Central Bank Lending of Last Resort

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Terminology: liquidity

How to define Lending of Last Resort?

- Central bank measures that lead to increases in liquid assets for eligible counterparties

Terminology: role of central banks

- Conventional monetary policy operations
  - Little interference in liquidity management of banks and measures exclusively for purposes of monetary policy, regularly to guarantee, above all, (internal) price stability
    - Reserve requirements as percentage of eligible liabilities
    - Open market transactions
    - Short-term lending under standing facilities
- Conventional ELA
  - Lending to individual solvent banks experiencing temporary liquidity shortages

Terminology: Traditional ELA approach

- LoLR requires
  - Solvent banks
  - Adequate collateral
  - Above market interest rates

- And central bank exercises
  - Constructive ambiguity

Terminology: non-standard MP operations

- Unconventional monetary policy
  - Heavy interference in liquidity management of banks for macroeconomic purposes
    - High-volume and longer-term market transactions such as asset purchases and lending with long-term maturity
- Identical with general LoLR for pan-sectoral purposes
  - For reasons of financial stability, thereby distinguished form open market operations for sole purpose of monetary policy?

Terminology: narrow and wide understanding

- Narrow definition corresponds to the traditional understanding of LoLR, nowadays commonly referred to as Emergency (Liquidity) Assistance

- Wide definition cannot be distinguished from unconventional/non-standard monetary policy measures as seen during the financial crisis because non-standard monetary policy measures pursue several objectives

LoLR from 2007-2016

- Unprecedented need for liquidity in the entire financial sector in the U.S. and Europe from mid-2007 to early 2009 (peak of the global financial crisis)
- While granted directly to institutions, such LoLR was aimed at markets
  - unlimited (short-term) lending
  - complemented by large-scale asset purchase programmes
    - To provide liquidity in illiquid market environments
    - In the Euro zone additionally to provide markets for sovereign debt instruments

LoLR from 2007-2016

- Unconventional monetary policy became the new standard for many years (above all in the Eurozone)
- Problematic developments:
  - collateralization requirements lowered, leading to risk exposures of central banks
  - central banks venturing into monetary financing of banks (and with QE of other holders of eligible assets)

LoLR from 2007-2010

FED system:

- Special conditions applied to **primary** lending facility from 17 August 2007 to 19 February 2010:
  - spread between the primary credit rate and the target federal funds rate (penalty interest) was reduced from 100 to ultimately 25 basis points,
  - maturity was extended from overnight to ultimately 90 days
- BUT
  - Recipients of PCF (and TAF – next slide) were financially sound,
  - High collateral requirements applied without exception,
  - Senior creditor status of FED beyond collateralized assets.

LoLR from 2007-2010

FED system:

- Primary Credit Facility (PCF) experienced acceptance issues (stigma)
- Introduction of a tender procedure with auction-determined interest rates
  - Term Auction Facility (TAF)
  - proved significantly more popular

LoLR from 2007-2010

FED system:

- Institutions that did not qualify for the primary credit facility could receive **secondary credit loans**
- Purpose: bridging liquidity shortages until market lending became available or resolution was unavoidable
  - Moderate penalty rates (50 basis points),
  - Restrictions on the usage of secondary credit extensions,
  - Higher haircuts on collateral,
  - Stricter oversight.

LoLR from 2007-2010

FED system

- Special programmes (AMLF, DMLF et al.) for non-deposit taking institutions:
- Based on sec 13(3) Federal Reserve Act
  - Used for the first time since the 1930s
  - Highly criticized creation and funding of SPVs (Maiden Lanes) for 'balance-sheet' cleansing of non-banks (purchase of toxic financial instruments)
  - Beneficiaries were Bear Stearns and JP Morgan (for the acquisition of BS) and American International Group (AIG)
- Such measures are now limited as a result of amendments to sec 13(3) FRA under Dodd Frank: "any emergency lending program or facility is for the purpose of providing liquidity to the financial system, and not to aid a failing financial company"

LoLR from 2007-2016

Eurosystem:

- Standing facilities (overnight lending)
- Main (normally one week) and longer-term **refinancing operations** (normally 3 months, exceptionally up to 48 months)
  - Collateral requirements eased
- Massive asset purchase programmes
  - Securities Markets Programme (SMP)
  - (Potentially) Outright Monetary Transactions (OMT)
  - Expanded asset purchase programme (APP) and corporate sector purchase programme(CSPP) = “QE”

LoLR from 2007-2016

Eurosystem

- No individual lending to individually affected institutions
  - Fiscal facilities stepped in to provide capitalization
    - Euro-area governments supported by EFSF and ESM
    - ESM authorized to capitalize directly (no execution as to date)

LoLR from 2007-2015

- All generally applied lending facilities require collateral, in theory “adequate” collateral
- Adequacy was adjusted to deteriorating asset ratings but (partially) compensated by higher haircuts
  – By the FED system for recipients under individual lending programmes
  – By the Eurosystem for all open market operations (especially in terms of sovereign debt)

ELA in the Eurosystem

Official statement (Eurosystem):

- Euro area credit institutions can receive central bank lending not only through monetary policy operations but exceptionally also through emergency liquidity assistance (ELA).
- ELA means the provision by a **Eurosystem national central bank** (NCB) of
  - central bank money and/or any other assistance that may lead to an increase in central bank money
  - to a solvent financial institution, or group of solvent financial institutions, that is facing temporary liquidity problems, without such operation being part of the single monetary policy.
- Responsibility for the provision of ELA lies with the NCB(s). This means that any costs of, and the risks arising from, the provision of ELA are incurred by the relevant NCB (no sharing of expenses – losses – among the Eurosystem members)

