Liquidity Provision in Resolution and Post Resolution Comments to Dr. Christos V. Gortos

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The views expressed here are my own views and not those of Bank of Spain and the Eurosystem
Dr. Gortos´ Paper

• Highlights the **limitations**:  
  ➢ Two general believes in the EU Regulation:
    • Private mutualization is sufficient in dealing with liquidity needs in resolution
    • Reluctance to rely on public backstops particularly at the euro area level to deal with the “tail risks”

• The **inadequacy of the LOLR** as a source of liquidity in resolution
Banks: Importance of liquidity

• Banks are subject to two types of liquidity risk (*Allen et allí, 2008*)
  • Idiosyncratic
  • Systemic

• Liquidity “buys time” in bank crisis resolution to:
  ✓ Define the bank’s “Resolution Scheme”
    • Banking Union: involves several bodies (SRB, NRAs, Commission, Council)
  ✓ Restore bank’s solvency via “bail-in” and other resolution tools
CDS spreads contain compensation for default risk: Longstaff, Mithal and Neis (2005) and Brennan, Blanco and Marsh (2005)
Sources of liquidity: **Central banks**

- **LORL**: Not adequate source of financing in resolution
  
  ✓ Limited by the amount of “sufficient” collateral held by the firm
  
  ✓ A decision at the discretion of NCB
    - Bank may not comply with the min capital regulatory requirement at end 6 mo.
    - Collateral assessed by the NCB
    - Credit risk born by national sovereign: Increases the negative loop
Sources of liquidity: **Central banks**

- Proposed Eurosysterm Resolution Liquidity (NCB):
  
  ✓ Banks under “Resolution Scheem”
  ✓ *Ex ante* fixed conditions, *i f*(counter party risk, collateral and maturity)
  ✓ Guaranteed by the ESM \( \rightarrow \) Breaks the bank – sovereign loop
  ✓ Priority in repayment
Conclusions

• Regulatory reform in the aftermath of the crisis addresses “idyiosincratic” liquidity risk \dots but NOT completely

• CBs address “Idyiosincratic” AND “Systemic” liquidity risks
  • In resolution: LOLR is not effective tool
    ✓ Eurosystem Resolution Liquidity: liquidity facility with the public backstop of the ESM to deal with “tail risks”