

Cash outflows in crisis scenarios: do liquidity requirements and reporting obligations give the SRB sufficient time to react?

Banking Union Scrutiny

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Abstract

Bank failures have multiple causes though they are typically precipitated by a rapidly unfolding funding crisis. The European Union's new prudential liquidity requirements offer some safeguards against risky funding models, but will not prevent such scenarios. The speed of events seen in the 2017 resolution of a Spanish bank offers a number of lessons for the further strengthening of the resolution framework within the euro area, in particular in terms of inter-agency coordination, the use of payments moratoria and funding of the resolution process.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.



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Comments by Nicolas Véron are gratefully acknowledged, and Nicolas Moës provided valuable research assistance.

RESPONSIBLE ADMINISTRATOR

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LINGUISTIC VERSIONS

Original: EN

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Manuscript completed in March 2018

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EXECUTIVE SUMMARY

The European framework for bank resolution is now well established. It passed an important milestone with the resolution of a significant Spanish bank in 2017. However, the framework has been designed for slowly building solvency crises. In reality, most bank failures are precipitated by much more rapidly evolving liquidity crises, and might stretch the already complex process.

New rules on banks' liquidity coverage came into effect in 2015 and offer some safeguards against overly risky funding models that were exposed in the financial crisis. After the long period of monetary easing, all banking systems and all large banks amply meet this requirement. The root causes of bank failures – lack of profitability and solvency, or sudden reputational or integrity problems – might nevertheless still precipitate a cash crisis, and banks are vulnerable to contagion from sovereign markets.

A distressed bank's liquidity and the success of any resolution scheme will depend on both the bank's own contingency funding plans and potential official liquidity assistance. Market confidence in liquidity provision before and after resolution will limit distressed asset sales, though clearly moral hazard from overly generous liquidity support needs to be minimised. The principles designed by the Financial Stability Board, and public sector funding backstops established in the United Kingdom and United States, offer valuable models in this area.

The European resolution framework is at present still poorly prepared for a liquidity crisis involving a large cross-border bank, let alone a more systemic crisis. Decentralised implementation of emergency liquidity assistance by individual central banks, and intervention in creditor rights through payments moratoria based on national law, are incompatible with the emerging integrated euro-area banking market.

The key aspects that should be reviewed in the ongoing work on completion of the banking union are: i) strengthening of cooperation and information exchange between the European Central Bank and the Single Resolution Board, including by taking macro-prudential risks into account in planning the resolution of individual banks; ii) harmonising the use of payments moratoria across the euro area, and extending their use throughout the resolution process and across all asset classes; iii) establishing a credible and transparent liquidity backstop by the ECB to fund the resolution process, guaranteed by the Single Resolution Fund and national budgets.

1. INTRODUCTION

With the resolution of Spain's Banco Popular in June 2017, Europe's bank resolution framework is generally seen to have successfully passed its first test. Once the European Central Bank had determined that the bank was failing, the Single Resolution Board (SRB) swiftly took action. Subordinated creditors were bailed in, shareholders wiped out, and the bank was sold to the much larger Santander Bank for a nominal €1. A complex process involving multiple institutions seems to have worked efficiently. Europe delivered on the promise of not providing further taxpayer support to a failing bank, even in the case of a relatively large institution.

But a closer look reveals some shortcomings. Fortuitously, the 'sale of business' path to resolution worked because a much larger and well-capitalised domestic acquirer was at hand, and was able to inject significant liquidity and capital in the days following the resolution. No other domestic bidder showed interest, and consolidation of the bank into a stronger European institution was never a prospect. Alternative scenarios, which this time did not materialise, could easily have resulted in a significant burden on the domestic resolution fund.

More worryingly, this first test case revealed that a resolution triggered by a rapidly unfolding liquidity crisis might well strain the process. In a context of consistently negative media coverage of the bank, customer deposit outflows accelerated in the days leading up to the resolution. A lack of collateral cut the bank off from emergency liquidity assistance (ELA), for which no guarantee from the government could be obtained. Resolution could not even wait until the weekend, when an already rushed procedure would typically take place.

The EU Bank Recovery and Resolution Directive (BRRD, 2014/59/EU) and the complex interaction between the SRB, the ECB, the European Commission and national institutions seem to have been conceived for the scenario of a slow-burning deterioration in the solvency of a bank. But liquidity crises are inherent in modern financial systems. A new prudential liquidity requirement that came into effect in 2015 provides only very limited buffers in such a case. The question hence arises how the powers of the SRB and its interaction with other institutions should be adjusted, and whether additional liquidity support might be required to prepare for future liquidity crises that take individual banks to the point of failure, and possibly into resolution.

