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Emergency Lending Assistance

Information about the role of emergency lending assistance in **recovery and resolution**, and about its **terms and conditions**, **eligibility criteria**, **management**, and **relationship to the standing liquidity facility**.

Emergency Lending Assistance, or ELA, is a loan or advance to eligible financial institutions (FIs) and financial market infrastructures (FMIs) at the Bank of Canada's discretion.[1] The provision of ELA is extraordinary and designed to provide last-resort liquidity to individual FIs or FMIs that are facing serious liquidity problems.

These entities – FIs and FMIs – are critical players in the financial system susceptible to large and sudden liquidity shocks. Deposit-taking FIs make loans to individuals and businesses, partially financing them through redeemable retail deposits and short-term wholesale funds. If an otherwise sound FI experiences a large and sudden withdrawal of deposits and wholesale funds, it can become illiquid owing to a mismatch in the timing of cash inflows and outflows. Payment clearing and settlement systems, or FMIs, can also experience liquidity shortages under extreme scenarios such as multiple member defaults.[2] While an FMI must have adequate financial resources and arrangements to manage extreme but plausible scenarios, these may not be sufficient under every scenario.

ELA is not intended to address broader, more severe system-wide liquidity shortage and is distinct from other extraordinary liquidity facilities that may be activated during times of funding market stress and made available to a broad set of participants.[3]

ELA's Role in Recovery and Resolution

ELA can play a role in both the recovery and resolution of an individual FI or FMI:

Recovery

An FI or FMI under extreme stress can trigger a process known as recovery, whereby the entity takes actions to restore the market's confidence in its financial soundness. ELA can provide liquidity in support of recovery actions undertaken by an FI.[4]

Resolution

Should recovery actions be insufficient to mitigate stress faced by an FI or FMI, the firm's resolution authority could place the FI or FMI into resolution. At the point of entering resolution, the FI or FMI would be deemed "non-viable." Through the resolution process, the resolution authority would seek to maintain functions that are critical to the economy and return the firm to viability, or liquidate the firm in an orderly fashion.[5] ELA could serve as a source of temporary public sector liquidity to support the broader efforts of authorities to conduct an orderly resolution of the firm.

In both recovery and resolution, the Bank retains its discretion to provide ELA.

Emergency Lending Assistance in recovery or resolution

Figure 1 illustrates how ELA may support an FI or FMI's return to long-term viability. This serves to highlight important differences between the role of ELA in recovery and resolution.

