The Lender of Last Resort in the Euro Area: Where Do We Stand?

Karl Whelan
University College Dublin
Presentation at University College Cork
March 9, 2018

Plan for this Talk

- Lender of last resort
  - Rationale
  - Traditional recommendations
- Two criteria
  - Clear and transparent procedures
  - Distinction between solvency and liquidity problems
- Bank resolution procedures
- Review of Euro Area procedures:
  - Pre-BRRD emergency lending by ECB
  - Post-BRRD emergency lending and resolution procedures

Why Do We Need the LOLR?

- Banks are the heart of the financial system and serve many economic purposes.
- But banking systems are innately unstable due to maturity mismatch.
- Bank runs threaten even solvent banks as losses get inflicted in crisis-induced fire sales.
- So banks need a strong LOLR that will back them in a crisis provided they are solvent.
- Many reasons why central banks, and not central government, should play this role.

Bank Resolution

- The huge literature on the LOLR often neglects another important element of financial stability policy: Bank resolution.
- If the LOLR deems a bank insolvent and thus does not wish to extend credit, the authorities need a clear and efficient way to close the bank and repay creditors.
- Without a clear policy on bank resolution, creditors will face greater uncertainty in a crisis situation and will be even more likely to run on a bank.
- So clear bank resolution procedures are required every bit as much as a clear LOLR policy.

Bagehot on the LOLR

- LOLR policy recommendations always come back to Walter Bagehot's Lombard Street (1873).
- Bagehot was concerned that the Bank of England should acknowledge its role in stemming panics, and set out its principles for doing so.
- Bagehot's recommendations usually summarised as "*to avert panic, central banks should lend early and freely (i.e. without limit), to solvent firms, against good collateral, and at high rates.*"

Bagehot on the Bank of England

“In common opinion there is always great uncertainty as to the conduct of the Bank: the Bank has never laid down any clear and sound policy on the subject. As we have seen, some of its directors (like Mr. Hankey) advocate an erroneous policy. The public is never sure what policy will be adopted at the most important moment: it is not sure what amount of advance will be made, or on what security it will be made. The best palliative to a panic is a confidence in the adequate amount of the Bank reserve, and in the efficient use of that reserve. And until we have on this point a clear understanding with the Bank of England, both our liability to crises and our terror at crises will always be greater than they would otherwise be.”

Honohan on the LOLR

“one can speak of a bank being solvent -- in the sense that its assets will, when they mature, provide more than enough to repay those who have lent to the bank -- while at the same time being illiquid -- in the sense that the bank is unable to repay its borrowings immediately and cannot find other lenders who can tide it over. Obviously, putting a solvent but illiquid bank into bankruptcy is unnecessarily costly for society which is where emergency liquidity assistance (“lender of last resort”) from the central bank arises. The emergency loans should be made at a penalty rate so that banks have an incentive to avoid getting into a situation of illiquidity. However, the main difficulty lies in determining whether the bank really is solvent. For this, one cannot rely on what will all too often be a self-serving and over-optimistic assessment from the troubled bank. Instead, the regulator must have assembled the necessary information and analysis to provide the needed advice.”

The Eurosystem's Rules on Loans to Banks

- The Eurosystem's loans to banks were from 1999-2008, its principal monetary policy instrument.
- Rules that seem very clear:
  - Loans must be collateralised.
  - Publicly available list of eligible collateral with "haircuts" for each asset.
  - Losses on loans shared among Eurosystem central banks
- Reality:
  - The composition of the single list can change from month to month at Governing Council's discretion.
  - A "risk control framework" exists that can single out individual assets or institutions as not being eligible for regular credit from ECB.

