

How to provide liquidity to banks after resolution in Europe's banking union

Banking Union Scrutiny

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Abstract

Banks deemed to be failing or likely to fail in the banking union are either put into insolvency/liquidation or enter a resolution scheme to protect the public interest. After resolution but before full market confidence is restored, the liquidity needs of resolved banks might exceed what can be met through regular monetary policy operations or emergency liquidity assistance. All liquidity needs that emerge must be met for resolution to be a success. In the euro area, this can only be done credibly for systemically important banks by the central bank. We discuss how to establish guarantees against possible losses in order to allow liquidity provisioning in times of resolution.

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EXECUTIVE SUMMARY

When banks are deemed to be 'failing or likely to fail' in the European Union's banking union, they are either put into insolvency/liquidation or enter a 'resolution scheme'. The Single Supervisory Mechanism (SSM) typically decides that a bank is failing or likely to fail after consulting the Single Resolution Board (SRB)¹.

Funding of banks after resolution has recently become part of the euro-area political debate following the resolution of Banco Popular. Conceptually, two aspects have to be distinguished when considering funding of banks in resolution: how to restore solvency and how to provide liquidity. Solvency is restored through bail-in and recapitalisation if needed, including from public funds. Liquidity needs, however, need to be met differently.

In normal times, the European Central Bank (ECB) and national central banks (NCBs) provide liquidity either through ordinary monetary policy operations (ECB) or through emergency liquidity assistance (NCBs). In times of resolution, a gap emerges in the European framework: the treaties allow the ECB to provide liquidity only against collateral. But what happens if the newly-created bank (or old restructured bank) lacks sufficient collateral to meet its liquidity needs? A framework is needed to fill this gap. The more credible the framework, the less likely it will actually be drawn on.

Only the ECB is able to provide liquidity credibly to large banks after resolution. A scheme solely relying on the Single Resolution Fund (SRF), even if it could draw on the European Stability Mechanism (ESM), would not be credible as it has limited firing power. But in the absence of appropriate collateral, the ECB would need to get a public guarantee against possible fiscal risks.

For as long as banking union remains incomplete on both institutional and economic grounds, we argue that there is a role for the ESM, the SRB/SRF and the national treasury (in which the bank in resolution is located) to provide public guarantees. The respective finance minister(s) would have to play a role in resolution decisions and state aid concerns need to be accounted for.

Once banking union is complete, the guarantee should be given only by the euro-area fiscal body (ESM or a euro-area treasury) with recourse to the SRF to ensure that losses remain with the industry. The ESM treaty would need to be revised to be able to give guarantees and backstop the banking union. Moreover, the ESM managing director needs to get the discretion to act without approval of all ESM members during the resolution weekend. The ESM managing director should then be involved in the resolution decision, similar to other jurisdictions, and would need to be held accountable *ex post* by the responsible parliament(s).

¹ As of March 2018, 127 banking groups fall under the direct responsibility of the SRB. National Resolution authorities are responsible for all other banks (<https://srb.europa.eu/en/content/banks-under-srbs-remit>).

1. INTRODUCTION²

European banking union aims to delink banks from the sovereign and thereby increase the stability of Europe's financial system. It is widely accepted that a completed EU banking union should have a single rule book, a European supervisor, a European resolution and insolvency framework and a European deposit insurance system (Pisani-Ferry *et al*, 2012). It was also recognised early on that achieving a completed banking union will be difficult because of its fiscal implications (Pisani-Ferry and Wolff, 2012, and discussions at the informal ECOFIN in 2012)³. It is exactly at the intersection of banking policy and the possible implications for taxpayers that policy discussions have been most difficult in the course of the last six years. This applies also to the discussion on liquidity provisioning in resolution.

EU policymakers have made progress in the course of the last six years in advancing the banking union architecture, despite major difficulties and a strengthening of the links between banks and sovereigns in some countries. The transfer of supervisory powers in the ECB's Single Supervisory Mechanism (SSM) was one of the key architectural changes in the euro area (Véron, 2015). The Single Resolution Mechanism (SRM) is the other existing key pillar of the banking union, alongside the SSM. At the same time, banks' exposures to sovereign debt have increased in a number of countries and cross-border bank mergers have been limited (Gonçalves Raposo and Wolff, 2017).

