LIQUIDITY IN RESOLUTION: CENTRAL BANKING VS. ESM SOLUTIONS – ALTERNATIVES OR SYNTHESIS?

Professor Concetta Brescia Morra
University of Roma Tre, Department of Law

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OUTLINE

- The European legal framework outlined in 2014 for banking crisis management: the issue of liquidity needed by an ailing bank
- The lesson from the experience post BRRD
- A comparative analysis to address the liquidity issue in resolution:
  - the U.S. model
  - the UK model
- The legal obstacles to apply the UK model in the euro-area
- The legal obstacles to apply U.S. model in the Euro-area
- Conclusions

The European legal framework outlined in 2014 for banking crisis management: the issue of liquidity needed by an ailing bank

- The need for emergency liquidity assistance from a central bank **should not, per se, be a condition that sufficiently demonstrates** that an institution is or will be, in the near future, **unable to pay its liabilities as they fall due**;

- access to liquidity facilities **including emergency liquidity assistance by central banks** may constitute State aid pursuant to the State aid framework

- Notwithstanding the role of central banks in providing liquidity to the financial system even in times of stress, it is important that Member States **set up financing arrangements** to avoid that the funds needed for such purposes come from the national budgets. **It should be the financial industry, as a whole, that finances the stabilization of the financial system**

The European legal framework outlined in 2014 for banking crisis management: the issue of liquidity needed by an ailing bank

- The resolutions plans and the liquidity issue:
  - the resolution plan should not assume any central liquidity emergency assistance;
  - liquidity issues are key for resolution planning:
    - precise **understanding of the liquidity position of the bank and its funding structure**
    - **evaluate the liquidity needs** that could arise after the resolution weekend
    - **availability of liquidity providing-options** (in particular the collateral available), that could be activated

The European legal framework outlined in 2014 for banking crisis management: the issue of liquidity needed by an ailing bank

- The SRB should use the SRF “only to the extent necessary” to ensure the effective application of the resolution tools and powers, meaning to **ensure the continuity of critical functions of the bank under resolution**

- In line with these objectives, the SRF may be used mainly:
  - to guarantee the assets or the liabilities of the institution under resolution, its subsidiaries, a bridge institution or an asset management vehicle;
  - to make loans to the institution under resolution, its subsidiaries, a bridge institution or an asset management vehicle;
  - to purchase assets of the institution under resolution;
  - to make contributions to a bridge institution and an asset management vehicle

- Fund can be used “directly” to absorb losses or provide capital to an institution under resolution in exceptional cases (due to the State aid discipline), **but there are no limits to use the SRF to address a liquidity issue of a bank under resolution**.

The lesson from the experience post BRRD

- The Banco Popular case showed the difficulties of the SRF of providing enough financing means **to address liquidity shortfalls**.

- Indeed, the financial means, immediately available, of the SRF are capped at the sum of the *ex-ante* contributions that the SRF may raise.

- These funds may be not enough in the case of **a systemic bank crisis** where **a buyer cannot immediately be found**

A comparative analysis: the U.S. model

- In the United States according to the current legal framework:
  - when a bank (Insured Depository Institution – IDI) fails, the FDIC is ordinarily appointed as receiver and the **FDIC has standing authority to borrow from the Treasury** (the line of credit was increased during the last financial crisis from 30 to 100 billion dollars);
  - the Secretary of the Treasury <u>may place a *large systemically important financial companies*</u> (Other than IDIs) in receivership and initiate liquidation, under special conditions. The Orderly Liquidation Fund (OLF), **a separate fund in the Treasury Department of the United States**, is authorized to use taxpayer funds to carry out OLA liquidations for **the provision of temporary public funding to support resolution** of a failed covered financial company.
- In both cases provision of funds may serve <u>**as a temporary source of liquidity in the event that private-sector funding cannot be obtained**</u>.

A comparative analysis: the U.S. model

- Any borrowings from the U.S. Treasury **are obligations of the FDIC**, for the repayment of which **levies can be imposed, if necessary, on banks**. Therefore:

  - the **losses of a banking crisis are borne by the banking system** and not by taxpayers;

  - the U.S. system does not prevent the utilization of public funds **by way of bridge financing** during the receivership, if, in the view of the FDIC, this is necessary, **including to deal with a liquidity shortage** of the IDI or of the Financial Company in resolution

A comparative analysis: the UK model

Bank of England's approach to resolution, October 2017

- **A flexible approach for the provision of liquidity in order to support the group resolution strategy**

- First: a bank in resolution **would have access the Bank's published facilities**, as set out in the 'Red book', **subject to the meeting the necessary eligibility criteria**

