

## BRIEFING

# Emergency Liquidity Assistance - moving away from “constructive ambiguity”?

*This briefing gives an overview of the objectives and nature of emergency liquidity assistance that may be provided by central banks for banks facing sudden liquidity problems. It also provides a short description on how this is done by the European System of Central Banks inside the Banking Union and raises some questions on how this could evolve in the future.*

## 1. Liquidity management in normal and in exceptional situations

Sound liquidity management is one of the day-to-day key functions of a bank, as pointed out by the Bank for International Settlements: In principle, a bank should at all times be able to meet its obligations as they fall due, even if the exact needs for cash are uncertain by nature, considering that they are affected by external events as well as the behaviour of clients and contractual partners. In normal times, every bank will have the amount of cash internally available that it expects to be needed, including a safety margin; a bank can moreover cover additional needs by borrowing money from other banks in the interbank market or by borrowing money from central banks as part of the standard monetary operations. In standard monetary operations, a central bank makes cash available provided that the borrowing bank can pledge a security or post “eligible collateral”, such as government bonds with acceptable credit ratings.

But what happens if a bank is suddenly faced with an unexpected large need for cash, for example due to sudden deposit outflows such as in a bank-run, or due to large margin calls in order to back-up tumbling securities transactions?

In exceptional situations, central banks can become the “lender of last resort”, in which case money can be granted to a solvent financial institution that is experiencing temporary liquidity problems - assuming there is no reasonable doubt that the money borrowed can be recovered in full, and that this source of funding is only used temporarily, not permanently. This is at least what the G10 central bank governors initially had in mind when - as a response to international bank failures - they discussed<sup>1</sup> the concept of the “lender of last resort” in 1974.

Those two criteria - solvency of the bank and temporality of the emergency support - are also said to be applicable in the euro area according to the procedures for Emergency Liquidity Assistance (ELA) as adopted and published in October 2013 by the European Central Bank (ECB). While the criterion of solvency is often discussed by researchers, less attention is given to the question how to define the temporary nature of liquidity support<sup>2</sup>.

## 2. Constructive ambiguity and moral hazard

In reality, it is not always clear which exact criteria banks have to fulfil to get access emergency liquidity from their central bank in case of need. In fact, some central banks made a deliberate choice not to set out all applicable criteria and procedures and rather leave room for “constructive ambiguity”.

That was at least the prevailing situation before the Banking Union was established in the EU: *“In practice, central banks (and public authorities responsible for financial crisis management) were reluctant to set out their approaches to ELA because of concerns about serious moral hazard and adverse effects on market functioning. By end-2006, about half of the central banks of the G10 advanced economies had publicly released statements on their ELA policies. Generally, these statements set out broad guidelines or principles for ELA. Many central banks, particularly in the euro area, were deliberately vague about their ELA policies, emphasising the importance of constructive ambiguity.”*<sup>3</sup>

More recently, the ECB’s ELA policy seems to move from the traditional “constructive ambiguity” approach, which in its extreme form means that the capacity of a central bank to provide ELA should not even be mentioned, to a more transparent approach and open discussions of the issue.<sup>4</sup>

The quote above shows that the main reason for not setting out under which exact conditions ELA can be made available are concerns about “moral hazard”, meaning that banks could be tempted to ignore the principles of sound liquidity management if they can exactly figure out the terms and conditions for emergency central bank support and rely upon that measure. On the contrary, the “constructive ambiguity” approach gives more leverage to the central bank upon failure of a bank, as the central bank enjoys more freedom to accept or refuse the request for ELA

Moral hazard is also constrained by the fact that the use of ELA typically comes at a price:

- On the one hand, the central bank funding is typically subject to a penalty rate of interest.
- On the other hand, falling back on ELA may also be perceived as a signal to the markets that a bank is in trouble, which is a stigma that banks try to avoid.

### **Box 1: Disclosure of ELA**

Whether and to what extent a bank uses ELA is typically not disclosed, neither by the bank benefitting from the support measure nor by the central bank granting it, for the very reason that the disclosure might give rise to speculation and increase funding difficulties.