This note focuses on one specific aspect of the discussion on banking union: the terms under which liquidity is provided to banks after resolution. We explain the issue of liquidity in resolution. In doing so, we first separate the conceptual roles of fiscal⁴ and monetary policy before making suggestions on how the European framework could evolve. It is important to understand that a resolution framework that is not clear on who provides liquidity after the resolution of a bank is deeply flawed. Market confidence in the new entity after resolution fundamentally depends on the trust that markets have in its ability to be liquid and meet its obligations. It may take several weeks until markets start trusting the new institution. The topic of this note is thus central to the debate on Europe's banking union and resolution framework.

So, what is bank resolution? Resolution is a relatively new instrument that is employed as an alternative to a simple insolvency procedure or liquidation of a failing bank. This alternative is chosen if the liquidation/insolvency of a bank is considered to be harmful to the real economy. More specifically, the resolution of a bank occurs when the relevant authorities determine that the bank is (a) 'failing or likely to fail', (b) there are no supervisory or private sector measures that can restore the bank to viability within a reasonable timeframe, and (c) resolution is in the public interest, i.e. the resolution objectives would not be met to the same extent if the bank were wound up under normal insolvency proceedings.

² The authors would like to thank numerous interlocutors in the EU institutions, national treasuries and UK and US officials for sharing their insights with us in the preparation of this note. We would also like to thank Bruegel colleagues for their feedback. All remaining errors are ours.

³ The large exposure of banks' balance sheets to national debtors, both sovereign and private, has been identified as a key stumbling block for introducing far-reaching euro-area wide insurance systems. These linkages have tended to increase rather than decrease in the absence of major cross-border bank mergers (Sapir and Wolff, 2013) and given the increasing exposure to sovereign debt of banks' balance sheet in some countries (Véron, 2017; Schnabel and Véron, 2018).

⁴ Merler and Wolff (2014) discuss recapitalisation of banks in resolution.

In the euro area, the ECB's SSM and the SRB both play crucial roles in banking resolution. The ECB's SSM typically⁵ takes the decision that a bank is failing or likely to fail after consulting the SRB. The SRB, an EU agency, has been entrusted with centralised decision-making power in respect of resolution since January 2016. It derives its powers from both the Bank Recovery and Resolution Directive (Directive 2014/59/EU – BRRD) and the Single Resolution Mechanism Regulation (Regulation (EU) 806/2014 – SRMR)⁶.

The SRB determines whether there are any alternative measures that would prevent the bank's failure and assesses if resolution is in the public interest. If the latter condition is not met, the failure will be addressed at national level by the authorities in charge of normal insolvency proceedings⁷.

The SRB decides on the resolution plan, employing one or several of the four resolution tools with the aim of minimising the cost to the public. The four tools are: i) the sale of business, ii) the establishment of a bridge bank, iii) asset separation measures, and finally, iv) bail-in. The SRB/SRF's function is to absorb losses and compensate creditors, as well as to provide liquidity in resolution. The SRB also owns, manages and decides on the use of the Single Resolution Fund (SRF). The SRF is currently being built up with contributions from the banking sector.

Funding of banks after resolution has recently become part of the euro-area political debate. In particular, financing after resolution became a focus of attention following the June 2017 **resolution of Banco Popular**, one of the first big cases of a failing bank handled by the SRB. The role of Emergency Liquidity Assistance (ELA) funding was extensively discussed in this case, for example, in European Parliament (2017) but questions remain. The buyer (Banco Santander) provided a lot of funding, which might have been difficult to find in the absence of a strong private buyer in the current banking union set-up. During the Banco Popular debate, Eurosystem resolution liquidity (ERL) was mentioned as a potential tool for providing such liquidity. But critics, such as ECB governing council member Yves Mersch, also highlighted that *"resolution planning should not assume that central-bank liquidity will fill the gaps"*⁸.

Conceptually, two aspects have to be distinguished when considering funding in resolution: how to restore solvency and how to provide liquidity. First, the main resolution tools are geared toward restoring solvency. In particular, the bail-in instrument is meant to ensure loss absorption and possibly recapitalisation. In addition, the use of public resources and in particular the SRF (and the ESM if the backstop is agreed) to support restructuring and the recapitalisation of the bank, is part of the funding needed for banks in resolution. Second, banks before and after resolution typically have significant liquidity needs. Such needs are met in normal times by the central banks, i.e. the ECB and national central banks through ELA⁹. But it is unclear how liquidity needs in resolution would be met.

⁵ The SRB may also determine that a bank is considered failing or likely to fail if it has informed the ECB of its intention to do so and the ECB has not reacted within three days (Art 18, SRMR).