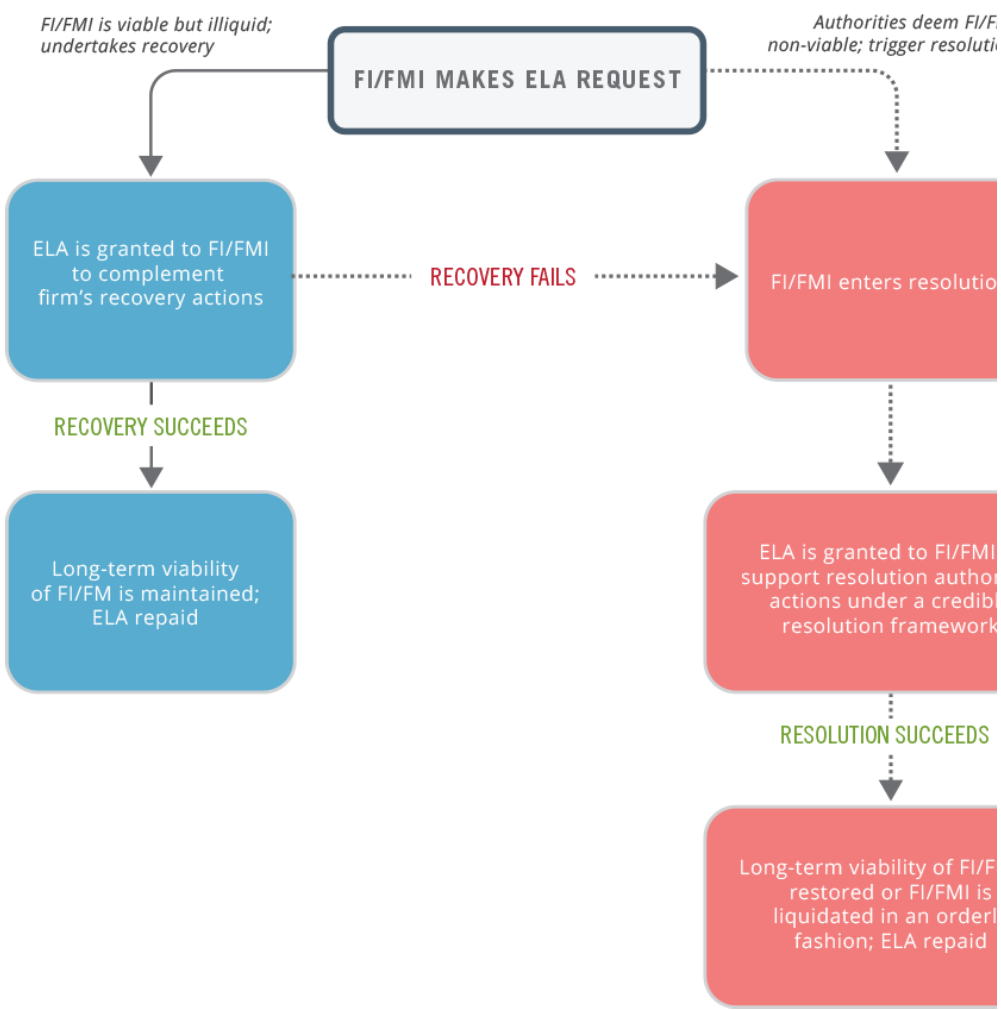

Figure 1: Emergency Lending Assistance in recovery or resolution

The following assumptions apply:

1. **Eligibility conditions for ELA are satisfied:** Eligibility conditions depend on the type of entity making the ELA request (see **Eligibility Criteria**).
2. **The Bank decides to offer ELA:** The provision of ELA complements either the recovery actions of the FI/FMI or the resolution actions of the resolution authority.

The provision of ELA can create the risk of moral hazard, where FIs and FMIs mismanage their liquidity risk because they assume central bank support will be available. Supervisory scrutiny and liquidity regulations can help to mitigate moral hazard.[6] Nevertheless, the Bank imposes eligibility requirements and terms and conditions for ELA to encourage FIs and FMIs to manage their liquidity safely and to rely on private funding sources.

Terms and Conditions

The terms and conditions of ELA loans are determined by the *Bank of Canada Act*, the *Payment Clearing and Settlement Act* (PCSA), the Bank's lending policies and its loan and security agreements.[7] The terms and conditions are designed to provide the appropriate safeguards to protect the Bank from financial and legal risk and to mitigate moral hazard.

Interest rate

The minimum rate that the Bank charges on ELA loans is the Bank Rate, which is the rate of interest that the Bank charges on one-day loans to major financial institutions. While the Bank has the discretion to charge an interest rate higher than the Bank Rate, historically, the Bank has charged the Bank Rate for ELA.

Term

Under the *Bank of Canada Act*, the Bank can provide ELA for a maximum term of six months. The loans can be renewed for a period of up to six months, at the Bank's discretion, as many times as the Bank deems necessary. In practice, ELA loans would typically be structured as one-day loans, to be rolled over daily.

Collateral

The *Bank of Canada Act* requires that all Bank lending be secured.[8] As with lending under the Bank's Standing Liquidity Facility (SLF), the Bank must be able to obtain a valid first-priority security interest in any collateral pledged or assigned to support ELA.[9] If the counterparty fails to repay the ELA loan, the Bank can then sell or retain the collateral to address any losses it may face. The Bank is willing to take a broader range of collateral for ELA than it accepts for credit under the SLF. This can include but is not limited to

- the Canadian-dollar non-mortgage loan portfolio (NMLP);
- less liquid securities, including collateralized own-name securities; and
- Canadian-dollar mortgages.

Because there are additional challenges inherent in accepting mortgages, the Bank expects FIs to consider preparing alternative forms of collateral to ensure that ELA can be readily accessed if needed. The Bank therefore generally expects to take mortgages as a last resort to maintain financial stability. To protect the Bank from loss, the Bank retains the right of refusal for any asset, accepting only that collateral for which it can manage the associated legal, financial and operational risks.

