

Last resort lending – the (still) limited role of the European Central Bank in the Emergency Liquidity Assistance mechanism

Florence School of Banking and Finance

Professor Dr. Christos V. Gortsos, *Law School, National and Kapodistrian University of Athens*

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Outline

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- II. The content of the ECB Agreement (2017): a detailed presentation
- III. Towards a revision of the existing ELA mechanism

I. Introductory remarks

1. Last-resort lending by central banks as a liquidity crisis management measure

Definition, functions and delimitation

- In accordance with the (predominant) traditional approach, last-resort lending means the provision of liquidity by a monetary authority, *i.e.* a central bank, to individual solvent banks in exceptional circumstances and on a temporary basis – this power is typically associated with central banks given the synergies existing between the provision of liquidity to the banking system, safeguarding the stability of payments systems, and ensuring financial system stability, which highlights the close relationship between the monetary and financial systems
- The term ‘**lending of last resort**’ is also used for the provision of financial support to independent states faced with financing of public expenditure and public debt refinancing problems (on an international level, this role is assumed by the IMF and on EU level by the ESM)

1. Last-resort lending by central banks as a liquidity crisis management measure

Definition, functions and delimitation

- Last-resort lending as an instrument of liquidity crisis management should be distinguished:
 - at least conceptually, from measures undertaken at the level of solvency crisis management; and
 - from monetary policy measures implemented by central banks – in both cases, central banks provides liquidity to the banking system; nevertheless, in the case of monetary policy actions, the objective is not to ensure the stability of the financial system, but to maintain price stability, the liquidity granted is not of an emergency nature, but rather permanent, and the liquidity is provided to the banking system as a whole rather than to individual banks

I. Introductory remarks

2. Principles governing the implementation of last-resort lending

- According to theory again:
 - ✓ a bank's solvency is a prerequisite for its ability to have access to lending of last resort – relevant information must be provided to the central bank by the competent supervisory authority (which may be the central bank itself)
 - ✓ last-resort lending should be provided against adequate collateral, and at a rate higher than that of monetary policy operations, on the premise that this rate should be of a punitive nature and, thus, act in a way to discourage banks, but also due to the (lower) quality of the collateral provided

2. Principles governing the implementation of last-resort lending

- The terms for exercising the power of central banks to act as lenders of last resort are not usually set out explicitly in legislative or regulatory provisions. This is attributed to the fact that, according to the principle of **'constructive ambiguity'** relating to the conditions that must be met in order for the central bank to intervene in the capacity of lender of last resort, the central bank must have the highest discretion possible to this end in order to be in a position to appropriately weigh the risks and act accordingly in each given case.

I. Introductory remarks

3. The euro area framework – documentation on the ELA mechanism

(1) Given that neither the Treaties nor the ESCB/ECB Statute contained any explicit provisions on last resort lending (and there are also no relevant provisions in the TFEU) two alternative, diametrically opposed views had been put forward:

- according to the **‘decentralised approach’**, this power should be assigned to the NCBs of the Member States whose currency is the euro;
- according to the **‘centralised approach’**, the ECB should be the competent authority, assisted by the NCBs

I. Introductory remarks

3. The euro area framework – documentation on the ELA mechanism

(2) On the occasion of the onset in 2010 of the fiscal crisis in the euro area and its negative impact on the banking system of several Member States, last resort lending to credit institutions established in euro area member states was repeatedly activated: in the 2010-2013 period, in turn by Ireland, Greece, and Cyprus, in 2014, by Portugal, and lately (2015-2018) again by Greece; this is the ‘Emergency Liquidity Assistance’ (**the ‘ELA’**) mechanism activated by NCBs-members of the Eurosystem rather than the ECB

(3) The procedural arrangements governing the provision of such liquidity had already been laid down **on 1 January 1999**, although they were not made public:

- on **17 October 2013** the GC decided to make them public by issuing a relevant Communication, and on **19 February 2014**, it approved certain, technical, specifications on these procedures, the content of which was included in a new Communication
- since **May 2017**, these procedural arrangements are laid down in its “Agreement on emergency liquidity assistance” (the **‘ECB Agreement (2017)’**)

II. The content of the ECB Agreement (2017)

1. General aspects

Scope of application – definition of the term ‘emergency liquidity assistance’

- The **ECB Agreement (2017)** acknowledges that ELA must be in compliance with the prohibition of monetary financing
- Credit institutions established in euro area Member States may draw liquidity from central banks in two alternative manners: either, as a rule, in the context of monetary policy operations or, in exceptional circumstances, via the emergency liquidity assistance. For the purposes of the Agreement, ELA occurs when *“(a) a Eurosystem NCB provides central bank money and/or (b) any other assistance that may lead to an increase in central bank money to a financial institution or a group of financial institutions facing liquidity problems, where, in either case, such operation is not part of the single monetary policy”*.
- The provision of ELA is not considered to be part of the single monetary policy in the euro area.