- Second: the BoE can provide liquidity support that **"may be secured"** against a wide range of collateral eligible in Sterling Monetary Framework operations in the necessary scale and for a sufficient period of time to allow the firm to make the transition to market-based funding

A comparative analysis: the UK model

- In case the use of any resolution tool would have implications for public fund, **including temporary liquidity support from the BoE via Resolution liquidity framework** <u>the authorization of the Chancellor of the Exchequer and HMT is needed</u>

- Any **losses incurred by the BoE or HMT in connection with the provision of liquidity support** via Resolution Liquidity Framework <u>would be recovered from the industry</u> in line with FSB guidance and requirements in the BRRD

Legal obstacles to adopt the UK model

- The 2017 Agreement by the Eurosystem national central banks provides rules for the Emergency Liquidity Assistance (ELA) **mainly for pre-resolution as a crisis prevention tool**

- According to the Agreement, the ELA could be provided by (national) central banks only:

    - **to illiquid but solvent banks**

    - **at a penalty rate**

    - **where the banks are able to offer “sufficient/adequate” collateral**

Legal obstacles to adopt the UK model

The need for liquidity of a bank under resolution is amplified, considering that the **Eurosystem monetary policy facilities are “frozen” for a bank after the declaration that it is “failing or likely to fail”**

This policy can be explained in order **to avoid the risk of breaching the prohibition of monetary financing of euro area sovereign** (art. 123 TFEU).

Should we to rule out the possibility of ELA provided by a national central bank after the point of resolution?

According to the 2017 Agreement:

- **a bank is considered solvent if certain thresholds of capital ratios are met or when there is a credible prospect of recapitalization**; the latter condition can be found in the context of a resolution scheme approved by the SRB **but** there is the need of **close coordination between ECB and SRB,** after the declaration that the bank is failing or likely to fail

- when a **bridge bank** has been set up in the context of a resolution scheme and **it has obtained a banking licence**, it is eligible for ELA

- **in both cases** the granting of ELA can only take place if the other conditions required by the 2017 Agreement are met, **such as adequate collateral**

ELA is responsibility of national central banks. This solution may distort the level playing field

Legal obstacles to adopt the U.S. model

A sensitive issue in the negotiation **for establishing the financial resources available to the SRF concerned the possibility of access to fiscal resources**. The final agreement provides that the **SRB shall contract for the Fund financial arrangements, including, where possible, public financial arrangements** where needed:

- to deal with a systemic threat and
- the amounts of financial means raised through *ex-ante* and *ex-post* contributions are not sufficient to meet the Funds' obligations

The Financial Stability Board's guidance published in June 2018 (*Funding Strategy Elements of an Implementable Resolution Plan,* June 21, 2018) establishes that the authorities in charge of resolution planning should *inter alia* "**identify the temporary public sector backstop mechanisms that could be used by a firm in resolution**"

The possibility of access to fiscal resources and the liquidity issue

Some progress on the political front has been made (December 4, 2018, confirmed in June 2019) under the reform of the the European Stability Mechanism (ESM) Treaty.

The **ESM will provide the common backstop on behalf the euro area in the form of a revolving credit line to the SRF**. Then the backstop:

- has been conceived as **"bridge financing"**; indeed, the agreement establishes a maturity of the loan of 3 years with a possible extension for a maximum of 2 years if requested by the SRB and to be granted by the ESM Board;
- will **be "fiscal neutral"** (repayments will come from the banking industry)
- by 2024 at the latest the backstop should be **fully operational with a volume of 55-60 billion of euro**;
- **is intended to cover all possible uses of the SRF**, according to the current regulation, **including the liquidity provision**

Conclusions

Considering that it is very important that the liquidity support in resolution is **sufficient**, **readily**, **available and the availability is predictable**

the creation of **a backstop for the SRF at the European level could reassure markets** limiting the risk of a liquidity shortfall **but**

- the governance and decision-making process of the ESM is crucial **to ensure that the liquidity provision should be prompt;**
- are the resources available **enough in case of a failure of a systemic bank?**
- what does it mean the provision of the Treaty establishing that **the ESM could require "additional safeguards" to grant the loan?**

Conclusions

Considering that **assessing solvency of a financial firm** with certainty is a complex task (CGFS paper April 2017) due to:

- balance sheet opacity and leverage
- in some cases illiquidity is the first step to insolvency
- in other cases solvency itself depend on whether ELA is available and the terms on which is offered
- solvency is not a static concept; it may change over the time, even if the bank's solvency status can be determined at the point ELA is requested

The assessment of solvency **always entails a degree of uncertainty**, which can be greater in times of stress. Therefore, **the BoE approach to ELA is hard to implement within the euro-area**, especially given the risk to breach the prohibition established by Article 123 TFEU