

Liquidity in Resolution

Discussion paper

June 2018

Executive Summary

Over the past few years significant progress has been made in the area of bank resolution planning, however further policy initiatives that surround resolution policy still deserve consideration. Liquidity in resolution is a topic that we believe warrants further consideration, particularly within the Banking Union. This is with a view to develop a facility, or facilities, that would be available to resolution authorities were they ever required to address potential liquidity issues following a firm's entry into resolution.

Several jurisdictions have already considered this in light of recent FSB guidance on the topic and have implemented such facilities. We encourage the same considerations be made within the European Union and suggest below ideas that we hope prompt further debate on such a new resolution liquidity facility. This discussion paper considers the important role of the availability of liquidity to support a bank through resolution, including the need for a public backstop lender of last resort for liquidity purposes.

We encourage policy makers, in particular those within the European Commission, European Central Bank, and the Single Resolution Board, to work together with national resolution authorities and national central banks to deliver on a credible and transparent framework for liquidity in resolution and welcome the views of interested parties on the issue.

Introduction

As institutions continue to improve their resolvability and put in place loss-absorbing capacity, it is appropriate to further consider the framework for liquidity in resolution. In particular the role that central banks play as 'lender of last resort' and how this will interact with the relatively new concept of a bank in resolution. This short note seeks to look at this issue at a high-level, setting out industry's thoughts, but also prompting the debate around the need for clarity in this area, particularly within the Banking Union, as also commented on by the European Banking Federation¹ amongst others².

Since the implementation of resolution frameworks across the globe, institutions have been working closely with resolution authorities to develop effective resolution plans and enhance resolvability. In producing and continually improving their forward-looking play-books, institutions are working now to put in place the necessary structures and procedures to help themselves and resolution authorities effectively navigate a resolution scenario, should it ever occur.

These planning exercises are not one-off events. They are a continuous process of review. One area in particular being the planning a bank does to ensure it has sufficient liquidity, collateral available to obtain it, or other options to deliver funds as they are needed during a resolution. Sufficient funding is important to ensure that critical economic functions can continue, for market confidence in the bank and for resolution to be successful.

¹ EBF - April 2018 - <https://www.ebf.eu/regulation-supervision/discussion-paper-on-funding-in-resolution-under-brrd/>

² BBVA research - May 2018 - <https://www.bbva.com/en/publicaciones/funding-before-and-in-resolution/>

The Financial Stability Board (FSB) guiding principles on the temporary funding needed to support the orderly resolution of a global systemically important bank³ ('Guiding Principles') acknowledge that following any recapitalisation a firm may experience heightened liquidity needs generated by market volatility, uncertainty surrounding asset valuations, and by an asymmetry of information regarding the firm's viability. The Guiding Principles set out the order in which liquidity should be sourced.

While AFME agrees that the primary source of liquidity for a firm in resolution should be the firm's resources and access to private sources of funding, we believe that it is important that there is clarity that banks in resolution have access, if necessary, to a temporary public sector backstop for liquidity purposes. This was recognised in the FSB draft guiding principles on "funding strategy elements of an implementable resolution plan", which recognised that *"an effective temporary public sector backstop funding mechanism should be available for use when necessary in order to provide temporary funding or promote market confidence and to encourage private sector counterparties to provide or continue to provide funding"*⁴.

Such mechanisms are already in place in a number of key jurisdictions, including the United Kingdom and the United States of America. The Bank of England (BoE) has set out its approach to include a Resolution Liquidity Framework (RLF)⁵, which would allow the bank in resolution to obtain liquidity to assist in the transition to market-based funding, albeit subject to appropriately punitive conditions to minimise moral hazard. This has been explained in further detail in a Memorandum of Understanding (MoU) presented to the UK Parliament⁶. In the U.S, the Federal Deposit Insurance Corporation (FDIC) may borrow funds from the US Treasury, which is equipped with a resolution fund to provide temporary backstop liquidity⁷.