If information about ELA is disclosed, the difficult position of banks using it is typically already well known in the markets (for example as recently in the case of the Greek banks, for which the Greek Central Bank [regularly](#) publishes at least the aggregate ceiling)

Some waivers in the banking regulation are specifically targeted at the non-disclosure of ELA. In the European Union, for example, banks have to disclose the extent to which they have pledged assets (asset encumbrance). Article 443 of Regulation (EU) 575/2013 of the [Capital Requirements Regulation](#) mandated the European Banking Authority (EBA) to develop guidelines on asset encumbrance, the final version was published on 27 June 2014 ([EBA/GL/2014/03](#)). Those guidelines explicit say that *“Specific modifications have been made ... to ensure that ... the amount of liquidity assistance given by central banks cannot be detected...”*.

Some rating agencies are critical about the decision not to disclose ELA. [Fitch](#), for example, argues: *“But failure to disclose, risks hiding the true liquidity position of a bank and may encourage investors to make conservative assumptions and withdraw funds sooner than they would do if transparency was provided.”*

### 3. Prevention of systemic effects – a key objective of ELA

The decision of a central bank to help a bank out of an emergency situation by providing ELA generally aims to prevent a domino effect on other banks leading to a systemic crisis.

Lars Nyberg, Deputy Governor of the Sveriges Riksbank, the Swedish central bank that saw a severe banking crisis in the beginning of the 1990s in which it had to provide ELA twice, said in a speech: “Clearly, ELA is a last resort measure that central banks use only when the stability of the financial system is at stake.”<sup>5</sup>

There is some discussion whether the eligibility to apply for ELA can only be based on the “systemic-ness” of banks, whether ELA should also be available to small banks or even non-banks, and whether the assessment of a bank’s eligibility would rather have to take the overall economic situation into account instead of the individual bank’s intrinsic features.<sup>6</sup>

Yet, wherever the line is drawn, central banks do not want to give the impression that they are willing to provide liquidity under all circumstances. The Bank of England, for example, clearly stated that a “zero-failure financial system” is not and shouldn’t be its overall aim, and that the decision whether to provide or extend ELA in any particular case must therefore always remain at the authorities’ discretion.<sup>7</sup>

### 4. Access to ELA in the Eurosystem

In the Eurosystem, the responsibility for the provision of ELA lies primarily with the national central banks, which bear the risks arising from ELA and incur all related costs.

Nevertheless, the ECB cannot be completely insensible to the risks taken by national central banks either. According to the agreed [ELA Procedures](#), the ECB may therefore restrict ELA operations if it considers that these operations interfere with the objectives and tasks of the Eurosystem.

In order to keep the ECB informed, national central banks shall keep the ECB informed about all ELA operations (see box 2 on “Minimum information”)

As generally stipulated in Article 14.4 of the [Protocol](#) on the Statute of the European System of Central Banks and of the ECB, the Governing Council can, with a majority of two thirds of the votes cast, prohibit national central banks to perform functions like the provisioning of ELA if it finds that these interfere with the objectives and tasks of the ESCB.

According to the ECB’s ELA procedures, the assessment whether there is a risk of interference with the objectives and tasks of the Eurosystem is on particular made if the overall volume of the ELA is expected to exceed a threshold of EUR 2 billion. Upon request, the Governing Council may then also decide to set a threshold and not to object to intended ELA operations that are below that threshold.

