Liquidity and funding for banks under resolution

Speech by Torbjørn Hægeland, Executive Director of Norges Bank Financial Stability at Finance Norway's seminar on recovery and resolution rules, 12 September 2019.

Thank you for the invitation to speak on an important aspect of bank resolution. As we have heard from the previous speakers today, from our colleagues at Finanstilsynet (Financial Supervisory Authority of Norway), the Norwegian Banks' Guarantee Fund and in Denmark, the new bank recovery and resolution framework is well designed to return a bank to solvency that has been placed under resolution.

However, resolved or not, a bank not only needs sufficient capital, but also needs sufficient liquidity. Payment intermediation is a vital core function of banks. Being a bank means participating in the settlement of payments, which means the bank must be liquid. How liquid is a bank that opens on a Monday morning after being resolved over the weekend? A newly resolved bank is not necessarily liquid for various reasons.

One reason is that prior to resolution, the bank will probably have depleted almost its entire stock of liquid assets, including securities eligible as collateral for Norges Bank's standing liquidity facilities.

Moreover, immediately after resolution, other money market participants may have doubts about the bank's viability, despite the recapitalisation that has taken place following the decision of the resolution authority. This may be the case particularly if a long time has passed since a bank has been resolved. The market will then be unfamiliar with the bank resolution process and the profile of a resolved bank. The result may be that the bank will have difficulty borrowing in the money market.

In this situation, the bank will need liquidity assistance and will turn to the central bank as an obvious source of support. Liquidity assistance to resolved banks is an issue under consideration by a number of central banks. The ECB is currently working on this issue, as we at Norges Bank are also doing.

The question I will focus on here today is:

How should Norges Bank react when a bank under resolution applies for emergency liquidity assistance (ELA)?

Before I answer that question, let me tell you in brief what I will not be speaking about today. I am not going to talk about the fixed-rate loans (F-loans), which Norges Bank uses to provide the money market in general with extra liquidity or the Bank's standing facilities, that is, D-loans or intraday loans. These loans are provided only against full collateral in the form of eligible securities, with the security's loan facility updated daily. Banks must pledge the collateral in advance. Each bank's borrowing limit is then automatically entered into Norges Bank's lending system.

Let us go back to the question of ELA.

Access to ELA is delimited. Norges Bank will process applications for ELA only from banks domiciled in Norway. Norges Bank will not evaluate an ELA application from a branch of a foreign bank. An application for ELA by a foreign bank must be submitted to that bank's home-country central bank. This is clearly spelled out in the Memorandum of Understanding between the Nordic-Baltic countries' central banks, as stipulated in section 5.4 (a).

"A request for Emergency Liquidity Assistance from a Bank within a Cross-Border Banking Group would be dealt with by the Bank's Home-Country Central Bank."[1]

Moreover, Norges Bank may only extend ELA in extraordinary circumstances, when financial stability is at risk if such a loan is not extended. A bank that the Ministry of Finance has decided to put into resolution will most probably satisfy that criterion, if it is experiencing liquidity problems.

But Norges Bank must set further requirements:

A bank receiving ELA from Norges Bank must be solvent and it must pledge satisfactory collateral.

Waiving these conditions would be tantamount to providing solvency assistance, which is not the central bank's task. This was clarified in the guidelines approved by Norges Bank in 2004 and will continue to apply under the new central bank act[2]. Norges Bank will not provide assistance to banks that are insolvent.

Section 3-1, fifth paragraph, of the new central bank act also stipulates that Norges Bank may only extend credit against satisfactory collateral.

Allow me to say a little more about the solvency requirement before I speak further on collateral for ELA.

A fundamental – and in this context an almost existential –question is:

Can a bank in resolution be considered solvent?

When the bank enters resolution, there is, at best, strong doubt as to the bank's solvency. However, the bank must be considered solvent at the moment a decision is made to recapitalise, that is, once Finanstilsynet has made a decision to write down portions of the bank's liabilities and, not least, to convert a sufficient portion of the bank's remaining liabilities to equity capital. Moreover, the resolution financing arrangement or the government may have decided to inject additional equity capital into the bank. These decisions must be made quickly and be legally sound. This underscores the importance of formulating the recovery and resolution plans so well as to remove all doubt with regard to the legality of Finanstilsynet's writedown and conversion decisions.