However, such a degree of clarity is yet to be provided elsewhere in the EU, particularly in the Banking Union. Member States such as Sweden have begun to set out the importance of temporary funding mechanisms for banks in resolution⁸, but AFME believes that further clarity is required within the Banking Union.

We discuss below potential sources of funding for a bank in resolution including options for how an effective temporary public sector backstop mechanism could be put in place under the Banking Union.

Liquidity as distinct from solvency support

It is very important to understand the distinction between liquidity and loss absorption. The suggestion of a public sector liquidity backstop should not be confused with taxpayer-funded bail-outs, or losses being placed upon public institutions. The BRRD framework requires banks to have sufficient loss absorbing capacity to enable losses to be absorbed and the institution recapitalised. This is distinct from the question of liquidity funding for a bank in resolution. Provision of liquidity to banks is a well established principle and if done correctly does not involve the public sector taking on losses of the institution. This is reflected in the words of Ben Bernanke in his comment piece on the Orderly Liquidation Authority (OLA), which provides a liquidity backstop facility for firms in resolution in the U.S. *"A temporary liquidity backstop is likely to be necessary to maintain critical operations as the firm is restructured... Importantly, though, these loans are limited in size and are temporary funding, not permanent capital. They are backed by first claims on the firm's assets and—if that is not enough—by an assessment on other large financial firms. The one group that is guaranteed not to see losses in an OLA is taxpayers."*⁹ We discuss below potential "safeguards" to address any potential moral hazard or risk to taxpayers.

³ FSB - August 2016 - <http://www.fsb.org/wp-content/uploads/Guiding-principles-on-the-temporary-funding-needed-to-support-the-orderly-resolution-of-a-global-systemically-important-bank-%E2%80%9CG-SIB%E2%80%9D.pdf>

⁴ FSB - November 2017 - <http://www.fsb.org/wp-content/uploads/301117-2.pdf> (Section 4: Temporary public sector backstop funding mechanisms and ordinary central bank facilities) page 15.

⁵ Bank of England - October 2017 - <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability/resolution/boes-approach-to-resolution.pdf?la=en&hash=8213BE00D67C4CADB948D51FEBD164E136A70BE6> (Box 2 – page 22)

⁶ Her Majesty's Treasury - October 2017 -

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/652187/Memorandum_of_Understanding_on_resolution_planning_and_financial_crisis_management_October_2017.pdf

⁷ European Parliament, Economic Governance Support Unit, April 2018 (PE 614.508) -

http://www.europarl.europa.eu/thinktank/en/document.html?reference=IPOL_IDA%282018%29614508

⁸ Riksgälden – March 2018 – Hans Lindblad's speech "Resolution – a paradigm shift in terms of how we handle banks in crisis". Page 5,

https://www.riksdagen.se/globalassets/dokument_eng/financial-stability/euromoney_eng.pdf

⁹ Ben Bernanke - former Chairman of the Federal Reserve - <https://www.brookings.edu/blog/ben-bernanke/2017/02/28/why-dodd-franks-orderly-liquidation-authority-should-be-preserved/>

Potential sources of liquidity and the role of central banks

At a very high-level there are two types of sources of liquidity that may be utilised by a firm. That from the private sector and (in extremis) from a public source, typically a central bank in its role as Lender of Last Resort (LOLR).

Private sector sources of liquidity are the only source of liquidity that institutions can consider in their resolution planning as per Article 10 of the Bank Recovery and Resolution Directive (BRRD)¹⁰. We agree that private sources should remain the primary source of funding for firms in resolution and reflected in resolution planning. In addition to resolution planning, there has been a very significant increase in emphasis of supervision of liquidity, together with the introduction of the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR).

