

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

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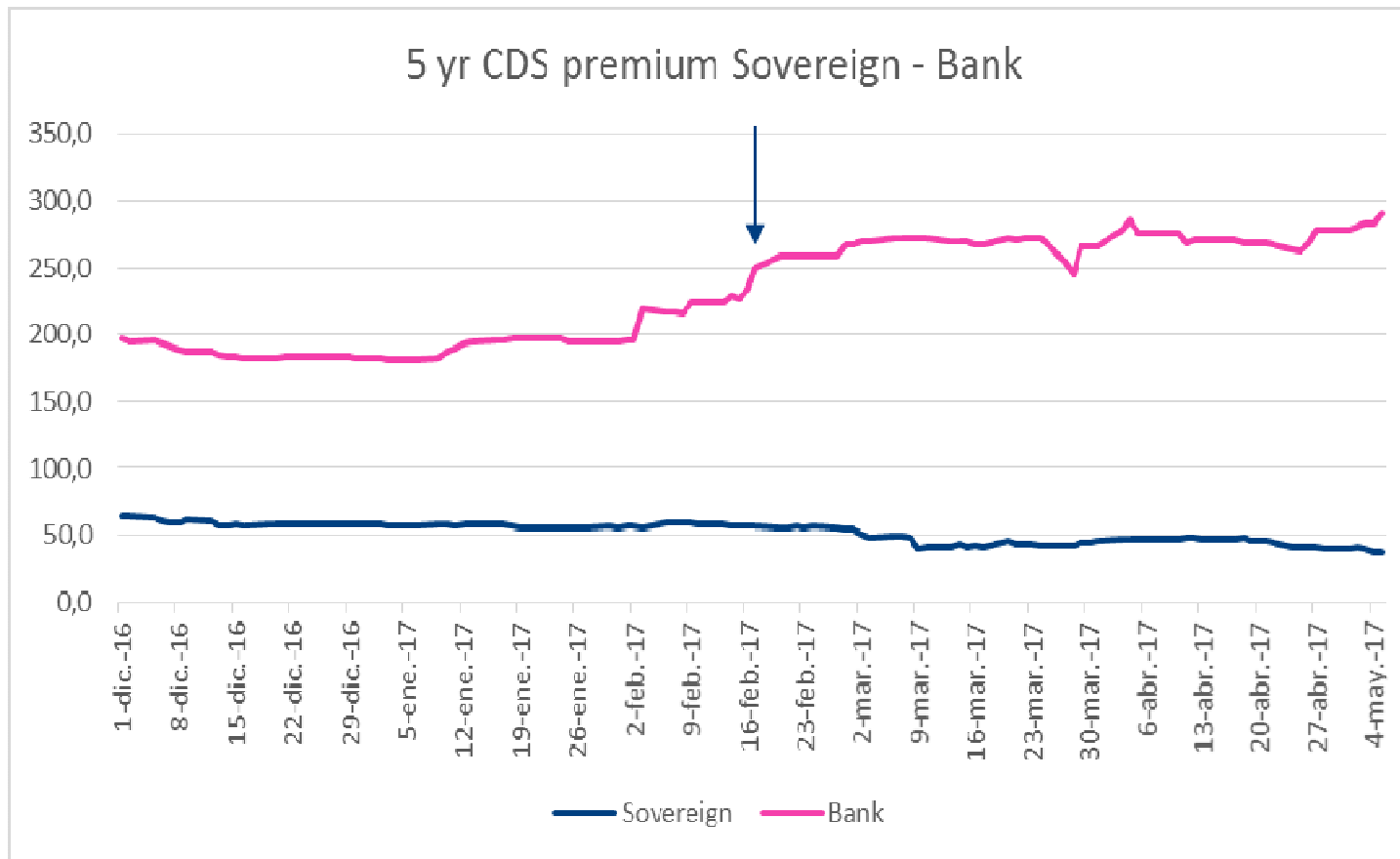
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Dr. Gortos' Paper

- 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 alii, 2008*)
 - Idiosyncratic ← Prudential reg + Reg on resolution + CBs
 - Systemic ← CBs
- 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 Eurosystem Resolution Liquidity (NCB):
 - ✓ Banks under “Resolution Scheme”
 - ✓ *Ex ante* fixed conditions, *i f*(counter party risk, colateral and maturity)
 - ✓ Guaranteed by the ESM → Breaks the bank – sovereign loop
 - ✓ Priority in repayment

Conclusions

- Regulatory reform in the aftermath of the crisis addresses “idiosyncratic” liquidity risk ... but NOT completely
- CBs address “Idiosyncratic” 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”