⁶ And while a first assessment of this reform by the European Court of Auditors (ECA, 2017) was discouraging at one level, citing many shortcomings of the new body, the report also provides signs that the situation is improving, and that the SRB is on its way towards fulfilling its assigned mission (Véron, 2018).

⁷ The resolution authority at the same time also seeks to ensure that no creditor would be worse off in resolution than insolvency (the 'no creditor worse off' test).

⁸ See <https://www.bloomberg.com/news/articles/2018-04-09/ecb-considers-proposal-for-new-cash-line-to-aid-bank-rescues>.

⁹ Significant questions have been raised on the role of ELA. Application of ELA has also been criticised for lacking sufficient transparency (Hallerberg and Lastra, 2017).

The Single Resolution Fund comes in as a last resort to support restructuring by the SRB¹⁰. The SRB may use the SRF only to ensure the efficient application of the resolution tools and exercise of the resolution powers. The SRB may use the SRF to cover losses or to recapitalise the entity once a contribution to loss absorption or recapitalisation equal to at least 8 percent of the total liabilities of the bank, including own funds, has been made by the bank's shareholders and creditors¹¹.

Once the ESM backstop to the SRF is agreed and the SRF is filled, resources of up to €120 billion would be available – too little to cover liquidity needs on its own. Discussions on the ESM backstop to the SRF are ongoing at the time of writing¹². The SRF does have an instrument to provide liquidity after resolution. But the liquidity needs of banks after a resolution and in a situation of distress easily surpass these limits. In particular, parts of the SRF might have been used for recapitalisation already. If a systemic crisis occurs or a major global systemically important bank (G-SIB) is resolved, liquidity needs could far exceed what the SRF or even the ESM backstop can cater for. The current framework is thus not credible for dealing with liquidity provisioning after resolution

¹⁰As defined by the Bank Recovery and Resolution Directive (BRRD, 2014/59/EU) and the Single Resolution Mechanism Regulation (SRMR, Regulation (EU) 806/2014).

¹¹ <https://srb.europa.eu/en/content/resolution-qa>

¹² For a simple exposition of the Commission's proposal, see https://ec.europa.eu/commission/sites/beta-political/files/backstop-banking-union_en.pdf. The aim is to finalise the discussion by the end of 2018.

2. LIQUIDITY IN RESOLUTION

Clarity and consistency in the framework is crucial for carrying out resolution successfully. In theory a new entity coming out of the resolution process would be ready to cover its needs by accessing the markets. In practice however, there are no guarantees that markets would perceive the resolution to have been successful, and certainly not immediately. This new entity would therefore be put to the test. The success of the resolution process depends as much on the valuation of assets as it does in the existence of a credible and complete framework for liquidity provision.

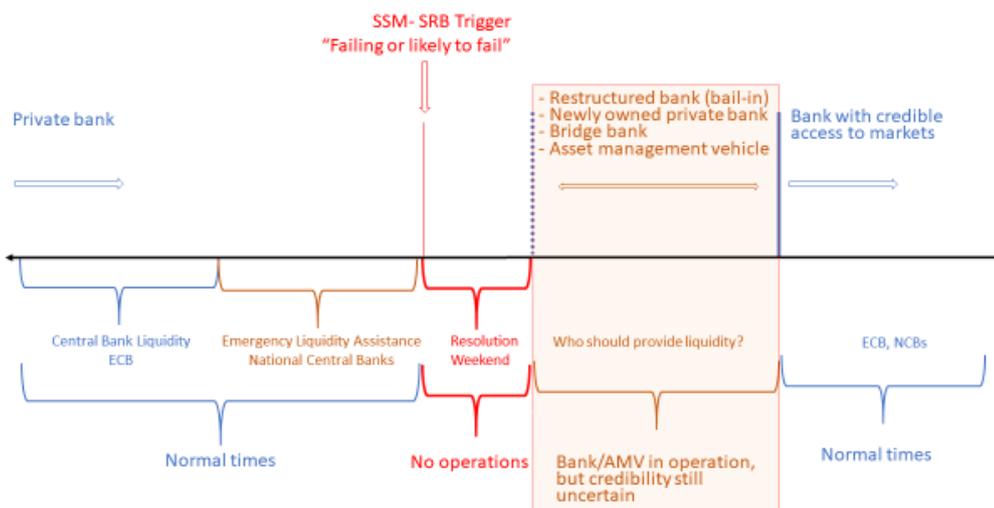
Any bank with liquidity needs has access to the standard ECB facilities. Further to that, national central banks also provide ELA against a wider set of (lesser-quality) assets as collateral. **Both the standard monetary policy facilities and the ELA are available to a bank coming out of resolution.**