Haircuts will be applied to collateral accepted so that the Bank lends an amount less than the current value of the collateral it takes. This protects the Bank against valuation risk and potential future declines in collateral value. For consistency, the haircuts applied to SLF-eligible collateral pledged for ELA would generally be set according to the Bank's SLF collateral policy, although the Bank reserves the right to impose different haircuts for collateral accepted under ELA.[10] [11] For loan collateral and for securities for which market prices are unavailable or judged to be unreliable, the Bank will value the collateral and set haircuts on a case-by-case basis to reflect their risk characteristics.[12]

Currency

FIs and FMIs are responsible for ensuring that they have reliable arrangements for liquidity support in foreign currencies important to their businesses, either through private sector support or foreign central bank facilities. For FIs qualified for ELA, the Bank could lend Canadian dollars on a collateralized basis to the illiquid institution, which could, in turn, exchange those Canadian dollars for the needed foreign currency. Where foreign exchange markets are also constrained, the Bank may provide foreign currency liquidity to eligible FIs. For FMIs, where it is operationally feasible, the Bank could provide foreign currency ELA, if needed, to prevent a Canadian-domiciled designated FMI from failing to meet its obligations to a foreign FMI.[13]

Eligibility Criteria

The Bank sets eligibility criteria for each type of financial entity. These criteria help protect the Bank from loss and minimize moral hazard while ensuring that ELA can fulfill its role in supporting the recovery or resolution of financial entities.

The Bank determines whether the preconditions for ELA are met prior to an ELA request and updates its judgment at the time of an ELA request. The opinions of relevant supervisors and resolution authorities will be a key determining factor for this judgment.

Below are the eligibility criteria.[14] [15]

Eligibility criteria for access to Emergency Lending Assistance

Federally-Regulated FI

- **Member of Payments Canada**
- **Credible recovery and resolution framework**

Provincially-Regulated DTIs

- **Member of Payments Canada**
- **Provincial indemnity**
- **Important to stability of the broader financial system**
- **Credible recovery and resolution framework**

Financial Market Infrastructure

- **Domestic FMI designated for Bank of Canada oversight**

Member of Payments Canada

The *Bank of Canada Act* provides the Bank with the power to make secured loans or advances to members of the CPA. Every bank is required to be a Payments Canada member. Provincial centrals are entitled to be members and can become a member upon application to and approval by Payments Canada.[16]

Credible recovery and resolution framework

A recovery and resolution framework consists of the powers, governance arrangements, strategies and facilitating tools that would be used by a firm to recover from stress, as well as the powers, governance arrangements, strategies and facilitating tools that authorities would use to support orderly resolution. A recovery and resolution framework is credible if it provides the relevant authorities, including the Bank of Canada, with a high degree of confidence that the long-term viability of a troubled institution can be maintained or restored, or the institution can be liquidated in an orderly manner, without systemic disruption. This is consistent with the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions.

The Bank does not intend to develop any specific criteria or requirements for recovery and resolution frameworks beyond those that have been or will be developed by the relevant supervisors and resolution authorities. Accordingly, institutions should continue to respect the guidelines and expectations for recovery and resolution planning established by their supervisors and resolution authorities. Before providing an ELA loan to an institution, however, the Bank undertakes the necessary due diligence to satisfy itself that all ELA preconditions are met.

While it will not develop specific criteria, the Bank generally considers a framework credible if it.

- seeks to maintain continuity of functions that are important to financial stability;
- identifies recovery and resolution strategies that can be readily implemented to address extreme stress events;
- provides for effective coordination and information-sharing with relevant authorities; and
- has sufficient funding and liquidity arrangements in place to respond to extreme stress events while ensuring that ELA, if needed for temporary funding, is used only after private funding sources are no longer available.

In general, the tools and processes forming the recovery and resolution framework should be commensurate with the size and complexity of the institutions within its jurisdiction. Documents describing a firm's crisis management or contingency planning would help inform the judgment of the Bank and the relevant authorities regarding the credibility of the recovery and resolution framework. Recovery and resolution plans ("RRPs") are not necessarily required of every financial institution in order to achieve a credible framework, but as an institution increases in size and complexity such plans provide greater assurance that a framework is credible.

Provincial indemnity

Provinces that have responsibility for the prudential oversight of provincial institutions will need to indemnify the Bank from any losses if the borrowing provincial institution were to default on its ELA loan. The requirement reflects the fact that provincial authorities have the legislative powers to regulate local co-operatives and therefore are responsible for the stability of the provincial financial sector. The indemnity would only cover any residual amount should the value of the collateral provided, as well as any guarantees by other institutions, prove insufficient.[17] Provincial indemnification is not required for access to the Bank's SLF or market-wide liquidity facilities.

Important to the stability of the broader financial system

Bank of Canada ELA would be available to a provincially regulated institution only if it is deemed, in the judgment of the Bank, to be important for the stability of the broader financial system. The Bank must be of the opinion that the distress or disorderly failure of the potential ELA recipient would have important adverse consequences for the broader financial system and the Canadian economy. This requirement reflects the responsibility of provincial authorities and the provincial centrals, to establish mechanisms to provide liquidity to local co-operatives under most circumstances. ELA would only be supplied in extreme scenarios.