II. The content of the ECB Agreement (2017)

1. General aspects

Allocation of responsibilities, costs and risks

(1) The provision of ELA falls under the *main* responsibility of the NCB concerned. As a result, the provision of such assistance is at the sole discretion of NCBs, on condition of course that the ECB has not prohibited it. Hence, it is not the ECB that provides ELA and the dilemma about a lender of last resort for the euro area has been resolved in that way.

(2) The NCB concerned (or a third party acting as a guarantor) incurs any costs and risks that may arise from the provision of ELA. In practice, this means that relevant funds appear on its balance sheet and any relevant losses are debited to its financial results. In any event, pursuant to **Article 26.3 ESCB/ECB Statute**, the ECB's Executive Board draws up, for analytical and operational purposes, a consolidated balance sheet of the ESCB, comprising those assets and liabilities of the NCBs that fall within the ESCB.

II. The content of the ECB Agreement (2017)

1. General aspects

Situations where ELA may be limited or prohibited

- NCBs may provide ELA unless the GC, pursuant to **Article 14.4 ESCB/ ECB Statute**, finds that its provision interferes with the ESCB objectives and tasks. In relation to that aspect, the ECB Agreement (2017) provides also that the violation of the prohibition of monetary financing under **Article 123 TFEU** may constitute such an interference with the objectives and tasks of the ESCB
- The provision of ELA is hence assessed *ex ante* as regards compliance with the prohibition of monetary financing. ELA transactions akin to an overdraft facility or other type of credit facility for the State, in particular, any financing of the public sector's obligations *vis-à-vis* third parties, or the central bank *de facto* taking on a task of the state, violate the prohibition of monetary financing. Nevertheless, the provision of ELA to insolvent institutions and institutions for which insolvency proceedings have been initiated under national law violates the prohibition of monetary financing

ent of the ECB Agreement (2017)

ELA solvency criterion for credit institutions

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% or 8%, respectively);
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k does not comply with these standards; in duly justified,
GC may decide to prolong this 'grace period'.

II. The content of the ECB Agreement (2017)

1. General aspects

The ELA solvency criterion for credit institutions

- In principle, the solvency of credit institutions is being assessed by the authorities competent for their micro-prudential supervision (i.e. in the euro area the ECB for ‘significant’ credit institutions and the NCAs, for ‘less significant’ ones). Nevertheless, the Agreement provides explicitly that a credit institution is considered solvent for ELA purposes in either of the following two cases:
 - *firstly*, its **CET1, Tier 1 and total capital ratios**, as reported under the CRR on an individual and consolidated basis, comply with the minimum regulatory capital levels (namely 4.5%, 6% or 8%, respectively);
 - *secondly*, if the above condition is not met, there is a credible prospect of recapitalisation by which the above minimum regulatory capital levels would be restored within 24 weeks after the end of the reference quarter of the data that showed that the bank does not comply with these standards; in duly justified, exceptional cases the GC may decide to prolong this ‘grace period’

II. The content of the ECB Agreement (2017)

1. General aspects

Duration and pricing of ELA

- The provision of ELA may only exceed twelve months at the latest, following a non-objection by the GC requested by the Governor of the NCB concerned once the provision of ELA exceeds ten months. If any provision of ELA exceeds twelve months, the Governor of the NCB concerned must justify the further provision of ELA in a letter to the President of the ECB on a monthly basis, and the GC may impose additional requirements and conditions
- In the case of ELA euro-denominated reverse transactions, NCBs should in principle apply a minimum rate equal to the Eurosystem's marginal lending facility rate plus 100 basis points, irrespective of the net cost of relevant guarantees and other costs of collateral – in the case of euro-denominated intraday ELA reverse transactions, NCBs should in principle apply a minimum rate equal to 1% p.a

II. The content of the ECB Agreement (2017)

2. Flow of information, control of liquidity effects and monetary policy

The main framework

- In order to ensure that ELA operations do not interfere with the single monetary policy, the ECB must have been informed or consulted, allowing a smooth sterilisation of any undesired liquidity effects and an assessment of any systemic implications
- The information must be provided by the NCB concerned and – regardless of the size or nature of ELA operations – and consist of specific elements
- The institution receiving ELA must provide:
 - a **funding plan** within two months following the first provision of ELA, and update it on a quarterly basis until the ELA is repaid; and
 - monthly updated information on the precise level of its **regulatory capital ratios** and its **leverage ratio** as reported under the CRR

II. The content of the ECB Agreement (2017)

2. Flow of information, control of liquidity effects and monetary policy

The main framework (continued)