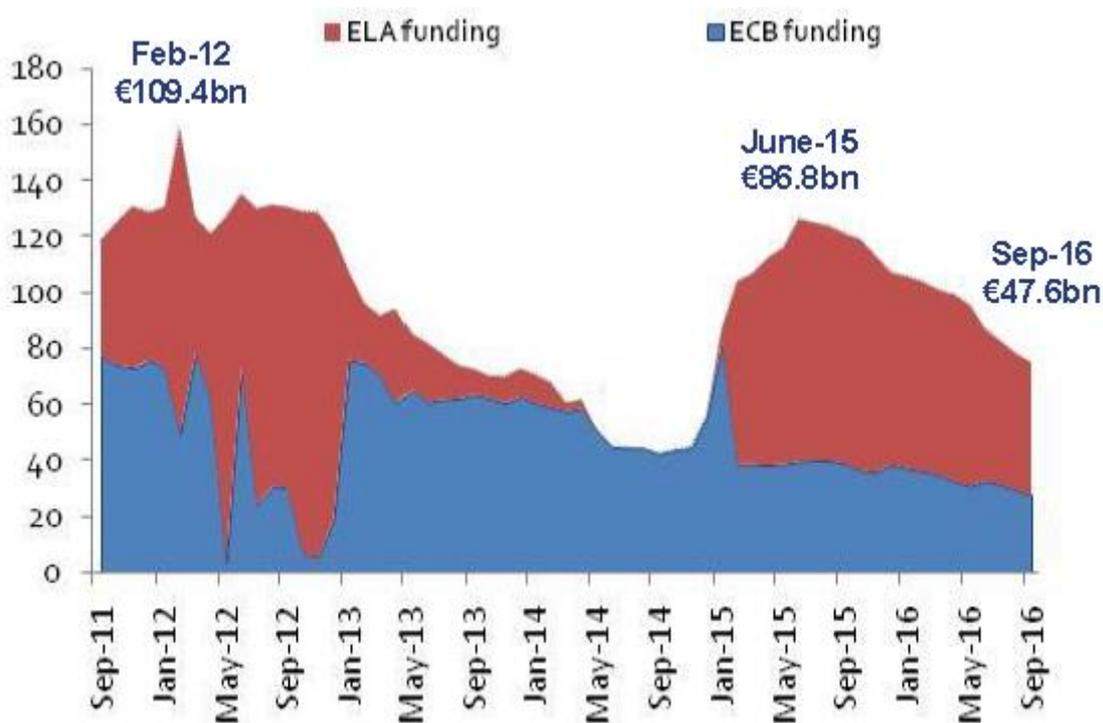
#### Box 2: Minimum information

In case a national central bank has to provide ELA, it shall inform the ECB in a timely manner at least about:

- 1) the counterparty,
- 2) the value and maturity date,
- 3) the volume,
- 4) the currency,
- 5) the guarantees or collateral required,
- 6) the interest rate to be paid,
- 7) the specific reasons for the ELA,
- 8) the supervisor’s assessment of the bank’s liquidity and solvency position,
- 9) as well as cross-border and potential systemic implications.

During the financial crisis, several banks in Ireland, Cyprus, Portugal, and Greece were supported with ELA measures. In particular ELA for Greek bank is outstanding in terms of size and duration (see Graph 1).

**Graph 1: Volume of ELA funding for the Greek banking sector since September 2011**



Source: [Investor presentation of Eurobank](#) (Third Quarter 2016 Results), p. 39

According to the [press statement](#) from the Greek Central Bank of 17 September 2015, for example, the ELA-ceiling for Greek banks, approved by the ECB, was set at EUR 88.9 billion. In relative terms, the amount of ELA available to Greek banks at that time therefore slightly exceeded 40% of the national Gross Domestic Product. The decision taken by the ECB at the end of June 2015, following the failure of negotiations on the closure of the second financial assistance programme, to maintain but not to raise the overall ceiling had significant consequences, as it triggered the need for capital controls (see [EGOV briefing](#) on Greece's financial assistance programme, box 5).

In comparison, however, the Greek Central Bank is very transparent as regards the total volume of ELA; detailed information on ELA is usually not disclosed by other central banks which led to some criticism and efforts to indirectly infer the information<sup>8</sup> from the ECB's consolidated balance sheet of the Eurosystem (also see Box 1 on the disclosure of ELA).

Commenting on the - from a traditional perspective - unusual features of ELA in the Eurosystem during the financial crisis, Peter Praet, Member of the Executive Board of the ECB, explained in a [speech](#) on 10 February 2016 how the role of the ECB as lender of last resort developed during the crisis, differentiating between the system-wide liquidity shock in the Euro area on the hand, which the ECB targeted with unprecedented monetary policy measures such as the unlimited allotment of funds at a fixed rate, and ELA provided to individual banks facing specific liquidity problems on the other hand.