ELA is an important facility to provide temporary liquidity to distressed banks. ELA can be tapped against collateral that may be of lower quality than that of standard monetary operations. In the past, ELA played an important role in the run-up to the referendum on the third programme bail-out terms held on 5 July 2015 in Greece. As Figure A 1 in the Annex shows, the ELA was used most between January and July 2015, when the Greek banking sector was struggling with heavy deposit outflows resulting from the uncertainty caused by the referendum. But ELA also plays an important role in individual bank cases, such as Banco Popular prior to its resolution. **But providing ELA does not mean that a bank will eventually be put into resolution, nor is it the only instrument available to provide liquidity to a bank after resolution.**

Liquidity after resolution refers to the provision of funding as soon as the resolution scheme is announced and comes into operation. The resolution process can lead to one of four possible structures: a new bridge bank, a restructured old bank until it has established sufficient credibility with private markets, a new bank that has been bought by a new owner, or an asset management vehicle. Two questions need to be addressed: who should provide liquidity in each of the four resulting outcomes, and are the mechanisms to provide liquidity in normal times sufficient for banks coming out of a 'resolution weekend'¹³? If the restructured bank is bought by another bank, the responsibility for providing liquidity would typically be fulfilled by the new owner. But in the other three cases, things are less clear. Figure 1 describes who provides liquidity for the different phases of a bank's life.

¹³ Resolution is typically carried out outside of market hours (i.e. over a weekend) to avoid market disruptions during the resolution process.

Figure 1. Liquidity provision in different states: a sequence



Source: Bruegel.

A successful resolution should mean that the new bank has a credible and sound balance sheet. Sufficient collateral should therefore be available to be used to obtain liquidity from the ECB. This new bank should comply with all the necessary banking regulations in terms of equity and it should be solvent. The ECB continues to be the institution that provides liquidity. Since the ECB is the supervisor that approves the licence, it is also natural that it provides the normal monetary policy liquidity. If the bank runs out of eligible collateral, the next step is to let the bank turn to ELA.

Nevertheless, the liquidity needs of banks after resolution could exceed what regular monetary policy operations and ELA can provide. Banks that are put into resolution typically reach that point in a situation of great financial stress with both a liquidity and solvency problems. The resolution process will have dealt with the solvency issues, through bail-in and the use of the SRF, but the SRB/SRF cannot deal with major liquidity needs if the bank is large (G-SIB). Liquidity needs for such banks might easily exceed the size of the SRF and its backstop. However, the ECB (and national central banks) are prohibited from providing liquidity without eligible collateral or guarantees. **The current resolution framework does not specify who should provide liquidity or against what guarantees if collateral is insufficient.**

In the past, banks called on state aid to guarantee funding when they run out of liquidity. For example, from 2008 to 2010, Germany's Hypo Real Estate benefited from the provision of guarantees amounting to €145 billion, which were deemed necessary in order to enable the continued operation of the bank when it faced insolvency¹⁴. The resolution of Dexia in 2008 was backed by French, Belgian and Luxembourg state guarantees amounting to €135 billion, including guarantees for ELA funding from the National Bank of Belgium¹⁵. On aggregate, liquidity support in the form of state guarantees

¹⁴ http://ec.europa.eu/competition/state_aid/cases/231241/231241_1279613_551_2.pdf. It has been reported, however, that such large guarantees might not have been necessary and instead ELA funding could have been provided. See *Spiegel*, 'Warum die Bundesbank auf eine Staatsgarantie drängte', 19 October 2018.

¹⁵ See http://ec.europa.eu/competition/state_aid/cases/245074/245074_1520672_505_2.pdf.

amounted to the most used state support tool during the financial and the subsequent European debt crises in 2008-13. European governments approved €1.5 trillion in capital and asset relief, and €4.3 trillion in guarantees to their ailing banking systems¹⁶.

The size of state aid guarantee funding highlights the limitations of using the SRF as liquidity support, even if the current framework allows for it. Moreover, the use of the Fund is, by construction, bound by what would be agreed in the resolution scheme. It could then not be adapted following a market response to the restructured entity. **There remains therefore a gap in the European framework that needs to be filled:** how to provide liquidity to a resolved bank that is deemed solvent but has insufficient collateral. This gap does not exist in the US or UK (Box 1).