Section 2 reviews the interaction between solvency and liquidity risks at the level of an individual institution, and to what extent regulation of banks' liquidity management provides safeguards in a cash crisis. A bank's recovery and any official resolution efforts will ultimately depend on official liquidity assistance, and section 3 reviews best practices, including from the UK and US, and compares the regime in Europe. Section 4 then identifies three types of reforms that should be examined to better prepare the resolution framework for scenarios similar to the one experienced now.

2. WHAT LEVEL OF PROTECTION DO THE NEW LIQUIDITY REQUIREMENTS PROVIDE?

Banco Popular, the SRB's first full-scale resolution, was a classic case of solvency risk manifesting itself through a dramatic cash crisis. Doubts about asset quality, including the discovery of larger than anticipated impairments, and the bank's poor earnings position coupled with a questionable management record had attracted ongoing media coverage. A rapid evaporation of liquidity followed in June 2017 and prompted the resolution decision (ECB, 2017). The interaction between solvency and liquidity risks is of course common in the lead-up to bank failures, and rating agency methodologies take limited comfort from high liquidity when the earnings and solvency position of a bank is in doubt (for instance, Moody's, 2015).

2.1 The interaction between solvency and liquidity risks

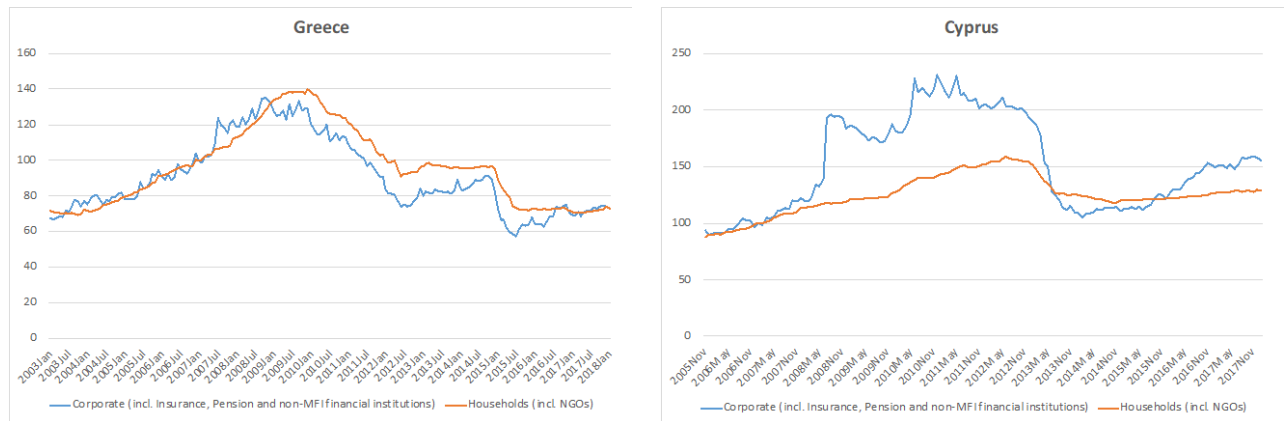
The failure to address liquidity risks has now been recognised as a major gap in prudential supervision prior to the financial crisis.

By virtue of its role in maturity transformation, a bank is by definition unable to honour full withdrawals of liabilities at any time. For an individual institution, solvency problems typically result in a funding crisis well before a supervisor sanctions inadequate capital coverage. Because the bank acquires private information about its borrowers' activities, external funding will always be plagued by uncertainty over the bank's net worth. If solvency is uncertain, further funding will become problematic, and a 'run' on deposits may result. As the bank is forced to liquidate long-term assets at a discount, solvency assessed at market prices will be further jeopardised.

These risks were well understood prior to the financial crisis, though capital regulation was seen as a sufficient safeguard to address liquidity risks. A bank with low leverage is less likely to suffer from a run on deposits. Conversely a bank that is highly liquid and hence invested in relatively safe assets will be less likely to encounter a solvency problem. Imposing a liquidity requirement as designed under the Basel III framework in addition to the traditional capital adequacy ratio will now safeguard banks to an extent against the liquidation costs arising from premature disposal of assets, and enable greater transparency of the pricing of assets that are inherently less complex.