Praet points out that as the crisis intensified, not only individual banks but entire national banking sectors were deprived of their previous access to liquidity (mentioning in particular the situation in Greece), which called for a different approach to ELA interventions in two ways:

- the duration of assistance lengthened (even though it should be as short term as possible, see box 3 on the timeframe),
- and the scope of assistance broadened from individual banks to entire banking systems.

### **Box 3: Timeframe for ELA**

In the [Opinion CON/2012/4](#), related to a guarantee scheme for liabilities of Italian banks, the ECB spelled out the relevant conditions for ELA operations: (i) it must be ensured that the credit provided by the NCB [national central bank] is **as short term as possible**; (ii) there must be systemic stability aspects at stake; (iii) there must be no doubts as to the legal validity and enforceability of the State guarantee under applicable national law; and (iv) there must be no doubts as to the economic adequacy of the State guarantee, thus fully preserving the NCB's financial independence.

## **5. The assessment of solvency**

As mentioned before, the standard prerequisite for banks requiring emergency liquidity assistance is that they are solvent, the value of their assets must hence be greater than the sum of their entire debt obligations (from that perspective one might note that the minimum capital level required for a banking license is way higher than the solvency level).

A central bank asked to provide ELA will inter alia take the banking supervisor's assessment of the bank's position into account. In the Euro area, such assessment may since the establishment of the Single Supervisory Mechanism on 4 November 2014 either fall into the remit of the national banking supervisor (for assessments about "less significant" banks) or into that of the supervisory arm of the ECB at European level (for assessments of "significant" banks).

While solvency is rather straight forward concept in theory, the borderline between illiquidity and insolvency is more difficult to draw in practice. The value of a bank's assets, for example, very much depends on whether the bank is considered to be a "going concern", meaning that it is supposed to continue its banking activities, or a "gone concern", assuming it will stop all its operations. Moreover, as in particular the situation in Greece has shown, the assessment of a bank's solvency is intertwined with the decision to provide or prolong financial assistance to the country itself, if that bank has outstanding loans to its national government.<sup>9</sup>

In fact, what is striking is that solvency is such a prominent prerequisite, although there is a lot of agreement that a bank's solvency position is very difficult to assess in a crisis situation. Paul Fisher from the UK's Prudential Regulation Authority points out that providing ELA will always include some doubt whether the money can be recovered in full: "If a central bank lends enough money to a firm where solvency is inherently uncertain – and it *always* is for a bank in a liquidity crisis – then however well collateralised the loan, there is a risk of losing money – public money."<sup>10</sup>

## **6. Allocation of competences in the Eurosystem**

As set out above, at present the responsibility for the provision of ELA lies primarily with the national central banks.

Some, however, argue that the ECB should have more competencies for the provisioning of ELA at least with regard to those banks that are directly supervised by the ECB<sup>11</sup> and that such step would

be necessary to complete the Banking Union<sup>12</sup>, not least because banking groups with significant operations outside their home country may find it difficult to get access to ELA<sup>13</sup>, if required.

A bank falls under direct supervision by the ECB if it is classified as being a significant institution, which - according to the [SSM Framework Regulation](#) of 16 April 2014, Article 39 (3) (b) - is inter alia assessed based on

- its importance for the economy of the Union
- or its importance for the economy of any participating Member State.

It may be up for debate whether the criterion that puts a bank under direct supervision by the ECB is equally suitable for the allocation of competences regarding the provisioning of ELA. Alternatively, one could ask which effect the bank's failure will have if it is not given access to ELA, for example because its solvability is questionable: Would a bank's failure have an impact of the economy of the Union (in which case the decision to grant ELA may be well placed with the ECB), or would it only have an impact on the economy of any participating Member State (in which case the decision to grant ELA may be well placed with the national central bank, assuming it has full access to all the relevant supervisory information). The optimal allocation of competences for providing ELA in the Eurosystem should, of course, ensure that the level playing field in the Banking Union is maintained, applying a similar set of rules to banks of different size and in different locations.