- An institution receiving ELA and being in breach of such own funds requirements must submit a recapitalisation plan to the ECB for assessment within a timeframe determined by the GC
- If ELA is provided for a period exceeding six months, the Governor of the NCB concerned must address a letter to the ECB President outlining the intended exit strategy from the ELA provision and for as long as the institution is receiving ELA it must update the exit strategy in case of relevant changes to the exit plan

II. The content of the ECB Agreement (2017)

2. Flow of information, control of liquidity effects and monetary policy

Size of ELA operations exceeding specific thresholds

(1) If the size of ELA operations envisaged by one or more NCBs for a given financial institution or a given group thereof **exceeds a threshold of 500 million euros**, the NCB(s) involved must inform the Executive Board at the earliest possible time prior to the extension of assistance

(2) In addition, if the size of ELA operations envisaged by one or more NCBs for a given financial institution or group **exceeds a threshold of 2 billion euros**, the Executive Board must decide in a timely manner whether the issue needs to be addressed by the GC:

- if the Executive Board concludes that there is a risk of interference with the single monetary policy, it must request the GC to take a position at short notice;
- NCBs are allowed to undertake the planned ELA operations, unless the GC decides to prohibit their execution, on the grounds that they interfere with the single monetary policy of the Eurosystem, within 24 hours of the notification

II. The content of the ECB Agreement (2017)

2. Flow of information, control of liquidity effects and monetary policy

Communication on ELA

- At their discretion, NCBs may to communicate publicly about the aggregate provision of ELA in their country, if they deem it necessary. In such a case, the NCB must notify in advance the GC with regard to the intended communication plan and content, including a communication proposal
- The communication, nevertheless, should not refer to any assessment made or decision taken by the GC, but may contain information on the ELA ceiling (including the duration of its applicability) to which the GC did not object, the actual amount of ELA provided by the NCB on average over a recent period of time, and relevant context information, if deemed helpful to facilitate a proper perception by the public. The GC may object to the proposed communication plan and content in view of the potential broader confidence and financial stability implications for the euro area

III. Towards a revision of the existing ELA mechanism

1. Differentiation according to the significance of credit institutions

- Upon the entry into operation of the SSM it is appropriate to look into the scope for differentiation on the basis of the significance of credit institutions exposed to liquidity risk – in particular, less significant credit institutions, which remain in principle under the direct micro-prudential supervision of NCAs, should reasonably continue to have access to the ELA mechanism, as currently in force
- On the contrary, as regards significant credit institutions which are under the direct micro-prudential supervision of the ECB, the eventuality of the ECB acting as a lender of last resort gains particular importance. This eventuality has quite recently (22 February 2018) been raised by the former ECB President, Mario Draghi, where he stated: *“The ELA policy should be changed and I personally have argued several times for a centralisation of ELA. This is a remnant from a past time, but to change it we ought to have the agreement of all the members of the governing council, namely all countries in fact. They have to decide that they would abandon this remnant of national sovereignty in monetary policy, because that is what it is”*

III. Towards a revision of the existing ELA mechanism

2. The advisability for the ECB to act as lender of last resort for significant credit institutions

- The arguments in favour of this power remaining with NCBs for as long as the conduct of other policies aimed at safeguarding the stability of the European banking system is decentralised have been weakened - this is not only true because their micro-prudential supervision has mainly (with regard to the specific tasks laid down in the SSMR) been transferred to an EU level, but also because the same applies to their resolution under the SRMR
- A point of concern in this context is potential conflicts of interest within the ECB arising from its function as monetary authority and lender of last resort, on the one hand and banking supervisor on the other (this applies to central banks in general) – apart from any “burden-sharing considerations”, this point of concern has been addressed in **Article 25 SSMR** with the creation of ‘Chinese walls’ between the ECB’s monetary and supervisory functions

III. Towards a revision of the existing ELA mechanism

2. The advisability for the ECB to act as lender of last resort for significant credit institutions

- As a result, there are stronger arguments in favour of the ECB acting as lender of last resort for significant credit institutions short of liquidity established in euro area Member States. Such an approach is fully consistent with the fact that several components of the bank safety net, used with a view to safeguarding the stability of the European banking system, have already been ‘Europeanised’
- Accordingly, the author argues that the ECB being lender of last resort for significant credit institutions is one of the necessary elements of a complete BU

III. Towards a revision of the existing ELA mechanism

3. The feasibility of the ECB becoming a lender of last resort for significant credit institutions

- The crucial point still is the legal basis (i.e. the feasibility of the ECB's being lender of last resort)
- The argument that the ECB may not intervene as lender of last resort in the euro area for lack of an explicit relevant provision in the TFEU and the ESCB/ECB Statute, is nevertheless contestable