

# Liquidity Provision of the Last Resort: Who Should Do What?



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# Bagehot's Prescription



- § Lend freely, to solvent banks, against good collateral, at penalty rates
- § Not done in the Great Depression – for fear of losing gold reserves
- § In the financial crisis/euro crisis: freely, to banks of doubtful solvency, against collateral of mixed qualities, at low rates
- § Bagehot worried about viability of central banks
- § Today's naysayers worry about moral hazard and central bank profits

# Pre-Crisis Division of Tasks



- § M o U's of the early 2000s:
- § Solvency problems to be dealt with by national governments
- § Liquidity problems of individual banks by national central banks
- § Liquidity problems of the system by ECB – through market interventions
- § Result of national desires for control over banks and ECB apprehension about moral hazard in bank supervision

# Recent Issues



- § How to deal with doubts about solvency
- § How to deal with the danger of losses
- § Should ELA stay with national central banks?
  - § Moral hazard argument about supervision now goes the other way
- § What criteria for discontinuing ELA?
  - § Is ELA simply a lever for ECB power over member states?

# The Solvency Requirement



- § Bagehot's Prescription based on need to maintain viability of central bank
- § If we want liquidity support to contain contagion, why condition on solvency?
- § Example: Danat-Bank 1931 – clearly insolvent, but...
- § Counterargument: Ensure exit, reduction of excess capacities, avoid procrastination
- § Example: Cyprus
- § Do central bank losses matter?

# Liquidity Provision in Resolution



- § How much time does the SRB have to decide on a plan? See BPE experience
- § BRRD/SRM Regulation say nothing about liquidity
- § The „weekend resolution myth“
- § Resolution fund is not up to the task
- § DB or BNPParibas would need guarantees for over 1 trillion euros
- § „The ECB must do it“
- § ECB: We will not fund banks in resolution

## Reform needed



- § Either: government guarantees ensuring continued money market/large-deposit funding
- § Or: ECB funding supported by guarantees from SRM Fund (plus fiscal backstop)

# Funding for Winding Banks Down



- § How much time is there to wind down a portfolio of non-performing loans?
- § Example: FDIC and S&Ls: ten years
- § Example: Venetian banks – bad bank funded by Intesa with guarantees against losses
- § FDIC: industry levy + clawbacks – with interim funding from Treasury



# Reform Proposal



- § Shift winding down of banks out of insolvency law and to European level (SRM-AMC)
- § Levy + clawbacks (bail-in) as for FDIC
- § Ensure interim funding by???
  - § ECB with guarantees
  - § Fiscal backstop?