and credible exit strategy. The current regulatory framework is also different from the one before the crisis for having built-in mechanisms to limit moral hazard. Supervisory choices recently have also shown that being a systemically important bank does not necessarily give the green card for resolution. This in turn is per se a strong argument to limit opportunistic behaviour from the banking sector.

While moral hazard certainly deserves the concerns of authorities and needs to be tackled, its possible negative effects should be pondered against the beneficial impact of transparency on market confidence. One of the reasons why banks have to resort to ELA is because they are unable to access markets funds for the discussed lack of confidence of private lenders as well as due to information asymmetries. Having a clear and credible mechanism for the provision of funds would in fact increase the confidence of private lenders to deal with the troubled borrower as their own credit risk becomes lower.

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<sup>55</sup> Art 67 (3).

## 4. CONCLUSIONS

The recent cases of bank insolvency have brought to the fore the need to establish a backstop facility to sustain the provision of funding in the resolution phase. After describing the main terms of the debate, the paper strongly supports the creation of such a backstop facility. The paper questions the extent to which the financing arrangement should exclusively be linked to the exercise of a resolution action in consideration of the dynamic boundaries between illiquidity and insolvency.

Depending on how the liquidity backstop facility is structured, a broader scope could have a positive macroprudential impact by contributing to limit systemic (liquidity) crisis within asset and interbank markets. However, such backstop cannot be a wide blanket and should still be subjected to eligibility criteria that limit moral hazard. Given the Treaty limitations, in particular the prohibition of monetary financing and the fact that central banks provide liquidity and not capital (and thus cannot assist insolvent institutions), the ECB/NCBs cannot play a role in the financing of resolution.

The paper also argues that ELA on an individual bank basis should be centralised at least for significant institutions in the light of the SSM/Banking Union and considering that no Treaty amendment would be needed in this regard, since Article 18 of the ESCB Statute provides sufficient legal basis.

Though the paper does not take a clear stance as to which authority should be entrusted with the relevant mandate for such a backstop facility, it makes it clear it should not be the European System of Central Banks (ESCB). The choice of the authority would depend mainly on the broader aim of the facility and the form it will actually take. As a consequence, we analyse which body may be better suited to do it, depending on the characteristics of the facility.

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