But the financial crisis of course also revealed systemic liquidity risks. These risks arose as risk premia for government debt became correlated with the much more short-term inter-bank funding markets, where there were close inter-linkages between sovereign and banking balance sheets. As borrowing funds became prohibitively expensive, liquidity in asset markets evaporated to such an extent that asset disposals could only be done at fire-sale prices (Brunnermeier *et al*, 2009). In addition, in several banking systems, various institutions were excessively exposed to a single asset class, such as residential property. Forced asset sales by individual banks infected funding rates for the entire sector.

Rapid falls in customer deposits in some euro-area crisis countries underlined the speed with which funding problems can spread across a financial system, including to institutions that are ostensibly sound (Figure 1). For this reason, liquidity levels are now closely monitored, including for purposes of macro-prudential policy.

Figure 1: Evolution of customer deposits in Greece and Cyprus (Jan. 2007=100)

Source: Bruegel based on ECB data.

2.2 The new liquidity requirements for banks: a limited safeguard in a cash crisis

The financial crisis showed that capital regulation by itself is insufficient to prevent liquidity crises that affect individual institutions, let alone the entire financial system. Two liquidity standards were introduced as additional safeguards in the Basel III framework, and translated into EU law through the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD IV) in 2013: the liquidity coverage ratio (LCR), which is designed to secure short-term resilience by ensuring that each bank has sufficient high-quality liquid resources to withstand a stress scenario lasting one month; and the net stable funding ratio (NSFR), which essentially seeks to secure long-term stability up to one year.

The NSFR – the more demanding long-term ratio – came into effect in the EU in January 2018. The more short term LCR has been gradually phased in since 2015. The implementation within the EU of these two liquidity ratios has been largely in line with the standards defined by the Basel Committee. The so-called high-quality liquid assets that offer the most protection are narrowly defined and include assets that are liquid in private markets, eligible for central bank operations and not affected by wide price swings in times of crisis. In addition, the short term liquidity ratio makes demanding assumptions for the outflows over a hypothetical one-month stress scenario, and reflects the partial loss of deposits, a downgrade of the bank's credit rating, and greater haircuts on secured funding. Banks' coverage ratios are also very transparent, including through the disclosure guidelines finalised by the European Banking Authority (EBA) in 2017. A new EBA standard also establishes some additional safeguards on liquidity where ostensibly-liquid bank assets become compromised or encumbered.

In the case of Banco Popular, the liquidity coverage ratio clearly did not provide a sufficient safeguard against failure. Only weeks before the ECB determined that Popular was failing, a presentation by the bank's management pointed out the bank's apparently sound liquidity position, as the liquidity coverage ratio stood at 146 percent compared to the 80 percent coverage required at the time. This underlines that the liquidity coverage ratios rely on inevitably ad-hoc assumptions of outflows, and will not shelter banks from acute funding crises. Given a typical bank's high reliance on the overnight funding market, a large share of liabilities will need to be rolled over daily. While the new liquidity coverage requirement was no doubt needed given the experience of fragile funding structures ahead of the financial crisis, it is by no means a fail-safe mechanism in case of a crisis affecting an individual bank.

