FOR AGENDA

SM/11/178
Correction 1

July 15, 2011

To: Members of the Executive Board

From: The Secretary

Subject: **Lessons from the European Financial Stability Framework Exercise**

The attached corrections to SM/11/178 (7/12/11) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 58, para. 124, line 6: for "the European System of Central Banks (ESCB, composed of the ECB and the other NCBs)" read "the Eurosystem."

Page 58, para. 124, line 8: for "ESCB" read "Eurosystem."

Page 58, para. 124, line 9: for "There is no ESCB framework guiding NCBs in providing ELA to local banks, although some transaction must be approved by the Governing Council of the ECB to avoid undermining the single euro monetary policy." read "NCBs are required to inform the ECB of such operations. In cases involving large amounts of support above an agreed threshold, the NCB involved has to seek the approval of the ECB, in order to avoid interfering with the single monetary policy."

Questions may be referred to Mr. Enoch, MCM (ext. 35372), Mr. Everaert, EUR (ext. 38667), and Mr. Jansen, LEG (ext. 37787).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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Other Distribution:
Department Heads

- ***Budgetary Frameworks for Official Support***—MoFs should have the legal authority to enter swiftly into support transactions with financial institutions (recapitalization, acquisition of shares, extension of guarantees) and execute those through the transfer of financial resources. The FSAPs have demonstrated that sufficient provision is made for the former but not the latter. More specifically, authorities have been forced to enter into support transactions without necessarily having budgetary authorization to fund those transactions. Staff has therefore recommended that MoFs benefit from a standing budgetary authorization to provide official support, albeit with safeguards (such as adequate resolution frameworks) to mitigate moral hazard.

- ***Role of MoF in Bank Resolution***—Given that the effective resolution of ailing banks is likely to require temporary official financing,[55] the decision-making process of resolution agencies should provide for adequate coordination with the MoF. In particular with regard to the resolution of large or systemically important financial institutions, the MoF is likely to be involved in the design of resolution and crisis containment strategies. Legal frameworks should recognize this reality explicitly, and establish a clear and effective division of labor between the MoF, the central bank, and the resolution authorities, subject to appropriate confidentially arrangements. (Netherlands, Sweden and United Kingdom).

B. Emergency Liquidity Assistance

122. **The principles underlying the provision of emergency liquidity assistance (ELA) to banks are well-established.**[56] Such assistance should only be provided to banks that are illiquid but not insolvent. Moreover, such lending should be provided against high-quality collateral although, in a crisis, this requirement can be relaxed, and a central bank can accept any asset of the bank in question, in principle with a haircut to ensure that it is not at financial risk. In addition, such lending is not traditionally reported to the public at the time, on the assumption that such reporting would undermine the standing of the bank.

123. **In the recent financial crisis, European central banks made extensive use of emergency liquidity assistance.** On 2 October 2008, the European Union announced that guarantees from the German government, consistent with EC principles on state aid, enabled Hypo Real Estate Holding AG to "tap additional emergency liquidity lines" from the Bundesbank. As another example, RBS and HBOS received more than GBP 60 billion in

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[55] On the role of temporary public financing in orderly resolution see IMF: Resolution of Cross Border bank—A Proposed Framework for Enhanced Coordination, June 2010, pp 23–25.

[56] See Bagehot (1872). ELA is sometimes also referred to Lender of Last Resort (LOLR) funding.

emergency loans in the autumn of 2008, repaying the last of these loans in January 2009.[57] More recently, reports from the Central Bank of Ireland indicate substantial emergency liquidity is being provided to Irish banks.

124. **In the Euro-Area, under current arrangements, ELA is provided by, and at the risk of, the National Central Banks (NCBs), and not by the ECB.** In the Euro Area, the NCBs provide monetary policy credits to their local banks pursuant to a policy and legal framework established by the (Governing Council of the) ECB. Even though the NCBs are legally the counterparty of the borrowing banks, the risks and revenues from those credits are pooled within the Eurosystem. The framework for ELA is fundamentally different: such assistance is provided by individual NCBs and the risks are not pooled within the Eurosystem. (Losses thus accrue to the NCB and ultimately the Member State's Treasury.) NCBs are required to inform the ECB of such operations. In cases involving large amounts of support above an agreed threshold, the NCB involved has to seek the approval of the ECB, in order to avoid interfering with the single monetary policy.

125. **While the FSAPs found the relevant countries' frameworks for ELA to be adequate, they also revealed that the crucial distinction between ECB monetary policy credit and NCB emergency liquidity assistance is not always well understood by market participants.** This became evident when NCBs (as part of the ESCB) occasionally closed out local banks from access to monetary policy operations and shifted them toward ELA. In such cases, market participants did not understand that, given the greater risks associated with ELA, the haircuts imposed on collateral in this context are generally much higher than they are for monetary policy credits.

C. Bank Resolution

126. **It is generally recognized that a sound bank resolution regime is a key component of a country's crisis management framework.** Without such a regime in place, policy-makers will be faced with the difficult choice between letting a financial institution fail with a potential risk to financial stability or bailing out the institution with taxpayer money and serious moral hazard consequences. Many countries have therefore enacted special insolvency frameworks that apply to banks and that differ in several important respects from the general corporate insolvency regime. These frameworks typically give the banking authorities the central role in the conduct of insolvency proceedings and often minimize the involvement of the courts. In addition, sound bank resolution frameworks

[57] See the Bank of England's submission to the Treasury Committee, dated 24 November 2009. http://www.bankofengland.co.uk/publications/other/treasurycommittee/financialstability/ela091124.pdf