Box 1: Liquidity in resolution – the US and UK approach

The Bank of England is the resolution authority in the UK, acting in consultation with the Prudential Regulation Authority, the Financial Conduct Authority, HM Treasury and other stakeholders, such as the Financial Services Compensation Scheme¹⁷.

The Bank of England provides direct liquidity to banks through the Sterling Monetary Framework (SMF). The provision of ELA lies outside of the SMF and requires government approval. To receive ELA from the Bank of England banks must be solvent and have eligible collateral, which is broader than the collateral required through the SMF¹⁸.

The Bank of England and the Treasury implemented in 2017 the Resolution Liquidity Framework (RLF), which is yet to be used¹⁹. The RLF supplements the use of regular SMF facilities. It responds to situations in which *“a firm’s own resources are temporarily insufficient and access to private sector funding is not possible”*.

The RLF clarifies and formalises a *“flexible approach for the provision of liquidity in order to support the group resolution strategy”* (Bank of England Purple Book, 2017). There are no official caps on the scale, the duration and the rates applied to this type of liquidity support, as long as it is enough to *“allow the firm to make the transition to market-based funding”* (ibid). The liquidity is provided by the Bank of England against collateral with the same eligibility rules as the SMF.

The use of the RLF is available upon approval from the Treasury, according to the separation of roles between the Treasury and the Bank of England²⁰. Depending on the scale of the required funding, the Bank of England might request an indemnity from the Treasury, which provides the guarantee for the liquidity support.

¹⁶ See the European Commission database on state aid support during the financial crisis, available at http://ec.europa.eu/competition/state_aid/register/. Also, we use “approved” as opposed to effectively “used” state aid measures, as “approved” measures allow grasping the extent of signalling needed in the market to restore confidence.

¹⁷ 2009 Banking Act.

¹⁸ The MoU and Section 61 of the Banking Act account for the very exceptional possibility of the Chancellor mandating the Bank to provide ELA to an insolvent firm.

¹⁹ ‘Upcoming changes to the Treasury’s and Bank’s Memorandum of Understanding on Resolution Planning and Financial Crisis Management’, correspondence between the House of Commons Treasury Committee and HM Treasury, 29 September 2017, available at <https://www.parliament.uk/documents/commons-committees/treasury/Correspondence/2017-19/Correspondence-chancellor-memorandum-resolution-planning-crisis-management-290917.pdf>.

²⁰ As set out in the Memorandum of Understanding (2017).

There is no resolution fund based on taxpayer's money. Funds are raised through a bank levy and end up in the United Kingdom's Consolidated Fund. The Treasury can therefore use the money from that fund to cover potential losses, meaning it is ultimately the industry that carries the risk of the liquidity support.

In the United States, Title II of the Dodd Frank Act sets out the framework for resolving complex systemically important financial institutions (SIFIs), where liquidation through ordinary bankruptcy law would pose a threat to financial stability. The bank is declared by the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) as 'in default or in danger of default'. Both regulators send a seven-point written recommendation to the Treasury clarifying the risk of default and the likelihood of finding a private-sector solution.

The Secretary of the Treasury determines with the President that the conditions to trigger resolution are met²¹ and appoints FDIC as the receiver of the failed company and the Orderly Liquidation Authority. The FDIC, in this role, is then in charge of planning and conducting the liquidation and winding up the institution through the quick sale of assets or the transfer of assets to a bridge financial company.

As resolution authority, the FDIC can borrow from the Treasury's resolution fund, the Orderly Liquidation Fund (OLF). The use of the OLF needs to be approved by two thirds of the Fed Board of Governors and the Treasury Secretary in consultation with the President. The Treasury sets the amount, interest rate and duration of the advances. The OLF provides temporary liquidity to the bridge financial company, which ceases to exist as soon as private funding is again available. The funds are provided on a "fully secured basis"²². There is also the option for OLF to provide a guarantee.

Similarly to the UK, the OLF has not been used so far. The use of the fund can go up to 10 percent of the total consolidated assets of the bank until the Secretary of the Treasury and the FDIC agree on a plan and schedule for the repayments²³. After the FDIC has made a fair value estimate of the total consolidated assets of the bank, the use of the OLF can go up to 90 percent of that value.

The fund is financed *ex post*. The FDIC borrows from the Treasury to finance the resolution. If there is a net cost to the resolution, it is recouped by the FDIC through recoveries of the assets of the failed bank or contributions from the financial sector.