Emergency Liquidity Assistance

- Once a bank has run out of eligible collateral for regular Eurosystem loans, it must apply for ELA.
- This decision occurs at a national central bank level and the NCB takes on the balance sheet risk.
- The ECB's take on its role (from October 2014):
  - *The ECB neither provides nor approves emergency liquidity assistance. It is the national central bank, in this case the Central Bank of Cyprus, that provides ELA to an institution that it judges to be solvent at its own risks and under its own terms and conditions. The ECB can object on monetary policy grounds; in order to do so at least two thirds of the Governing Council must see the provision of emergency liquidity as interfering with the tasks and objectives of euro area monetary policy.*
- So the ECB's official line is that it doesn't provide or approve ELA but also that it sort of does.

Three Examples of ELA in Practice

1. Ireland
2. Cyprus
3. Greece

Ireland, 2010

- **September 2008**: Anglo Irish Bank runs out of eligible collateral. No ELA provided but the Irish government provides a near-blanket guarantee.
- **March 2009**: €11.5 billion in ELA given to Anglo, which turns out to be wildly insolvent.
- **2010**: ELA provided to other banks. Total is over €40 billion.
- **November 2010**: Trichet sends letter insisting Ireland enter EU-IMF programme requiring fiscal and structural reforms as a condition for continued authorisation of ELA.
- **2011 onwards** see financial stability restored:
  – Ireland enters EU-IMF programme and economy recovers.
  – Banks are re-capitalised and ELA is fully repaid.

Cyprus, 2013

- **End 2010**: Cyprus Popular Bank ("Laiki") and Bank of Cyprus build up holdings of €5.8 billion in Greek government bonds (1/3 of Cypriot GDP).
- **2011**: Losses wipe out Laiki's equity and almost all of BoC's.
- **October 2011**: Laiki receives €2.5 billion in ELA.
- **February 2012**: EBA communicates that Laiki needs a recapitalisation of €2 billion while BoC requires €1.5 billion.
- **2012**: Deposits flow out, capital position worsens and ELA increases, reaching €9.6 billion in July 2012.
- **2013**:
  - Election takes place
  - Post election, the ECB insists on EU-IMF programme and bank recapitalisation as condition for continuing ELA.
  - Government judged by EU-IMF as too indebted to recapitalise banks so haircuts are applied to depositors.
  - Capital controls put in place.

Greece, 2015

- 2014:
  - ECB conducts a comprehensive assessment and stress test and announces results in October 2014. Declares Greek banks solvent and have limited need for recapitalisation to meet its requirements.
- 2015:
  - Political uncertainty surrounding election leads to deposit outflows from Greek banking system and ELA increases.
  - Various Greek government-issued and government-backed assets removed rom the single list.
  - ECB insists that a new EU-IMF programme be put in place by new government as a condition for providing higher ELA.
  - Greek government ends up imposing capital controls because banks do not have access to liquidity.
  - Damage done to the economy and banking system requires further round of bank recapitalisation.

Have ECB's Procedures Been Clear and Transparent? No

- The line between regular lending and ELA is unclear and changes at key times during crises.
- Unclear relationship between national authorities and the ECB Governing Council.
- Clear evidence of links between willingness to provide emergency lending and wider political events (Irish and Greek EU\IMF programme negotiations, Cyprus election).
- Are decisions to limit ELA really made "*on monetary policy grounds*" or are some either set of criteria used?

Has ECB Been Clear about Solvency and Liquidity Considerations?

- Should ELA have been provided to banks like Anglo in 2010 that are highly insolvent with large injections of state money?
- Should ELA have been to banks Laiki in 2011 when it was insolvent?
- Should the timing of ECB requirements for bank recapitalisation depend on political events such as elections?
- Should liquidity support be suspended for banks that ECB itself has insisted are solvent and have passed stress tests?
- Why has ECB keep ELA limits in place even after banks (such as those in Cyprus and Greece) have been recapitalised?