ELA in the Eurosystem

- However, Article 14.4 of the Statute of the European System of Central Banks and of the European Central Bank assigns responsibility for restricting ELA operations to the Governing Council of the ECB if these operations interfere with the objectives and tasks of the Eurosystem.
  - NCBs must inform the ECB of the details of any ELA operation, at the latest within two business days after the operation was carried out.
  - Governing Council can restrict or prohibit ELA with two third majority

ELA in the Eurosystem

- In the event of the overall volume of the ELA operations envisaged for a given financial institution or given group of financial institutions exceeding a threshold of €2 billion, the Governing Council will consider whether there is a risk that the ELA involved may interfere with the objectives and tasks of the Eurosystem. Upon the request of the NCB(s) concerned, the Governing Council may decide to set a threshold and not to object to intended ELA operations that are below that threshold and conducted within a pre-specified short period of time. Such threshold may also refer to several financial institutions and/or several groups of financial institutions at the same time.

ELA in the Eurosystem

- Greek banks profit from a mix of general lending facilities and ELA.
  - Collateral adequacy requirements for Greek sovereign debt have been suspended for years to enable Greek banks to draw on standing facilities.
  - At times when their solvency seems particularly problematic or when the Greek government does not adhere to requirements of conditionality for its borrowing from Euro zone financial facilities, the Eurosystem suspends the suspension and the Greek national bank provides ELA to Greek banks for the same type of collateral that does no longer qualify as collateral for Eurosystem lending.
  - Difference: Under ELA Bank of Greece is solely liable for incurred losses (more theory than fact?)

ELA Eurosystem

- Issues:
  - “National solution” incompatible with design of the Eurosystem?
  - Counterproductive in light of centralized resolution mechanisms (Single Resolution Mechanism)?

Future of LoLR

- Lessons from the past:
  - Illiquid banks queuing in front of central banks cannot be turned away and allowed to collapse (systemic risks)
  - What about banks with solvency issues?
- Resolution mechanisms may be insufficient
- Resulting question:
  - Should the scope of application of LoLR be broadened to cover such banks?
  - Put differently: is the Bagehot model outdated and should central banks be allowed to bear the risk of insolvency of recipients of LoLR?

Future of LoLR

- Central banks cannot go insolvent like entities of private law
- Central bank activities show in their balance sheets and their lending activities are reflected as debt
  - Losses will affect their capital
  - Negative capital of central banks leads – as any form of monetary financing in general – to severe reputational loss for the currency and sovereign

Future of LoLR

- **General** monetary policy mechanisms must provide sufficient liquidity to all banks in times of general liquidity crunches
  - Scope of application must be wide but exclude banks with solvency issues to avoid LoLR "stigma"
- **Special** ELA programmes may be unavoidable for individual banks not meeting the general lending requirements
  - Justifiable by financial stability considerations if temporary
  - Such measures must be closely coordinated with resolution mechanisms and authorities and short-term in nature

Future of LoLR

- Principles of solvency and adequate collateral should remain strictly applicable
- Exceptions may be unavoidable, but must
  - be temporary,
  - be coordinated with resolution authorities, and
  - not lead to (systematic) monetary financing or recapitalization of banks or losses for central banks.

Future of LoLR

- Concept of **“constructive ambiguity”** seems outdated
  - FED system, Eurosystem and BoE have publicized their principles of LoLR lending
  - For reasons of reliability and trust in financial markets, availability of LoLR should not be subject to ambiguity
  - Moral hazards can be dealt with by bank regulation and strict conditionality

Future of LoLR

- Concept of **“penalty rates”** seems counter-productive
  - Increases financial difficulties
  - Stigmatizes

Future of LoLR

- **Lending to non-bank financial institutions?**
  - Privilege of banks as the mirror-image of strict regulation and special role in monetary policy transposition
  - Moral hazard issues
- BUT: as non-bank financial ('shadow banking') sector grows, regulation tightens
- **Essential criterion: in the interest of financial stability**
  - Argument: only central banks can afford to take temporarily untradeable assets on their books and wait until market prices recover

Legal aspects

- Authority of central banks to provide LoLR
- Mandate of central banks:
  - Assigned tasks exercised in light of objectives

Legal aspects

- Explicit and clear lending authority under FED Reserve Act
- General authority of the Eurosystem to engage in open market operations with banks
  - Subject to narrow Eurosystem objectives
    - Primary objective of (internal) price stability
    - No peer objective of financial stability

Legal aspects

- The **Eurosystem** pursues the objective(s) stipulated in article 2 ECB/ESCB statute:
  - (…) the primary objective of the ESCB shall be to *maintain price stability*. Without prejudice to the objective of price stability, it shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union (…)

Legal aspects

- No large-scale liquidity distribution to the banking (or financial) sector **if incompatible with ‘single mandate’**
- Generally **no ELA to individual institutions** since at very best in the interest of financial stability, but never required for purposes of monetary policy

Legal aspects

- Exception in case of SIBs supervised under the SSM?
  - Tasks to be read in light of objectives

- Article 3 ECB/ESCB statute defines the tasks of the **Eurosystem:**
  - to *define and implement the monetary policy of the Union*;
  - to conduct foreign-exchange operations (…);
  - to hold and manage the official foreign reserves of the Member States;
  - to promote the smooth operation of payment systems”.
  - In addition, it was recently tasked with the *supervision of all systemically important banks in the Euro area* under the Single Supervisory Mechanism (SSM) which reflects the further task in article 3(3) according to which “(…) the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions **and the stability of the financial system**”.