Norges Bank will not be in a position to contribute to securing a bank's liquidity until recapitalisation has been determined.

The next question is whether Norges Bank may extend ELA to a bank without the new equity capital in place, that is to say that it has actually been paid in. Yes. Once a decision has been made to put in place new equity capital, Norges Bank may extend liquidity assistance to the bank.

The fact is that a resolved bank is solvent as soon as a legally binding recapitalisation decision is made pursuant to the Norwegian regulation on recovery and resolution.

Let us have a closer look at collateral. If a bank, whether under resolution or not, applies to Norges Bank for ELA it is because it lacks sufficient liquid funds and ordinary collateral to enable it to participate in the settlement of payments. In a situation requiring ELA, only collateral assets other than those eligible for use in Norges Bank's liquidity facilities or for F-loans can be accepted.

Collateral that may be relevant for ELA are securities that do not satisfy the eligibility criteria for credit under the ordinary facilities. But the bank may not hold enough of those assets either, in which case non-traditional collateral may be relevant.

One type of non-traditional collateral of possible relevance for ELA are portions of a bank's loan portfolio. There are a number of practical challenges associated with accepting such collateral. And in a situation requiring ELA, time is of the essence, especially if the bank is also in resolution.

An amendment to the Financial Collateral Act in force from 2017 has substantially reduced the practical difficulties we were facing earlier. For Norges Bank to accept a residential mortgage portfolio as collateral, it is no longer necessary to notify each borrower individually.

Norges Bank's security interest in a residential mortgage portfolio and in the underlying pledged assets, that is, the dwellings in question, may now benefit from legal protection. For Norges Bank to obtain such a security interest in a residential mortgage portfolio, the Act requires that the bank concerned send Norges Bank a list of all the loans in the portfolio.

Norges Bank has begun to examine how to implement this in practice, in part in collaboration with representatives of Finance Norway and individual banks. We do not envisage an automated system for processing collateral akin to the one used in Norges Bank's standing facilities. We are aiming to establish a system that will be ready for use in a crisis, even if it will not be used in normal times.

Norges Bank will require that a residential mortgage portfolio that is to be used as collateral for ELA only comprises non-defaulted loans. This will enable Norges Bank to apply simple haircuts to the pledged portfolio. Such a rough valuation technique will save time, to the benefit of both parties, in what is likely to be a very hectic situation.

In the period ahead, Norges Bank, in collaboration with selected banks, will test various options for transferring information on all the loans in a portfolio of many thousand loans. We will draw up routines processing all this information by Norges Bank. We will contact banks and Finance Norway regarding these tests in the not too distant future. Experience from the testing will serve as a basis for updating Norges Bank's ELA routines.

The bank resolution process is time-critical. A resolved bank needs to have liquidity in place when it opens on the Monday morning after the resolution weekend. This means that any ELA will have to be granted over the weekend. Thus, an application for ELA will have to be submitted and processed as a part of the immediate resolution work. Remember, though, that Norges Bank may not extend credit until a legally binding decision has been made to recapitalise the bank.

It has traditionally been thought that a stigma is attached to a bank receiving ELA. This is probably a correct assessment of a bank in distress but not in resolution. Immediately after a bank has been placed under resolution, news that it has also received temporary ELA from the central bank could instead have a positive effect. It sends a signal that the central bank has confidence in the resolution and recapitalisation that has taken place. It also strengthens market and public confidence that the bank is liquid. It should therefore be in the interest of all concerned to make public the fact that the resolved bank is receiving temporary liquidity assistance from the central bank.

To conclude, liquidity assistance provided in the form of ELA from the central bank will never be a long-term solution for a resolved bank. ELA must only be a short-lived bridge to normal operation. ELA to a newly resolved bank will immediately improve the bank's liquidity, which will in turn strengthen confidence in the bank's viability. The resolution process – with recapitalisation – and ELA are thusdesigned to enable the bank to regain access to market funding and remove its need for ELA.

Thank you for your attention.

Footnotes

1. See Memorandum of Understanding on Cooperation regarding Banks with Cross-Border Establishments between the Central Banks of Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden

2. See p. 21 of Norges Bank's consultation response to Official Norwegian Reports NOU 2017:13: New central bank act.