Bank Recovery and Resolution Directive (BRRD)

- In 2015 a new ``single rulebook for the resolution of banks and large investment firms'' entered into force in the EU.
- Single Resolution Board (SRB) set up with new powers to restructure banks defined as ``failing or likely to fail'' including cross-border institutions.
- Key among the SRB's powers is the ``bail-in'' tool that could see bank liabilities ``written down in a pre-defined order in terms of seniority of claims in order for the institution to regain viability.''
- SRB can also use tools such as a ``sale of business'' approach and an ``asset separation'' approach.
- While shareholders, subordinated bonds and senior bonds are written down first, these procedures could still see deposits bailed-in depending on the size of the insolvency of the bank

BRRD in Theory

1. A clear set of rules that everyone understands for dealing with failing banks.
2. No more taxpayer-funded bailouts.
   – Commenting on the introduction of the single rulebook for the resolution of failing banks, EU Commissioner for Financial Stability, Financial Services and Capital Markets Union, Jonathan Hill, said "*The Bank Recovery and Resolution Directive equips public authorities for the first time across Europe with a broad range of powers and tools to deal with failing banks, while preserving financial stability. From now on, it will be the bank's shareholders and their creditors who will bear the related costs and losses of a failure rather than the taxpayer.*"

BRRD in Practice

- June 7, 2017:
  - Banco Popular of Spain is declared “failing or likely to fail“.
  - Shareholders and subordinated bondholders lose their money.
  - The bank is sold to Santander for one euro.
  - Depositors are protected and no state money is used.
- June 23, 2017:
  - Veneto Banca and Banca Popolare di Vicenza are also deemed failing or likely to fail.
  - It is decided not to use the SRB's resolutions tools.
  - The banks are wound up but no creditors lose money.
  - Italian government commits 17 billion euros and arranges a takeover of the “good parts'' of the bank.

Clear and Transparent?

- Bloomberg, June 25, 2017:
  - *In recent months, ``bank intervention is specific to each troubled bank situation on its own conditions, with government and regulatory decisions on how to intervene influenced by multiple major macro factors,'' said David Hendler, founder of Viola Risk Advisors, a credit analysis firm in New York state. ``For global bank investors, the European banking sector and how to invest in it is very confusing, not uniform, and difficult to predict."*

Definition of Failing or Likely to Fail

4. For the purposes of point (a) of paragraph 1, an institution shall be deemed to be failing or likely to fail in one or more of the following circumstances:

(a) the institution infringes or there are objective elements to support a determination that the institution will, in the near future, infringe the requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation by the competent authority including but not limited to because the institution has incurred or is likely to incur losses that will deplete all or a significant amount of its own funds;

(b) the assets of the institution are or there are objective elements to support a determination that the assets of the institution will, in the near future, be less than its liabilities;

(c) the institution is or there are objective elements to support a determination that the institution will, in the near future, be unable to pay its debts or other liabilities as they fall due;

(d) extraordinary public financial support is required except when, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, the extraordinary public financial support takes any of the following forms:

ECB Decision on Banco Popular

ECB determined Banco Popular Español S.A. was failing or likely to fail

7 June 2017

- Decision followed significant deterioration of bank's liquidity situation
- SRB assessed that resolution of bank is in the public interest and adopted resolution scheme

On 6 June, the European Central Bank (ECB) determined that Banco Popular Español S.A. was failing or likely to fail in accordance with Article 18 (1) of the Single Resolution Mechanism Regulation.

The significant deterioration of the liquidity situation of the bank in recent days led to a determination that the entity would have, in the near future, been unable to pay its debts or other liabilities as they fell due.

Consequently, the ECB determined that the bank was failing or likely to fail and duly informed the Single Resolution Board (SRB), which adopted a resolution scheme entailing the sale of Banco Popular Español S.A. to Banco Santander S.A.

ECB Vice-President on Banco Popular

- The following comments are from ECB vice president, Vitor Constancio:
  - ``The reasons that triggered that decision were related to the liquidity problems. There was a bank run. It was not a matter of assessing the developments of solvency as such, but the liquidity issue,"
  - ``Our role as ECB was just the declaration that the bank for liquidity reasons was failing or likely to fail,"
- Subsequent events suggest Banco Popular probably may have been insolvent but this language is potentially troubling.

What Would Bagehot Have Made of the ECB as LOLR?