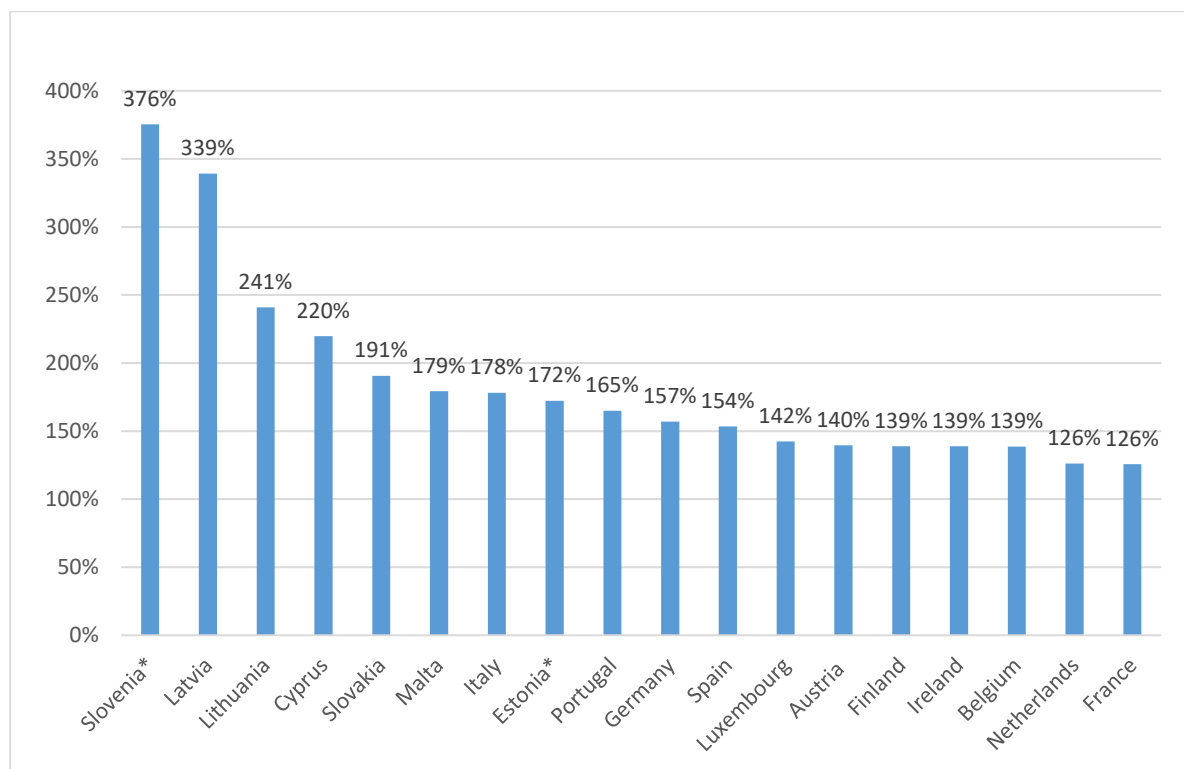
The two new liquidity ratios will nevertheless be a tool to spot strains in individual banking systems. The aim is that the new liquidity requirements will reduce information asymmetries as banks hold more transparent assets, albeit at the cost of further diminishing profitability.

EU supervisors put in place a thorough monitoring regime even before the new liquidity requirements came into effect. The European Systemic Risk Board (ESRB) in 2012 issued a recommendation that required intensified assessments of funding and liquidity risks, and more consistent risk-management policies within banks (ESRB, 2012). The 2017 update on implementation seemed to be positive on the work of national supervisors, and of course the ECB has focused additional scrutiny on liquidity risks in the euro area's largest banks (ESRB, 2017).

The EBA now regularly reports on liquidity risks. Given the protracted phase of monetary easing and subdued credit demand, liquidity levels in European banking systems are generally high. The EBA's Q3 2017 risk indicators showed the EU average LCR at 144 percent, with even the lowest quartile of banks at 133 percent (EBA, 2017b, and Table 1). Of the 134 banks that the EBA monitors, only one would have failed the LCR once it is fully phased in. While all but one bank met the ratio, specialised banks and locally active savings banks had the highest liquidity buffers, largely because of a number of derogations. Overall, the liquidity ratio has doubled since 2011, primarily through an increase in banks' holdings of high quality assets, such as government debt (EBA, 2017c).

An EBA assessment of the realism of funding plans found that banks were overly reliant on expected increases in deposits, which are uncertain because of increasing competition between institutions. The issuance by banks of securities that could be bailed in at the point of resolution (the minimum requirement for own funds and eligible liabilities, MREL) is planned for 2018 and 2019 and will be another challenge. Low capitalisation, low profitability, non-performing loans and other asset quality issues pose problems, particularly for smaller banks (EBA, 2017a).

In sum, liquidity buffers seem ample at present, even though risks might arise once the long period of accommodative monetary conditions comes to an end. The new prudential requirement for banks' short term liquidity ratios, coupled with the various macro-prudential tools, has certainly made a one-off liquidity crisis less likely. That said, such crises can still arise rapidly and with great ferocity because of underlying solvency issues, as underlined by Banco Popular, or because of reputational issues, as in the Latvian banking crisis of February 2018.

Figure 2: Liquidity coverage ratios in selected euro-area banking

* Data reported for less than three institutions.

Source: Bruegel based on European Banking Authority.

