Liquidity or moratorium?

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The ECB announced recently that it is studying the possibility of centralising emergency liquidity assistance (ELA) for banks in difficulties. At present the responsibility for this window lies with the national central banks, although with the authorisation of the ECB above certain limits. Any losses are absorbed by national Treasuries, although they can recover them in the long term by transferring them to the funds contributed to by the industry. The centralisation of ELA would involve: a sharing of these risks and would correct the disparities in its application observed in several recent cases of resolution in Spain, Italy, Latvia, etc.

Centralising this emergency window would mean a significant push towards Banking Union: with a single supervisor, a single resolution authority (and fund) and a single lender of last resort, the incongruity of keeping deposit guarantee funds segmented by country would stand out even more clearly. The European Deposit Insurance Scheme (EDIS) would go without saying.

A related but different problem is the disconnect between ELA and the banks' resolution framework. The arguments about liquidity in resolution ignore the fact that when a bank cease to be viable it normally has significant liabilities to the central bank in the form of ELA. The ECB is forbidden to lend to insolvent entities, so once that threshold has been passed it should cease to provide support. This framework has been made more flexible recently, such that it is possible for support to be maintained for a certain time if the entity has a credible recapitalisation plan. A mechanism should also be designed whereby the liquidity support from the central bank, which is necessarily temporary, is gradually taken over by the institution responsible for resolution (the Single Resolution Fund, SRF, with support from the European Stability Mechanism, ESM) until the entity regains access to the markets.

At the same time, in Brussels a revision of the Bank Recovery and Resolution Directive is being discussed, which should provide an opportunity to correct some of the deficiencies observed. However, some of the proposals being discussed may exacerbate fragmentation in the euro zone and impede progress towards Banking Union, particularly the so-called “moratorium” on certain liabilities in cases of resolution, which includes covered deposits. The idea is that in view of the probable outflow of deposits before or immediately after resolution, limits can be established for a few days on the availability of the guaranteed deposits; in other words a corralito. This is a bad idea which may lead to contagion to other institutions and trigger flights of deposits in more vulnerable financial systems, especially if the deposit insurance is kept at national level. With current technology allowing instantaneous transfers of deposits to any country, the moratorium is not an appropriate tool for confronting a liquidity crisis.

The central banks were created precisely to offer loans of last resort and avoid banking panics. It is paradoxical that Europe, due to its inability to establish a coherent framework for the supply of liquidity in resolution, should now be looking at resorting to the corralito as a normal tool for crisis management. If a few days need to be gained in the resolution process, the reasonable way of doing this would be with the support of liquidity, not by imposing limits on the withdrawal of deposits. But for this it is necessary to tie ELA to liquidity in resolution, as pointed out above.

The new bank resolution framework, which requires losses to be absorbed by creditors instead of taxpayers, is incompatible with the “constructive ambiguity“ that has traditionally imbued the framework of ELA. Buyers of bonds demand clarity on the conditions of bank resolution. And access to liquidity (including ELA) is a basic aspect of the rules of the game. The centralisation of ELA will contribute to establishing a more level playing field, with common and clearer rules; and it will represent a significant move forward towards Banking Union. But, contrary to what the European leaders supporting it seem to think, the possibility of a moratorium on covered deposits does not strengthen this scheme - it weakens it.

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