- Clear and sound procedures?
  - ECB still does not have clear procedures for dealing with banks that have used all of their eligible collateral but that still wish to borrow from the Eurosystem.
  - Unclear when declaration of “failing or likely to fail” leads to bail-in.
- Supporting solvent institutions
  - Plenty of lending during the crisis to insolvent banks.
  - Assurances about solvency provided by ECB don’t mean much if months later your bank account get frozen or your investment is wiped out.
  - Evidence now that solvent banks might get closed because of liquidity problems.

ECB\EBA Stress Tests, 2016

		Transitional CET1 capital ratio			
Country	Bank	Starting 2015	Baseline 2018	Adverse 2018	Delta Adverse 2018
AT	Erste Group Bank AG	12.35%	13.85%	8.19%	-416
AT	Raiffeisen-Landesbanken-Holding GmbH	10.47%	12.36%	6.14%	-432
BE	Belfius Banque SA	15.90%	17.60%	11.41%	-449
BE	KBC Group NV	15.17%	16.18%	11.27%	-389
DE	Bayerische Landesbank	15.23%	12.41%	8.34%	-690
DE	Commerzbank AG	13.77%	13.13%	7.42%	-636
DE	DekaBank Deutsche Girozentrale	14.44%	14.17%	9.53%	-492
DE	Deutsche Bank AG[18]	13.19%	12.08%	7.80%	-540
DE	Landesbank Baden-Württemberg	16.62%	15.90%	9.68%	-694
DE	Landesbank Hessen-Thüringen Girozentrale	13.79%	14.42%	10.10%	-369
DE	Norddeutsche Landesbank Girozentrale	12.99%	13.21%	8.67%	-432
DE	NRW.BANK	42.82%	39.44%	35.40%	-742
DE	Volkswagen Financial Services AG	11.97%	12.90%	9.56%	-241
DK	Danske Bank	16.12%	17.66%	14.02%	-210
DK	Jyske Bank	16.06%	19.85%	14.00%	-206
DK	Nykredit Realkredit	19.45%	22.47%	14.19%	-526
ES	Banco Bilbao Vizcaya Argentaria S.A.	12.04%	12.03%	8.29%	-375
ES	Banco de Sabadell S.A.	11.69%	12.96%	8.19%	-350
ES	Banco Popular Español S.A.	13.11%	13.45%	7.01%	-610
ES	Banco Santander S.A.	12.71%	13.24%	8.69%	-402
ES	BFA Tenedora de Acciones S.A.U.	14.57%	15.09%	10.64%	-393
ES	Criteria Caixa, S.A.U.	11.71%	11.67%	8.97%	-273

From SRB's Valuation Report: Liabilities and Equity, March 2017

Financial liabilities held for trading	1,553
Financial liabilities designated at fair value through profit or loss	610
Financial liabilities measured at amortised cost	131,199
Liabilities of credit institutions	35,904
Deposits from other creditors	78,885
Debt certificates including bonds	13,121
Subordinated liabilities	2,031
Other financial liabilities	1,258
Derivatives – Hedge accounting	1,046
Liabilities under insurance and reinsurance contracts	470
Provisions	449
Tax liabilities	400
Share capital repayable on demand	-
Other liabilities	611
Liabilities included in disposal groups classified as held for sale	-
Net intersegments financing	-
Total liabilities	**136,338**
Capital, reserves and retained earnings	11,205
Accumulated other comprehensive income	(304)
Profit attributed to the controlling company	(137)
Minority interests (non-controlling interests)	12
Total equity	**10,776**
Total equity and liabilities	**147,114**

Are We Ready for the Next Crisis?

- My assessment is No
  - Procedures around ELA remain unclear.
  - Unofficial Euro Area policy of capping ELA and imposing capital controls provides an incentive to run on troubled banking systems.
  - Doubts about stress test evaluations of balance sheets.
  - Questions about level of support for solvent banks and fairness in treatment of creditors at resolved banks.
  - Have the EU and ECB increased or decreased the potential for self-fulfilling bank runs?