Note: Ratios refer to the regulatory definition of high quality liquid assets over potential outflows in a hypothetical one month stress scenario. The regulatory minimum was 80% in 2017, and 100% from 2018. Figures are based on the EBA survey of 164 banks.

2.3 What prompts a decision of 'failing or likely to fail'?

A bank's cash outflows will generally be the manifestation of a more long-running crisis of profitability and capital adequacy. A shock to funding will rarely be the sole cause of failure. It is of course conceivable that an otherwise sound institution is impacted by systemic risks, for instance through contagion that affects its holding of sovereign debt, which would require a more wide-ranging intervention in the sector. In general, therefore the resolution process will have sufficient time to prepare because institutions that have questionable capital adequacy are well-known.

In terms of the ultimate trigger for resolution, the current legal framework gives the ECB – as the responsible authority for taking a decision that an institution is 'failing or likely to fail' – plenty of options. Art. 18 (4) of the Single Resolution Mechanism Regulation allows that decision to be taken based on a number of factors:

- a. the bank is noncompliant with regulatory requirements for authorisation, or is likely to be in future;
- b. the bank will be insolvent in financial terms (liabilities exceeding assets);
- c. the bank is unable to pay its liabilities, or might not be able to do so;

- d. extraordinary public support would be required.

In each instance, the decision that the bank would *in future* fail to meet certain conditions (for authorisation under the CRR), or would become illiquid, must be based on objective criteria. However, in essence, there seems to be plenty of scope for the ECB to anticipate a resolution decision for a bank with an underlying capital problem, and then to take such a decision on the basis of a forward-looking judgement, including an ongoing funding crisis.

In its decision that Banco Popular was failing, the ECB was at pains to document the likely infringements of regulatory criteria and its imminent illiquidity (points a and c above)¹. Whether a sudden cash crisis triggers resolution will of course depend on the official liquidity assistance that might be made available to a bank in crisis, and also on market expectations of official funding that might be forthcoming once the resolution is triggered.

3. EMERGENCY LIQUIDITY ASSISTANCE AND RESOLUTION FUNDING IN THE EURO AREA: FIT FOR PURPOSE?

Liquidity crises, affecting both individual banks and the whole sector, are an inherent feature of financial systems. It has been a long-established principle of supervision that banks need to prepare for such eventualities through their own contingency funding plans. But ultimately, banks might need to rely on the traditional central bank lender of last resort function, which funds solvent institutions that have temporary liquidity problems.

Should it come to a resolution, the decision that a bank is 'likely to fail' will of course accelerate liquidity outflows, and access to the conventional monetary policy instruments will be frozen. It is likely that the institution that emerges will still be plagued by uncertain asset values and might not be able to access market funding in the immediate aftermath of the resolution. Official funding for the resolution process could be required where the solution relies largely on private sector involvement, as is the case when the 'bail-in' or 'sale of business' resolution tools are employed.

Private funding plans and official liquidity assistance, both before and after the point of resolution, therefore depend on each other, and form a continuum. Unless market participants see future official funding of the resolution process as relatively transparent and adequate, they might well precipitate funding outflows that could push the bank to the point of failure, or put at risk the resolution process and the extent of bail-in, which could have been quite limited. Clearly, the risk is that such official liquidity support might quickly give rise to moral hazard within banks, which will adapt their risk management in the light of the expected funding.

¹ The decision points out that the bank's own liquidity measures have been inadequate, and that ELA by the Bank of Spain similarly fell short in the days preceding the resolution decision (ECB, 2017).

3.1 High level principles from the Financial Stability Board

The Financial Stability Board's *Key Attributes of Effective Resolution Regimes* were endorsed at the 2011 G20 summit. They set out a number of principles for funding of banks in resolution². Since then, the FSB has attempted to articulate this in more detail, including through its guiding principles on funding of institutions in resolution (Financial Stability Board, 2016), and a 2017 consultation on funding strategies³.

The FSB's work of course only applies directly to the 30 globally systemically important banks (G-SIBs). However, the characteristics that distinguish a G-SIB – size, interconnectedness and complexity – are not too different from those that identify the 'significant institutions' under the ECB's supervision, or the public interest criterion that identify banks under the scope of the SRB.

The FSB recommends that the legal framework should encourage private sector sources of funding, such as through privileged senior funding status post-resolution⁴. The FSB also calls for public sector backstop funding that is large enough relative to the entities potentially subject to resolution, can be delivered rapidly, and would be available for long enough following the resolution. The FSB's 2011 Attributes already flagged up the risk of moral hazard, and the 2016 document sets out how the terms of public resolution funding could be designed in a way to discourage too-swift recourse to public funding.