In forming its judgment on the importance of the provincial institution to the broader financial system, the Bank will consider, among other things, if:

- stress from the co-operative system is materially contributing to and/or amplifying adverse financial conditions;
- distress from a provincial or regional co-operative system is severely impairing economic activity in that region; and
- distress in one or more co-operative system is actively spreading, or has an ability to spread, through national co-operative frameworks and infrastructures.

Domestic FMIs designated for Bank of Canada oversight

The PCSA provides the Bank with the power to lend to FMIs designated as subject to the Bank's oversight (designated FMIs). A financial market infrastructure is designated by the Bank if it has the potential to pose systemic risk to Canada's financial system or if it is a prominent payments system that, while not systemically important, is critical for economic activity in Canada.[18]

Entities that would not generally be eligible for ELA include the following:

- **Insurance companies, mutual funds, and investment dealers:**
  These entities do not issue deposits and hold a significant share of their assets in illiquid, hard-to-value claims.
- **Foreign bank branches:**
  Foreign bank branches should look to the central bank of their home jurisdiction for emergency liquidity.
- **Foreign FMIs:**
  Lead central banks overseeing foreign-domiciled FMIs are responsible for ensuring that emergency liquidity is available to those systems. However, the Bank could facilitate the lead central bank's provision of Canadian-dollar liquidity should the lead central bank choose to do so.

Managing ELA

Coordination with the relevant authorities

It is important to note that central bank lending cannot recapitalize an FI or FMI or address the underlying problems that lead to liquidity shortfalls. Accordingly, the deployment of the Bank's liquidity facilities is just one component of a larger set of coordinated actions that authorities can take to support the stability of the Canadian financial system.

The Bank consults with the relevant authorities to determine whether the preconditions for ELA have been met prior to and at the time of an ELA request. The Bank also endeavours to keep the relevant authorities informed of prospective ELA situations and to notify them immediately if ELA is provided to an institution.

For federally regulated FIs, the Financial Institutions Supervisory Committee (FISC) is the primary forum for the exchange of information and for coordinating strategies, such as those for contingency planning, among federal authorities when dealing with troubled institutions that are still viable.[19] Relatedly, federal authorities would primarily coordinate resolution strategies for non-viable firms through the Canadian Deposit Insurance Corporation's Board of Directors. The borrowing institution may be required to provide increased reporting (data and other information) to the Office of the Superintendent of Financial Institutions or the Bank on the institution's evolving situation.

For provincially regulated deposit-taking institutions, the Bank endeavours to establish formal arrangements for communication with the relevant provincial authorities.

For FMIs that are also overseen by other regulatory authorities, the Bank establishes co-operative arrangements with those authorities to facilitate communication and coordination.

Exiting ELA

The ELA loan agreements between the Bank and the borrowing entity would create a one-day revolving facility in which the Bank would have discretion to decline to make any further one-day loans. This would allow the Bank to readily cease ELA.

The Bank would cease ELA if this was judged by the Bank to be appropriate. This could occur, for example, if the borrowing entity no longer met or is unlikely to continue meeting all necessary ELA eligibility criteria or if the collateral to support ELA was no longer sufficient.

ELA Disclosure

The Bank is legally prohibited from disclosing the identity of borrowing institutions. The amounts of ELA advances are not included in the Bank's *Weekly Financial Statistics* until public disclosures have otherwise occurred. Any outstanding ELA advances are included in the Bank's monthly balance sheet and its annual and quarterly financial statements at an aggregate level.

The Relationship Between the Standing Liquidity Facility and ELA

The **Standing Liquidity Facility** (SLF) is part of the Bank's routine operations and helps smooth the functioning of the payments system by providing overnight secured advances to Lynx participants experiencing temporary liquidity shortages due to unexpected payments system frictions. The Bank monitors SLF usage for any unusual access that may be a sign of significant and persistent liquidity shortage, which the SLF is not intended for. In such extraordinary circumstances, eligible financial institutions may consider requesting Emergency Lending Assistance (ELA) from the Bank. ELA is intended to address persistent liquidity shortages and can provide more substantial and prolonged credit.

Since SLF advances are designed to help resolve day-to-day Lynx payment frictions, there is no presumption of a protracted liquidity problem or solvency risk with its use. In contrast, under ELA, there is clearly a significant liquidity problem affecting the institution so the risk to the Bank, as its lender, is greater. Consequently, more stringent eligibility conditions and different terms and conditions apply under ELA.