²¹ Of which 1) the company is in default or danger of default, 2) no viable private sector alternative is available to prevent the default of the company, or 3) resolution under the Bankruptcy Code would threaten financial stability.

²² [78 Fed. Reg. at 76616.](#)

²³ This process lasts for the 30 days immediately following the appointment of the FDIC as a receiver.

3. THE WAY FORWARD

After a successful resolution, the bank should have been re-established as solvent. It is important to underline that central banks should not recapitalise the bank or absorb losses to ensure the solvency of the bank. On the contrary, it is the SRB's task to rigorously apply the various resolution tools, which ensures that the newly established or restructured bank fulfils all the necessary solvency criteria. As such, these reopened entities have access to regular central bank liquidity. Only the case of creating an asset management vehicle, which is not a bank, does the new entity not have access to central bank liquidity. Its liquidity needs will need to be fulfilled by the SRF.

Liquidity provisioning after resolution should be done by the central banks. The SRF is too small and it would be inappropriate to ask for contributions from the banking industry to enlarge the SRF just to cover temporary liquidity needs. Also the ESM is not a tool for providing liquidity to banks. Even if the "backstop" was established, it would have limited ability to raise funds as it is not a treasury with large tax resources, by comparison to, say, the US treasury, which does provide liquidity. Liquidity provisioning is in principle the job of the central banks. Providing abundant liquidity is particularly crucial in instances of broader systemic crises.

However, since the ECB cannot provide liquidity to banks without collateral, public guarantees need to be established. The European treaties do not allow the ECB to carry out monetary policy operations without adequate collateral²⁴. As outlined in section 2, in the weeks after resolution, the liquidity needs of the restructured or new bank might exceed the available collateral. In such circumstances, public guarantees are necessary to allow the ECB to provide liquidity. Those guarantees would cover possible losses resulting from the liquidity provisioning in case the new bank runs into new difficulties and even faces the possibility of insolvency or liquidation. This is arguably a rare case as the whole purpose of the resolution managed by the SRB is to restructure and resolve the bank so that it is viable. Such a basic division of labour would be comparable to the UK's framework, where the Bank of England provides liquidity but the Treasury first needs to guarantee possible losses (Box 1). It would be somewhat different to the US where the FDIC's Orderly Liquidation Fund would typically provide liquidity, drawing on a credit line from the Treasury.

Providing liquidity to banks after resolution should ideally not affect monetary policy. The ECB's primary mandate is price stability and its liquidity operations are geared towards that goal. However, additional liquidity provision, in particular for G-SIBs, could affect overall liquidity provided by the ECB. One could foresee therefore that such liquidity would be provided at a penalty. At the same time, we would highlight that should a G-SIB need to be resolved, financial stability concerns would be significant and the ECB would need to play a role in ensuring financial stability²⁵.

The guarantee could in principle be given by (a) one or several national treasuries, (b) the SRF, (c) the ESM, or (d) a combination of one or several of the options (a)-(c).

- The national treasury that could be used would be the one(s) of the bank's residence. If it is a bank operating in several countries, more than one treasury might have to be involved. The advantage of option (a) is that national treasuries tend to have relatively deep pockets. Moreover, since those guarantees are only needed once ELA is exhausted, a national guarantee would make perfect sense since the ultimate risk relating to ELA also resides with the national central bank, whose owner is the national treasury. The disadvantage of option

²⁴ Article 18 of the [ECB Statute](#) laid down in Protocol 4 annexed to the Treaties, as established by Art. 129 of the TFEU.

²⁵ See Article 105, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A12002E105>.

(a) is that it is against the spirit of the banking union. In fact, it would reinforce, in extreme cases, the link between banking fragility and the fragility of the national sovereign: the doom loop is not cut. Moreover, since the resolution plan is designed by the European SRB, it would be hardly incentive-compatible to ask a national treasury alone to carry the ultimate liquidity risks. Moreover, as soon as national state aid is given, state aid rules and restrictions would apply.