3.2 Resolution funding in the UK and the US

To assess the operation of a resolution funding regime in practice, the experiences in the UK and US are instructive.

- The Bank of England views its regime as in line with the FSB principles. In addition to its usual liquidity facilities, the BoE has established a Resolution Liquidity Framework to provide liquidity in either sterling or foreign currency, and to allow the bank in resolution to make the transition to market-based funding. This remains an exceptional facility, and there is no presumption in the resolution plans that such funding would be available. The terms of funding are set in line with the need to complete the resolution swiftly, but are also sufficiently punitive to encourage the return to market-based funding, minimising moral hazard effects. This liquidity is provided through the BoE, though the central bank may in turn obtain a guarantee ('indemnity') from the UK Treasury. Crucially, no upper limit for this funding is set. Losses subsequently incurred would be recovered from the industry⁵.
- Under the US Dodd-Frank Act, the Federal Deposit Insurance Corporation (FDIC) is designated as the principal resolution authority ('orderly liquidation authority'). The Act also established a resolution fund within the US Treasury to provide temporary backstop liquidity to support the resolution. The FDIC may borrow funds equivalent to up to 10 percent of the assets of the bank in resolution from the Treasury. The Treasury's facility is not pre-funded, and funding is secured

² See attribute 6 in the FSB [Key attributes of effective resolution regimes for financial institutions](#).

³ Financial Stability Board (2017).

⁴ Key attribute 6.3, and Financial Stability Board (2016).

⁵ Bank of England (2017).

against obligations issued by the FDIC, based on the liquidation plan. This facility is given preferential ranking in the liabilities of the bank. A Department of the Treasury (2018) review of the facility proposes further strengthening the safeguards against the taxpayer becoming excessively exposed.

3.3 Liquidity assistance in the euro area

In the euro area, the official liquidity assistance regime is less well established than in the UK or US. Pre-resolution funding through emergency liquidity assistance (ELA) is under national control, and subject to widely different interpretations. There is centralised funding post-resolution for banks within the SRB's scope, though the funding through the Single Resolution Fund (SRF) is as yet miniscule, and is divided into national compartments. Funding of banks in resolution is a key aspect of the unfinished agenda on bank resolution (Schoemaker, 2016).

ELA, the official funding provided to an individual bank that is solvent but temporarily illiquid, for all intents and purposes remains a competence that in the euro area is decentralised to national central banks. The fact that ELA is limited to solvent institutions does not mean it could not be used in a resolution (where a bank fails the more onerous regulatory requirements). ELA is at the discretion of the national central bank that provides it, and is determined by widely varying tolerances for the transfer of financial sector risk to national budgets. In the case of Banco Popular, for instance, the Bank of Spain adopted a fairly restrictive stance on the required collateral. The lack of additional official funding ultimately became the trigger for the ECB's decision on the bank's failure.

However, the use of ELA by a national central bank in a resolution is heavily circumscribed. The BRRD in effect prevent banks' resolution plans from assuming ELA will be provided⁶. Moreover, above a threshold of €2 billion, the ECB Governing Council will have the option to object to a national ELA operation if it deems it to amount to monetary financing (ECB, 2017a). This is clearly a very low threshold, well below what even a mid-sized individual bank might require⁷.

The various euro-area banking crises have of course led to a relatively liberal use of the instrument. As strains in asset markets led to contagion between different institutions, ELA was expanded to cover whole banking sectors. Cumulative ELA amounted to between 65 and 88 percent of national GDP in Cyprus, Greece and Ireland (Hallerberg and Lastra, 2017).

But these were systemic crises, and it appears that recently the ECB position on ELA use in bank resolutions has hardened. It now regards responsibility for ELA as being squarely with national central banks, and use of the instrument is national prerogative, based on objectives defined by national governments (ECB, 2018). This raises the question whether a cross-border bank, with significant assets outside its home country, would still warrant assistance to the same extent. Moreover, the assessment that a bank is still solvent might need to be adapted to reflect future asset prices. Solvency beyond the point of failure is extremely fluid and hard to judge, and in the immediate aftermath of a resolution, asset prices might well remain depressed.

