Liquidity and Resolution

Michael Hesketh

Florence School of Banking and Finance

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This presentation should not be reported as representing the views of the European Stability Mechanism (ESM). The views expressed are those of the author and do not necessarily represent those of the ESM or ESM policy.

Role of the ESM in this discussion

- The ESM is involved in ongoing technical discussions to establish a backstop to the Single Resolution Fund (SRF)
- If the SRF would provide liquidity, this would change the likelihood of the backstop being called and would impact on ESM's lending capacity
- The issue of liquidity in resolution was discussed in the context of designing the ESM instrument of direct recapitalisation (DRI), which will be superseded by the backstop
- DRI has never been tested but the intention was to recapitalise a bank with ESM bonds, which could be used as collateral for repos with the market or central banks

Introductory comments

- As expressed by SRB, there are issues regarding liquidity in resolution:
  - The risk that a bank emerging from resolution fails due to liquidity concerns is a real issue
  - Only viable and solvent banks should be supported with funding
  - Liquidity funding is not risk free, hence the requirement for discounting the value of collateral
- Resolution funding should ensure that a bank is solvent, but this may be insufficient to ensure that market participants view it as viable <u>at that point in time</u>
- The gap in the framework should be closed by a mechanism that provides sufficient assurance for liquidity to be made available by normal counterparties (private sources or central banks), rather than finding an alternative source of liquidity
- This implies either a credible guarantee or collateral arrangement needs to be established to ensure liquidity is provided

Public sources of liquidity

- SRB correctly highlights that liquidity should be available immediately and in a sufficient amount
- The examples given (UK and US) both rely on treasury backing for liquidity using an intermediary with knowledge of providing liquidity
- In the absence of a euro area treasury, this means an alternative solution is needed.
- Any involvement of the ECB or national central banks as liquidity provider has to respect their mandate and institutional independence.
- Within the standard collateral framework, sufficient assurance on the quality of collateral needs to be given to national central banks or the ECB.

Options to support the liquidity provider

- Several options put forward focus on some form of public support:
  - Guarantee provided by the member state
  - Guarantee provided by a public entity (e.g. SRF)
  - Recapitalising the bank with SRF bonds to be used as collateral for repos
- These would need to fit with the current regulatory framework and to be of sufficient credit quality to provide reassurance to the liquidity provider
- The ESM has been mentioned as a potential guarantee provider, but ESM does not have a guarantee instrument as an available tool. Any change would require a change in the ESM Treaty to be agreed with all Member States.
- The potential liquidity needs of large systemically important banks are big and careful design would be needed to not erode the ESM's lending capacity.

Options to support liquidity

- Regulatory compliance with collateral requirements
- Public liquidity support
- Market solution based on a collateral pool?

THANK YOU!

Name: Michael Hesketh

Position: Principal Banking Expert

Phone: +352 260 962 215

Email: m.hesketh@esm.europa.eu

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