That aspect would merit further consideration in the ongoing debate about the future ELA framework in the Eurosystem, given that financial stability concerns are at the very heart of any central bank's ELA decision.

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<sup>1</sup> The G10 communiqué of 10 September 1974 reads: “[The Governors] *recognized that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that to that end means are available and will be used if and when necessary*”.

<sup>2</sup> Compare, for example, R. S. Delston and A. Campbell: “[Emergency Liquidity Financing by Central Banks: Systemic Protection or Bank Bailout?](#)”, IMF working paper May 2002; M. Hellwig “[Financial Stability, Monetary Policy, Banking Supervision, and Central Banking](#)”, Max Planck Institute for Research on Collective Goods working paper September 2014; P. Tucker: “[The lender of last resort and modern central banking: principles and reconstruction](#)”, in BIS Papers No 79 “Re-thinking the lender of last resort”, Monetary and Economic Department, September 2014, p. 10-42

<sup>3</sup> D. Domanski, R. Moessler, and W. Nelson (2014) “[Central banks as lender of last resort: experiences during the 2007-2010 crisis and lessons for the future](#)”, Staff working paper, Finance and Economics Discussion Series, Federal Reserve Board, Washington

<sup>4</sup> See C. Zilioli in “[ECB Legal Conference 2015: From Monetary Union to Banking Union, on the way to Capital Markets Union: New opportunities for European integration, December 2015](#)”, p. 49

<sup>5</sup> L. Nyberg: “[The infrastructure of emergency liquidity assistance - what is required in today’s financial system?](#)” BIS Review 42/2000

<sup>6</sup> See, for example, M. Dobler, S. Gray, D. Murphy, B. Radzewicz-Bak: “[The Lender of Last Resort Function after the Global Financial Crisis](#)”, IMF Working Paper WP/16/10, January 2016, p. 22 ff.

<sup>7</sup> See “[Review of the Bank of England’s provision of Emergency Liquidity Assistance in 2008-09](#)”, report by I. Plenderleith presented to the Court of the Bank of England, October 2012, p. 42

<sup>8</sup> See J. Klose. “[Die Emergency Liquidity Assistance der EZB – ein Blick in die Black Box](#)”, Wirtschaftsdienst, January 2016, Volume 96, Issue 1, pp 49–53

<sup>9</sup> See M. Götz, R. Haselmann, J. P. Krahen, S. Steffen: “[Did emergency liquidity assistance \(ELA\) of the ECB delay the bankruptcy of Greek banks?](#)”, SAFE Policy Letter No. 46, September 2015

<sup>10</sup> See P. Fisher: “[Practical issues for the Lender of Last Resort](#)”, published in the document “ECB Legal Conference 2015: From Monetary Union to Banking Union, on the way to Capital Markets Union: New opportunities for European integration, December 2015”, p. 88

<sup>11</sup> See, for example, B. C. Scouteris, P. L. Athanassiou: “National central bank tasks and the boundaries of the ECB Governing Council’s powers under Article 14.4 of the Statute: State of play and future prospects, Commemorative Volume in memory of Professor Dr. Leonidas Georgakopoulos, Bank of Greece’s Center for Culture, Research and Documentation, 2016, forthcoming, section 4

<sup>12</sup> See C. Gortsos: “[Last resort lending to solvent credit institutions in the Euro area before and after the establishment of the Single Supervisory Mechanism \(SSM\)](#)”, published in the document “ECB Legal Conference 2015: From Monetary Union to Banking Union, on the way to Capital Markets Union: New opportunities for European integration, December 2015”, p. 67

<sup>13</sup> Ioannis Glinavos reports in his blog “[Challenging Emergency Liquidity Assistance - Decisions in International Tribunals](#)”, published on 1 July 2016, about an appeal at the International Centre for Settlement of Investment Disputes by the Cyprus Popular Bank Group, which operated under the name Laiki Bank. Laiki Bank had significant banking activities in Greece, and argues in its appeal against Greece that in 2012 it was not given equal treatment by the Central Bank of Greece, which refused the group access to ELA for its Greek banking operations. Laiki Bank then had to turn to the Central Bank of Cyprus, and was later on wound down

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