In sum, the framework for a public backstop mechanism to the resolution process in the euro area seems less transparent and predictable than in the UK and US, and seems to fall behind some of the

⁶ Art. 10 (3) BRRD.

⁷ ECB (2016).

criteria proposed by the FSB. This is but one of many facets of the incomplete centralisation and risk sharing within the banking union. However, the implication is that uncertain funding mechanisms will raise the frequency and severity of liquidity crises, and force more speedy resolution processes.

4. IMPLICATIONS FOR THE EU RESOLUTION PROCESS

Notwithstanding the sounder funding practices, and the additional buffer created through the LCR, banks will remain exposed to cash crises, which might still arise from underlying solvency issues or the sudden emergence of reputational or integrity risks. The LCR mitigates but does not eliminate this risk. The possibility of a resolution prompted by a rapidly unfolding liquidity crisis therefore points to the need to strengthen three aspects of the process: closer coordination between the ECB and SRB; the more extended use of payments holidays or moratoria; and more transparent and predictable funding of the resolution process.

4.1 Exchange of information between SRB and ECB

The BRRD was conceived for a scenario of a ‘slow-burning’ solvency crisis in an individual institution. The complex resolution procedures that involve the ECB, SRB, European Commission, potentially the Council of the EU and ultimately national authorities, are a stretch at the best of times, when procedures need to be completed over the course of a weekend.

A rapidly unfolding liquidity crisis will require the ECB, as the principal supervisor, and the SRB to work speedily and in lockstep. This will be essential in the first two phases of the process: the determination that the bank is ‘failing or likely to fail’, where the ECB consults the SRB, and the SRB in turn may make a determination if the ECB fails to do so; and in the second step where the SRB is in the lead in assessing potential alternative private sector solutions.

Beyond this obvious call for close and speedy coordination it is not clear that fundamental procedural changes could be made. The memorandum of understanding between ECB and SRB already establishes very close coordination⁸. To ensure a continuous information flow, the ECB is represented in the SRB Plenary, and the SRB in turn joins meetings of the ECB Supervisory Board that are relevant for bank resolution (an involvement that might perhaps be expanded). The memorandum also mandates communication at staff level, and joint on-site inspections of banks. This coordination of course also covers recovery and resolution planning.

The European Court of Auditors (2017) has identified some inefficiency in the information exchange. For instance, the SRB is obliged to make special requests to the ECB for information on liquidity and capital (European Court of Auditors, 2017). One solution could be an automated information-sharing system for bank-specific data, to which staff from both institutions would have access. But there is no suggestion in the auditors’ report that the two institutions are working at cross-purposes. There is however a need for the SRB to put its bank-specific perspective into the context of broader market conditions, and to take into account potential contagion from sovereign or international wholesale

⁸ ECB (2015).

funding markets. Access to the ECB's crisis management division, as suggested by the ECA, could be a good step in that direction.

A liquidity crisis is a crisis of confidence. Some improvements to ECB-SRB cooperation could still be made but the already complex sharing of information with a wide range of stakeholders that are involved in the resolution process, including potentially all national representatives in the Council, might well be problematic.

4.2 Moratoria

Notwithstanding the already-close collaboration, in a rapidly evolving liquidity crisis, the ECB and SRB might need more time to react. For example, the February 2018 failure of Latvian bank ABVL was successfully managed with the help of a moratorium imposed for 5 days on all payments by the bank. Such an instrument is not available under Spanish law, and events around Banco Popular therefore unfolded much more quickly. A discussion around payments moratoria in Europe has therefore revived. These are well-tested instruments in bank regulation that provide powers for the suspension of payments by a bank of certain obligations, and for a standstill on it contracting new obligations.

In a liquidity crisis such a bank holiday can be sensible to prevent a self-perpetuating bank run by the bank's depositors and other creditors. Withdrawals are not based on the intrinsic value of the bank but rather on its capital position given the fire-sale prices observed by creditors. In this situation a moratorium can be a sensible 'circuit breaker'. It would provide additional time to assess information about the true soundness of an institution and its potential failure. In a resolution scenario this might reveal a very different need for creditor bail-in.

The BRRD already mandates very limited powers for moratoria. A resolution authority may suspend payments by a bank under resolution and prevent certain enforcement actions against that bank⁹. However, these powers are only available if the bank is already in a resolution process, and moratoria are limited to two business days only.