However, as set out in the draft FSB guidance, we also believe that a credible, clear, temporary public sector backstop mechanism is important to provide confidence in the resolution, making private sources more likely to be available in the market, support any temporary gap in market funding and support the success of the resolution. While a firm's own resources are expected to be a source for liquidity, were financial markets to be disrupted following the entry into resolution of one or more institutions there may be difficulty for that firm to obtain additional privately sourced funding. The Guiding Principles acknowledge this, stating "*Historical experience, however, suggests that such private funding support is likely to be limited in size and challenging to obtain when markets are broadly under stress*".

This shortage of available liquidity would not in of itself indicate the failing of the firm in resolution, or indeed its ex-ante planning. Instead it may come about due to an underlying lack of information in the market in relation to the institution that is undergoing (or has recently come out of) a resolution process. It could also be impacted in a systemic crisis where normal sources of private funding are unavailable.

Options for a temporary public sector funding backstop

It is important to consider the most appropriate mechanism to perform the role of a temporary public sector backstop for liquidity in resolution. In our view, central banks are likely to be best placed to provide the necessary liquidity in the volumes that may be required within a short space of time. We support the proposed FSB guiding principles that public sector backstop funding mechanisms should be:

- Credible in terms of size and sufficiently large to support the orderly resolution of potentially multiple large banks simultaneously;
- Capable of delivering temporary funding with sufficient rapidity; and
- The term of funding being sufficient to allow the bank in resolution to regain access to private sources of funding.¹¹

In the Banking Union the Single Resolution Fund (SRF) can be utilised for liquidity purposes. Currently the SRF does not have access to a credit line and does not have the resources to deploy the significant amounts of liquidity that may be required. As noted by the Chair of the Single Resolution Board, Elke König, "*Our fund will never be sufficient to be the sole answer and this means an important role for central banks, in particular for the European Central Bank*"¹². A similar acknowledgment came from Yves Mersch, who recently gave a lecture on central bank financing in resolution and questioned the adequacy of the fund in the event of a large and widespread financial crisis, particularly given the lack of a fiscal backstop.¹³ For this reason the interaction between central bank liquidity in resolution and the role of the SRF should be considered as part of the resolution funding framework in the Banking Union. While the SRF itself may not be sufficient for the provision of liquidity, it could potentially play a role in supporting the provision of private or central bank funding, for example through acting as a guarantor to private or central bank funding, ensuring that any losses would be borne by the industry.

¹⁰ BRRD (DIRECTIVE 2014/59/EU) - May 2014 - <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>

¹¹ GSB Guiding Principle 2

¹² Reuters - April 2018 - <https://www.reuters.com/article/us-ecb-banks-cash/ecb-could-provide-cash-to-failing-banks-if-conditions-met-coeure-idUSKBN1HU26A>

¹³ Yves Mersch, ECB – January 2018 - <https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180130.en.html>

Broader discussions on the SRF itself will also need to be taken forward in parallel with this debate. In particular on the need to establish a fiscal backstop to the SRF. This is the subject of ongoing inter-governmental discussions, as well as a legislative proposal published in December 2017 by the European Commission¹⁴. Mario Draghi, President of the ECB, recently commented on the case for a fiscal backstop to the SRF to complete the backing union *“Resolution needs financing, and the Resolution Fund, which is funded by banks, will ensure that it is paid for by the private sector. But in a very deep crisis, the resources of such funds can be depleted. That is why in all the other large jurisdictions, such as the US, the UK and Japan, resolution funds are backstopped by the fiscal authority. The aim of such backstops is not to bail banks out: any funds borrowed are repaid by the private sector over time. Rather, the aim is to create confidence that bank resolution can always be enacted efficiently, which has a stabilising effect in a crisis and prevents more banks from being dragged into difficulties.”*¹⁵ AFME welcome the comments from President Draghi and the European Commission’s proposal for a backstop facility to the SRF, made available by the proposed European Monetary Fund. AFME supports the development of the backstop and encourages progress to be made on its delivery.

