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Liquidity in Resolution: the case for constructive certainty

For centuries, the doctrine of 'constructive ambiguity' played a key role in central banks' approach to failing banks. Uncertainty as to whether the liquidity lifeboat would arrive was felt to discourage reckless skippers at the helm of banks from sailing too close to the wind, or indeed to the rocks.

But the rules of navigation have now changed.

Banks are now equipped with double hulls, in the form of enhanced capital requirements and behind that an additional protective sheet of MREL or TLAC to give them the ability to recapitalise. They are like self-righting boats. To assist, we have built repair dockyards, in the form of resolution authorities, with all the necessary tools : bail-in, transfer strategies, asset separation vehicles, restructuring plans.

However, we have a problem in the Eurozone. We have built a dry dock, and banks, like any other vessel after repair, need liquid(ity) in order to float properly and go back to sea.

The absence of a liquidity provider for banks in resolution is the missing piece in the Eurozone resolution framework. Banks in resolution are the archetype of the banks that Walter Bagehot (in Lombard Street: A Description of the Money Market) saw as being deserving of support by a 'lender of last resort'. They are solvent, because their losses have been absorbed and they have been recapitalised, but they may be illiquid. They are stuck in dry dock.

Why can banks in resolution be solvent but illiquid? The essential reason is information mismatch. The dockyard, or resolution authority, knows perfectly the state of the hull and that they have carried out the necessary repairs. The bank is solvent once again. But prospective passengers, or private sector liquidity providers, will have an obvious desire to see for themselves that the bank can float before they venture aboard with their cash.

This is where we need to import into the Eurozone the concept of 'constructive certainty'. The markets needs to know that there is a dependable liquidity provider to enable banks to successfully emerge from resolution. If this is the case, the probability that private sector liquidity will become available is all the higher.

Liquidity provision in resolution is not the same as liquidity provision in the run-up to resolution. That function is a far more risky proposition, from which central banks understandably shy away. The debate as to who should provide the liquidity in resolution in the Eurozone has been going on for too long, and appears to have reached deadlock. This debate was resolved in the US and UK long ago.

Some confuse the provision of liquidity with the provision of capital and claim it constitutes State Aid. Others say that the ECB cannot provide liquidity because it would be incompatible with the monetary financing prohibition, and that the provision of liquidity in resolution is a government task and should be carried out by Treasury. But there is no Treasury for the Eurozone. The ESM may be the nearest thing to that, but any ESM schemes proposed to date have proved to be too cumbersome to be of practical use.

The current COVID crisis has shown that the ECB can act decisively in crisis conditions to provide liquidity to the entire banking sector. Surely it should be able to do so in response to the need to enable single banks in resolution to successfully leave dry dock, and it should say so.