- The advantage of option (b) is that the institution responsible for the resolution, the SRB, would also be the owner and administrator of the SRF. It would ensure the incentives of the SRB to design a resolution plan that creates a bank that becomes very quickly credible in the markets. However, there are two problems with this option. First, even an extremely credible resolution plan does not mean that markets can immediately trust a new bank. For example, rating agencies often take weeks or months until they re-adjust their ratings of banks. The SRF guarantee, even if possible losses out of liquidity operations would be only a fraction of the liquidity, might then be too limited. The second problem arises from what the ECB might consider an adequate guarantee. Here, in our view the ECB's demands should not be overly exaggerated in terms of the quality of the SRF guarantee. We consider it an exaggerated demand if the ECB requires guarantees to be immediately liquid. In fact, the SRF could hardly turn its guarantee on possible losses (which should only be a fraction of the actual liquidity) immediately into liquid cash to compensate the ECB. But also in normal monetary policy operations, the collateral held by the ECB is not necessarily more liquid. Still, the ability of the SRF on its own to provide guarantees might be too limited, even if ex-post contributions were included.
- The advantage of option (c) would be that the ESM is much larger than the SRF and enjoys a high rating to provide a credible guarantee. Moreover, it is a fully mutualised euro-area facility and would therefore contribute to the delinking of banks from their national sovereigns. However, the ESM treaty does not allow such guarantees to be given and would therefore have to be changed. Moreover, the decision-making process in the ESM still requires unanimity and such a mechanism might therefore be very difficult to activate during the weekend of resolution. This can be a serious obstacle to providing a solution in which timeliness is of paramount importance. Finally, the more the ESM provides guarantees for banks, the less firepower it has for possible financial assistance programmes. The option of using the ESM to provide the guarantee is linked to the discussion on the ESM backstop²⁶.

It is only natural that those institutions that provide guarantees for potential liquidity needs would also need and indeed want to be involved in the process of resolution. While this might increase the legitimacy and credibility of the process, at the same time the greater the number of institutions involved, the greater the degree of complexity and the less the *ex-ante* clarity and timeliness in the process.

²⁶ The discussion on the backstop is at time of writing ongoing in the Council of the EU based on a European Commission proposal (see https://ec.europa.eu/commission/sites/beta-political/files/backstop-banking-union_en.pdf). The political discussion was advanced in the June 2018 Franco-German Meseberg declaration (see <https://archiv.bundesregierung.de/archiv-de/meta/startseite/meseberg-declaration-1140806>). It should be clarified that the Meseberg declaration only refers to the need to work on liquidity provisioning after resolution. The envisaged ESM credit line to the SRF can be used in multiple ways but the declaration does not mention explicitly that this credit line could be used as a way to ensure that the SRF can provide a guarantee to the ECB for liquidity purposes.

Once banking union is completed, ELA is provided centrally and banks are completely separate from national sovereigns, the guarantee for liquidity provisioning should only be given by a euro-area fiscal body with recourse to the SRF. In other words, centralised liquidity provisioning should be guaranteed by a centralised treasury – and a recourse to the resolution fund should be established to ensure that any ultimate losses are borne by the banking sector as a whole and not by taxpayers. This would align Europe’s banking union with how the system works in the UK. The euro area treasury would then also need to participate in the decision to activate the resolution process itself. If the treasury was to be the ESM, the ESM managing director would need to be empowered to take decisions during the weekend and clear accountability rules would need to be established to hold him/her to account afterwards in the respective parliament(s). This would mean that the current system would have to evolve significantly. Currently, the national finance ministers cannot decide on whether to start resolution, nor do they have a say on the resolution plan. But that is acceptable as the SRB can only decide on the SRF, which is an industry-filled fund and not funded by tax resources. As soon as public guarantees are given for liquidity, the euro area treasury would have to be given a say.

As long as banking union remains incomplete and liquidity provisioning is still to a significant part done by national central banks through ELA, it might be appropriate to continue relying on some guarantee from the respective national treasury(ies) combined with a larger guarantee from the ESM. For this to be a useful and credible option, we consider it imperative that the ESM treaty reform ensures that an *ex-ante* guarantee line is agreed, on which the ESM managing director can draw. A system in which all finance ministers have to agree during a weekend to provide the guarantee is not fit for purpose, especially if some national finance ministers need to first get a green light from their parliaments. In the US, Congress does not have to be consulted during the resolution weekend but the Secretary of the Treasury together with the President takes the decision on liquidity. For relevant authorities’ incentive structures to be aligned, we also consider it imperative that the SRB/SRF provide a line of guarantees for such provisioning of liquidity. After all, it is the SRB that decides on the resolution plan and therefore should also be the most interested in ensuring that the emerging bank is as viable and credible as possible.

4. CONCLUSIONS

Banks that are put into resolution often have acute liquidity needs and their solvency is doubtful. It is the primary job of the SRB to apply one or several of the four resolution tools so that the public interest is respected and the damage to the real economy is minimal. After the resolution weekend, a new institution will reopen which will be: 1) the same bank, though restructured, 2) a new bridge bank, or 3) a new subsidiary of another bank. Regular access to ECB liquidity/ELA is ensured irrespective of which of the three vehicles is used. Access to central bank liquidity is not available if instead an asset management vehicle is created, in which case liquidity needs have to be catered for by the SRF alone.