We believe that alongside this a broader consideration of provision of liquidity support, as discussed in this paper, is necessary. In our view the most appropriate source of temporary public liquidity provision to a bank in resolution is likely to be the central bank.

Central banks already have various liquidity facilities available to banks and are well established at performing the function of “lender of last resort”. Funding is generally available secured against eligible collateral and at a punitive rate. This is only possible where certain conditions are met – most importantly that the institution be solvent. Currently national central banks are responsible for such Emergency Liquidity Assistance (ELA) in the euro area.

It is possible that these facilities should be open to a bank in resolution, or that a new facility, or facilities, specifically for this purpose be created. A bank in resolution, or immediately having exited resolution, will be freshly recapitalised. It will be solvent and viable. In addition to this, central banks are the only entities that can provide the adequate quantum of liquidity that may be necessary for a large bank in resolution, especially during times of broader market distress. As discussed below, central banks may also have swap lines in place enabling them to advance liquidity in other currencies if required.

However, it is important that it is clear to the market how any temporary public liquidity facility will operate with respect to a bank in resolution. There should be a clear and public communication of the policies that govern the use of the facility. Transparency surrounding the decision-making process that governs any deployment of liquidity is crucial. The very existence of the facility itself may bring greater confidence to markets, consequently reducing the need for its use. This is similar to deposit insurance, in that by explicitly providing depositors with a set level of cover they are less likely to withdraw deposits en-masse. In turn this reduces the risk that depositors of the institution would in fact incur any loss to their deposits.

In the past the key argument against providing clarity about the conditions surrounding any central bank liquidity provision, was that of moral hazard. In providing a clear means for institutions to access liquidity from a central bank, the fear was that institutions could exploit this by taking excessive risks knowing there would always be a central bank to help provide liquidity. The ensuing policy of “constructive ambiguity” from central banks is arguably no longer relevant in today’s post-crisis world. Today there are significant requirements for banks to maintain internal liquidity resources (e.g. the LCR), supported by greater supervisory focus on banks’ liquidity profiles. The EBA’s own analysis shows us that at end-Q42017, the weighted average LCR was in excess of 40% above the level required¹⁶, with over 25% of banks meeting more than double the level required.

The creation of resolution regimes means that banks can fail and will now be able to be put into resolution. Shareholders and creditors bear losses, not the taxpayer; management can be removed with past remuneration clawed-back where necessary; banks no longer benefit from an implicit state guarantee. Moral hazard has therefore been significantly reduced if not entirely eliminated as a result of post-crisis reform and

¹⁴ European Commission - <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52017PC0827>

¹⁵ Mario Draghi, ECB - May 2018 - <http://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180511.en.html>

¹⁶ EBA – see page 26 - <https://www.eba.europa.eu/documents/10180/2175405/EBA+Dashboard+-+Q4+2017.pdf/d429ed31-65ba-498b-9115-d0e4639112ac>

we therefore believe that the need for clarity outweighs any concerns about moral hazard. Where any such concerns remain, these can be addressed through appropriate safeguards as discussed below.

Some central banks have acknowledged this, for example Minouche Shafik, former Deputy Governor of the Bank of England, explained:

“Historically, one of the arguments for having ambiguity over the Bank’s provision of liquidity insurance, particularly against a wide range of collateral, was that clarity would induce moral hazard. ... Acting as a mitigant against this, the expansion of the Bank’s liquidity provision capabilities has gone hand in hand with two other key developments: the introduction of stronger liquidity regulation requiring banks to hold more liquid assets and the creation of a resolution regime which makes it more credible that firms will be allowed to fail in an orderly manner. Taken together, liquidity insurance, the resolution regime and microprudential supervision provide a framework of incentives for banks to manage their liquidity.”¹⁷

Given the progress that has been made in prudential and resolution policy, it now makes sense to reassess, and where necessary rethink, the roles of certain bodies such that they reflect the reality of the world as it is today. This includes central banks as LOLR, and the role they could play in resolution.