Past Emergency Lending Assistance Policies

The Bank of Canada as Lender of Last Resort

As the ultimate provider of Canadian-dollar liquidity to the financial system, the Bank of Canada has the unique capacity to create Canadian-dollar claims on the central bank and the power to make secured loans or advances to chartered banks and other members of Payments Canada. The Bank supplies overnight credit on a routine basis through the Standing Liquidity Facility (SLF) to direct participants in the Large Value Transfer System, and Emergency Lending Assistance (ELA) to solvent deposit-taking institutions that require more substantial and prolonged credit. The authors review the policy framework that guides the Bank's lender-of-last-resort function, including the key issues, terms and conditions, and eligibility criteria associated with its SLF and ELA activities. Also discussed are foreign currency ELA, the relationship between SLF and ELA, systemic risk and Bank of Canada intervention, and the potential provision of liquidity to major clearing and settlement systems.

Bank of Canada Lender-of-Last-Resort Policies

The Bank of Canada has distinct roles as a lender of last resort. This article outlines how and under what circumstances the Bank can routinely provide liquidity to facilitate payment settlement, as well as the various ways it can respond in more exceptional situations.

Footnotes

1. The power to provide ELA to FIs comes from the *Bank of Canada Act*, s. 18(h). The power to provide ELA to FMIs comes from the *Payment Clearing and Settlement Act* (PCSA), s. 7(a) and 7(b). [←]

2. A member participant is usually a type of financial institution but can include other types of entities.[←]

3. During the 2007-09 financial crisis, the Term Purchase and Resale Agreement (PRA) Facility, Term PRA Facility for Private Sector Instruments and Term Loan Facility were activated as part of the Bank's extraordinary liquidity facilities.[←]

4. Examples of recovery actions that a financial institution could take are restructuring business lines and raising capital or funding.[←]

5. Examples of resolution actions with respect to an FI or FMI include recapitalization and restructuring. The resolution authority could also choose to wind down the firm in an orderly fashion.[←]

6. For example, new Basel III regulations such as the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) help to mitigate moral hazard and reduce the probability that institutions will require ELA.[←]

7. View the Bank of Canada **Rules Governing Advances to Financial Institutions** for further information on ELA provision to financial institutions.[←]

8. See *Bank of Canada Act* s. 23(d).[←]

9. An institution would need to provide the Bank with acceptable legal documentation to support the Bank's security interest in pledged or assigned collateral. See **Rules Governing Advances to Financial Institutions** for further details on the documentation required.[←]

10. Collateral that is acceptable under the Standing Liquidity Facility (SLF) will also be accepted for ELA. For more information on the Bank's SLF collateral policy, see **Assets Eligible as Collateral under the Bank of Canada's Standing Liquidity Facility** .[←]

11. For example, haircuts applied to the non-mortgage loan portfolio may be different under ELA than under SLF.[←]

12. Because the Bank has the flexibility to accept any collateral for which it can manage the associated risks, it does not publish a complete list or haircut schedule for collateral accepted under ELA.[←]

13. A domestic FMI could require intraday access to foreign currency to meet its obligations to a foreign FMI, and foreign currency ELA could therefore prevent an unnecessary and costly default of the domestic FMI.[←]

14. A deposit-taking institution is a type of financial institution that accepts deposits, which are fixed-value promises to pay, often redeemable at short notice.[←]

15. In the case of trust companies, the "in-trust" nature of the assets held by such a firm means that ELA could be provided only through a loan secured by company assets, or through an outright purchase of assets, associated with provisions to sell the assets back to the trust company at predetermined prices.[←]

16. For a list of Payments Canada members, see **Payments Canada Members List**. For FIs, ELA funds would generally be disbursed through Canada's **Lynx** system. Only Payments Canada members can be Lynx participants. For federally-regulated FIs that are not Lynx participants, ELA funds would be received through a Lynx participant clearing on their behalf. For credit unions or caisse populaires that are not members of Payments Canada but meet all other eligibility conditions, the Bank can lend to their provincial central with Payments Canada

membership. The central could then pass on the liquidity to the individual credit unions or caisses populaires that are not themselves Payments Canada members.[←]

17. Federal credit unions would be subject to the same eligibility criteria as other federally regulated deposit-taking institutions.[←]

18. For designated FMIs, see **Regulatory Oversight of Designated Clearing and Settlement Systems**. [←]

19. For the legislative basis underpinning FISC, see Section 18 of the *Office of the Superintendent of* ***Financial Institutions Act***.[←]