Systemically important, large banks will have major liquidity needs after a resolution. Those liquidity needs might exceed for a period of a few weeks those that the ECB/ELA alone can meet because it takes time for markets and rating agencies to reassess the viability of the resolved bank. During those first weeks, extraordinary liquidity demands will need to be satisfied or else a new bank crisis could emerge.

The SRB/SRF alone cannot meet such additional liquidity needs, which leaves a major gap in the European bank resolution framework. Public guarantees for additional ECB liquidity are needed. We propose that those guarantees should eventually be only provided by a fully reformed ESM with recourse to the SRF. The ESM managing director or a euro-area finance minister would need to be involved in the decision making on resolution. But for a long transition period, especially while banks are still largely tied to national circumstances and ELA is provided by national central banks, we suggest that it would be useful that a part of the guarantee be provided by national treasuries. At the same time, the larger part should ideally be provided by the reformed ESM (with an *ex-ante* guarantee line given to the ESM managing director, making national parliamentary approval unnecessary during the weekend). This mixed system would create significant governance difficulties; therefore, we would prefer that the euro area rather quickly decides on a system that would complete banking union in all its aspects.

A related but further-going discussion is about the centralisation of ELA, a wish expressed by ECB president Mario Draghi in February 2018²⁷. We think that such a step is desirable and consistent with the centralisation of banking supervision. At the same time, centralised ELA might imply stricter demands on the quality of the collateral because of the greater mutualisation of risks. This could reduce the provisioning of liquidity to distressed banks, possibly increasing the frequency of resolution and insolvency processes. As such, the discussion on the pros and cons of this step goes well beyond the question of liquidity provisioning after resolution.

Another connected discussion is about how the continued existence of substantial differences in national insolvency legislation affects capital and liquidity needs in resolution. In particular, an important rule for resolution is that no creditor should be worse off than in insolvency. But given that insolvency laws are different across the banking union, the shape of SRB resolution plans might be different in different countries. This in turn can have implications for liquidity needs. **We therefore consider it of high importance that policymakers make progress in harmonising national insolvency legislation.**

²⁷ Committee on Economic and Monetary Affairs, Monetary Dialogue with Mario Draghi, 26 February 2018, transcript available at <http://www.europarl.europa.eu/cmsdata/140021/1147067EN.pdf>.

Finally, progress should be made on a number of technical discussions. The SRB has a moratorium tool (BRRD Article 69) and a power to temporarily suspend termination rights (BRRD Article 71) and there is at time of writing a discussion on extending those powers, including to pre-resolution situations. This note cannot discuss these tools in further detail but obviously they concern a sensitive and contractually complex topic and any changes need to be enacted carefully.

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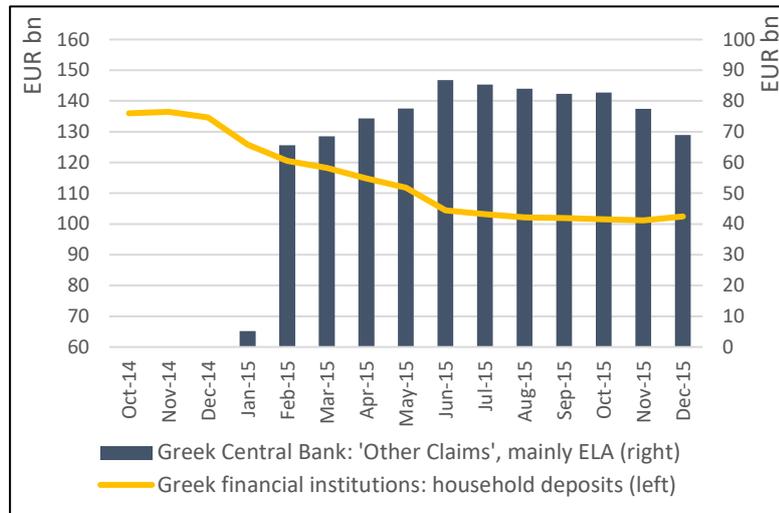
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ANNEX

Figure A 1. Household deposits at domestic lending institutions and Central Bank other assets, mainly representing ELA, in EUR bn



Source: ECB and Bank of Greece.

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