Sir Paul Tucker, Chair of the Systemic Risk Council, and former Deputy Governor of the Bank of England is clear in his support for such a proposition *“More central banks need to make this change clear in public statements of their LOLR principles. Indeed, they ought to be shouting from the rooftops about this general transformation. Concretely, I would like to see them open each and every speech on their LOLR role and responsibilities with a disquisition on the ‘revolution in resolution policy and technology’.”¹⁸*

While consideration could be given to clarifying the ability of banks in resolution to access existing facilities, we believe that the clearest approach would be to develop a specific facility for temporary funding of a bank in resolution, i.e. a Resolution Liquidity Assistance (RLA) facility. This would provide a clear approach and enable consideration to be given to the specific conditions that are relevant to a bank in resolution. For example, consideration could be given to potential use of such a facility (or facilities) in conjunction with a guarantee from the SRF, the scope of eligible collateral and the need to support the resolution objectives.

Safeguards / Conditions for funding

With central banks being the only plausible source of non-private liquidity, both in going-concern and resolution scenarios, the conditions under which central bank money can be lent to institutions should also be made clear ex-ante. Such conditions should be set to dis-incentivise firms from using public sources of liquidity unless it truly is a last resort measure, to reduce any moral hazard, but also to encourage them to turn to private sources at the earliest possible opportunity. The FSB Key Attributes set out under ‘KA 6.4’ a minimum set of conditions that should apply in any provision of temporary funding by public authorities. These are further developed in the Guiding Principles.

We agree with the FSB Key Attributes and Guiding Principles regarding the conditions surrounding the funding of firms in resolution and seek to build upon these. As such we suggest that the following conditions would provide an appropriate basis to underpin any resolution liquidity assistance provided by central banks:

- A determination has been made that the provision of temporary funding is necessary to foster financial stability and will permit implementation of a resolution option that is best able to achieve the objectives of an orderly resolution;
- that private sources of funding have been exhausted or cannot achieve these objectives effectively;
- The bank has been, or is in the process of being recapitalised through bail-in or other resolution tools;
- any provision of temporary liquidity support from a public sector backstop mechanism should be accompanied by intensified supervision by supervisory and/or resolution authorities as appropriate;

¹⁷ Bank of England - Goodbye ambiguity, hello clarity: the Bank of England’s relationship with financial markets, 25 February 2015:

<https://www.bankofengland.co.uk/speech/2015/goodbye-ambiguity-hello-clarity-the-boe-relationship-with-financial-markets>

¹⁸ Sir Paul Tucker - ADI/BIS FSI Conference, Basel, 1 February 2018 - https://www.bis.org/fsi/p180209_tucker.pdf

- The liquidity is dedicated to sustain the credit institution in the execution of the resolution strategy;
- The financing is temporary and must be replaced by private funding as soon as possible - the term of any temporary funding provided by public sector backstop mechanisms should generally extend no longer than needed to maintain continuity of critical functions to achieve an orderly resolution, but sufficiently long to allow the GSIB in resolution to regain access to private sources of funding;
- The liquidity is provided at a penalty rate but without deteriorating the solvency capacity of credit institutions;
- The liquidity is secured, with some flexibility depending on the situation – i.e. if the SRF is used as a guarantor (potentially with its future backstop through the European Monetary Fund) or where the collateral that could be provided by the resolved entity is broader than that under the ‘Emergency Liquidity Assistance’ collateral framework. Where collateral is required in the absence of a guarantee, haircuts should be prudently calibrated to provide for a source of repayment from the assets of the firm in resolution;
- the allocation of any losses, should they occur, be allocated to the institution and the industry through ex-post assessments. The liquidity enables the stabilisation of the bank after entry into resolution by providing confidence to markets and clients. It avoids moral hazard given its limited duration and its penalty rate, and the fact that it is only available in resolution. Existing monitoring of asset encumbrance enables identification of available collateral.