The implementation of this aspect of the BRRD has in any case been very uneven. A survey by the Commission found widely different standards in member states in terms of the scope of liabilities covered, the agency that can activate such tools and how long they can be in effect¹⁰. National implementation practices thus, in effect, define different creditor rights in different jurisdictions. In the case of the resolution of a cross-border bank, national agencies will not be able to apply the same solutions to all parts of the bank at the same time. In a systemic crisis involving several banks, the present powers would be clearly inadequate.

Powers for a payments moratorium in the BRRD were therefore an important aspect taken up in the Commission's so-called risk reduction package of November 2016. The Commission proposed to apply this instrument also in the pre-resolution phase, to considerably extend the maximum duration of such measures and to limit differing national moratorium powers. This seemed sensible as it would facilitate more uniform treatment of creditor rights and could help in dealing with an imminent liquidity crisis,

9 Articles 69 and 70.

10 EU Commission (2016).

including during the assessment of whether the institution is considered to be failing, and to design a resolution that reflects that valuation.

While the case for payments moratoria is sound from the perspective of the resolution authority, this rationale of course needs to be balanced against the interference with creditor rights. With the prospect of more extended payments holidays before and after a resolution decision, funding terms for an institution that is considered to be at risk would deteriorate more quickly. The industry has also cautioned against the risk for margin requirements and financial netting practices, as claims on different institutions or in different jurisdictions can no longer be considered equivalent¹¹.

4.3 Funding in resolution

Where a resolution solution depends on a private sector solution – as in the ‘sale of business’, or ‘bail-in’ tools – the entity that emerges will still experience considerable funding uncertainty. Investors and depositors will question the new capital levels after the write down of claims and the entity will also be exposed to legal challenges, as is the case now with Banco Popular.

Securing the critical functions of the bank will therefore depend on funding conditions that promote market confidence. Greater certainty over the funding for an entity emerging from resolution will be reflected in reduced funding risks *ahead* of resolution.

The prevalence and severity of liquidity crises therefore calls for an urgent overhaul of the regime for resolution funding. The principles proposed by the FSB for globally systemic banks should apply in equal measure to those banks potentially subject to resolution overseen by the SRB. Banks subject to the SRB’s actions are systemic and resolution is by definition in the public interest. A sufficiently large public-sector backstop should similarly be in the public interest.

The ELA agreement between national central banks and the ECB should be revised, and a higher threshold for scrutiny by the Governing Council could reflect the potentially considerable funding needs that will need to be guaranteed by national budgets.

There is also a set of institutions for which national interest and current ELA policies will be inadequate. The potential liquidity outflows from a mid-sized bank, let alone a European G-SIB, would easily outstrip the SRF’s ultimate size. Some banks might have sizable exposures outside their home countries. Where the ECB shifts responsibility for resolution funding back to national central banks and sees it guided by national interest alone, funding support will fall short. A funding backstop provided by the ECB could be guaranteed by the SRF, including the unallocated *ex-post* contributions. This would be similar to the model used by the Bank of England, where there is no *ex ante* limitation on funding.

11 ISDA (2017). [Challenges with expanding BRRD Moratoria Powers](#).

5. CONCLUSIONS

The framework for EU bank resolution is a very recent construct that has passed its first major tests well. But it needs to be prepared for a future phase in which the normalisation of monetary policy and ongoing consolidation in a banking sector with a structural low profitability problem will no doubt lead to a higher frequency of resolutions. Some major innovations in post-crisis financial regulation act as a brake on overly risky funding models of banks, but will not shield banks from cash crises. The liquidity run and subsequent resolution of Banco Popular should be a salutary lesson in this regard.

The three proposals made in this report are in line with others in the direction of completion of the banking union. Closer coordination between the SRB and the ECB as the principal euro-area authorities would improve consistency and the speed of delivery of resolution solutions, and would ideally take into account the ECB's insight into systemic liquidity risks and potential for contagion. The other two proposals – to harmonize the use of moratoria powers, and provide a credible ECB backstop for funding of banks in resolution – relate to the need to provide an appropriate level of centralisation and liquidity where systemic euro-area banks transcend the interest and fiscal capacity of individual member states.

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This document was provided by the Economic Governance Support Unit at the request of the ECON Committee.



PE 614.508

Print ISBN 978-92-846-2725-7 | doi:10. 2861/560| QA-04-18-261-EN-C

PDF ISBN 978-92-846-2724-0 | doi:10. 2861/458922| QA-04-18-261-EN-N