Further conditions surrounding the super-priority of claims for the facility on the institution in resolution should be investigated. In the U.S., where liquidity is provided from the US Treasury facility in resolution, it is given preferential ranking in the creditor hierarchy. Whilst this may be beneficial from the view point of the facility it would be necessary to carefully consider how this would interact with the broader creditor hierarchy and the impact on private sources of liquidity. Were such a super-priority to be considered we would encourage analysis be undertaken to properly assess the impact of such a policy on the broader objective of encouraging the transition back to private funding sources and broader impacts. Other safeguards, as mentioned above such as a claim on the SRF as guarantor may be more aligned with the wider policy intention. Such an arrangement may negate the need for super-priority and should give confidence that the facility would not stand to make a loss.

Where a resolution liquidity facility is provided for, it is vital that it is clear how the resolution authority can utilise it, and under what conditions liquidity can be obtained. The level of transparency provided should be such that the resolution authority is able to plan for any potential use of the fund (outside of the resolution planning process) and with full knowledge of when and to what extent the facility can be accessed. Ambiguity as to the availability of the facility during the resolution of an institution is neither constructive nor conducive to a credible and effective resolution process.

Cross-border considerations

When addressing planning for funding in resolution, it is important to consider cross-border issues such as liquidity needs in differing currencies. As explored in the Guiding Principles¹⁹, home and host authorities should cooperate through Crisis Management Groups and resolution colleges to support the consistent and effective implementation of group-wide and local resolution funding plans. Effective cooperation and information sharing between authorities is vital to support this. Resolution authorities should liaise with each other to develop preparations in order to operationalise any necessary actions as set out under Section 6 of the Guiding Principles. These include developing approaches to address currency mismatches and enable the rapid provision of liquidity in different currencies.

¹⁹ FSB – August 2016 – Section 6 page 17 - <http://www.fsb.org/wp-content/uploads/Guiding-principles-on-the-temporary-funding-needed-to-support-the-orderly-resolution-of-a-global-systemically-important-bank-%E2%80%99CG-SIB%E2%80%99D.pdf>

AFME strongly believes that arrangements should be made to ensure liquidity can be provided in certain key currencies, or at the very least to ensure that currency swaps can be entered into to secure funding across relevant currencies. The ECB is well placed in this regard, given the reserve currency status of the Euro, and the recognition of the ECB as an independent, trusted, and leading central bank.

Further ahead it should be considered how central banks could work together across the globe to provide multi-currency liquidity in resolution and set out a global policy in this regard to provide confidence and transparency in global cooperation.

One further cross-border aspect to consider, particularly within the EU, is the impact of internal requirements on the availability of both liquidity and collateral in resolution. In the absence of adequate waivers within the EU (or at the very least within the Banking Union) liquidity and collateral may become trapped within entities of a banking group, with such resources being unable to be transferred or utilised elsewhere to support a group's resolution. Where liquidity is trapped then both the prospect of illiquidity and the point-of-non-viability can be accelerated. Where collateral is not accessible this may complicate the provision of liquidity in resolution, e.g. if it is trapped in a subsidiary within a host member state. As greater levels of such ring-fencing are observed there is likely to be a greater need for an RLA facility. We would therefore encourage policy makers to consider the impacts higher intragroup requirements (e.g. internal MREL and solo liquidity requirements) have on the availability of liquidity and collateral, and the increased importance of such resolution liquidity facilities.

Conclusion

Liquidity in resolution is an important topic that warrants further consideration, particularly with regard to the development of a temporary public backstop for liquidity in resolution. Providing a clear and transparent means by which firms in resolution can obtain liquidity is vital to deliver upon the FSB's Key Attributes and subsequent Guiding Principles.

We welcome the opportunity to discuss this issue further and look forward to working with policymakers on this topic.

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