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Banking Union and the ECB as Lender of Last Resort¹

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1. Introduction

The idea of a euro area “banking union” is often discussed but the reality is that the euro area is still a very long way from having a fully integrated and coherent banking system. I’m not sure if a formal definition of a well-functioning banking union exists but one could imagine it having a number of key features. These would include a common set of regulations, a single supervisory body, a common source of funding for bank resolution and a common deposit insurance scheme. The euro area now has the first and second item on this list, is moving slowly towards the third item (a resolution fund) and is thinking about someday having the final item (common deposit insurance) in the sense that the European Commission has a proposal for common deposit insurance but it is unclear whether this will get broad political backing.

These features are not, on their own, sufficient to have a stable and well-functioning unified banking system. Another important element is free movement of capital – depositors should be always free to move their money between banks in different geographical areas and should feel that their deposits are equally safe in all parts of the system. A final crucial part of a well-functioning banking union is a clear and reliable lender of last resort. Maturity transformation is a key aspect of why fractional reserve banking systems are useful but it is also accounts for why these systems are prone to periods of instability. Without a clear guarantee that solvent institutions will always have access to liquidity from the central bank, financial crises will be a recurring feature.

In this paper, I focus on how the lender of last resort function works in the euro area. I will argue that the Eurosystem does not provide a clear and transparent lender of last resort facility and discuss how this has promoted financial instability and has critically undermined free movement of capital in the euro area. Until this weakness in the euro area’s policy infrastructure is fixed, it will be difficult to have a truly successful banking union.

The structure of this paper is as follows. Section 2 discusses the role played in the banking system by central banks as lender of last resort and then outlines how the Eurosystem approaches lending to banks, including its Emergency Liquidity Assistance (ELA) procedures. Section 3 provides an in-depth discussion of three different cases in which the ELA was provided – in Ireland, in Cyprus and in Greece. Section 4 puts forward some new proposals for the Eurosystem’s emergency lending procedures.

2. The Eurosystem's Lending Procedures

In modern times, monetary policy – open market operations designed to regulate the supply and cost of liquidity – is seen as the principal task of central banks. However, up until the mid-twentieth century, the key function of central banks was their role as a lender of last resort in times of crisis. Perhaps the most famous discussion of lender of last resort policy is Walter Bagehot's (1873) *Lombard Street*. Bagehot's recommendations are summarised by former Bank of England Deputy Governor Paul Tucker (2009) as

to avert panic, central banks should lend early and freely (i.e. without limit), to solvent firms, against good collateral, and at "high rates".

Tucker's speech noted that Bagehot was concerned that

the Bank of England should acknowledge its role in stemming panics, and set out its principles for doing so: "The Bank has never laid down any clear or sound policy on the subject."

Somewhat incredibly, this is exactly the situation the European Central Bank is in today. It has no clear or sound policy on how to stem panics. Here I will describe the Eurosystem's procedures for lending to banks. The description comes in two parts, first covering the Eurosystem's standard monetary policy operations and then discussing what is known as Emergency Liquidity Assistance.

2.1 Collateral in the ECB's Standard Monetary Policy Operations

Textbook descriptions of monetary policy operations tend to focus on open market operations in which securities are permanently bought or sold. The ECB's approach to monetary policy, however, has been to influence liquidity conditions and the terms of credit via loans to banks through its so-called refinancing operations.

An important aspect of the ECB's refinancing operations is a set of explicit collateral requirements describing the assets that banks must pledge to obtain loans. These collateral requirements reflect the important potential opportunity cost associated with creating money to provide loans to banks. Money creation can, under some conditions, create inflation, thus passing on indirect costs to the public. Even in the absence of an impact on inflation, it is important to consider the risk that is taken on by a central bank when creating money to purchase assets: If an asset purchase goes badly, there is an opportunity cost arising from the fact that the central bank could have purchased a different asset that could have generated positive returns which could then have been remitted back to central governments. In particular, the provision of credit to weak banks that are then unable to repay the loans provides a potentially unfair publicly-funded boost to the creditors of these banks.

Since its inception, the ECB has had a comprehensive risk assessment framework based on the requirement that banks must submit collateral from a specified list of eligible assets in order to obtain a standard loan from the Eurosystem. Lending to banks in the euro area is a decentralised operation with the loans being provided by the national central banks (NCBs). If a bank defaults on a loan provided by a NCB, this collateral is then taken by the NCB. If the acquired collateral fails to cover the value of the original loan, the agreed procedure is that the losses incurred will be shared across all of the members of the Eurosystem.

The Eurosystem has always had a broad collateral framework, incorporating a large amount of assets of different types. The framework involves a risk assessment of each eligible asset with a "haircut" set so that, for example, if an asset has a 10 percent haircut, a bank that pledges a face value of €100 million of this asset as collateral will be entitled to a loan of €90 million.

While the availability of a public list of eligible collateral makes the terms of standard Eurosystem loans that prevail at any point in time clear to the public, that is not the same thing as saying the rules are fixed. Indeed, the ECB Governing Council regularly makes decisions to adjust the framework by adding and subtracting various items from its eligible collateral list or by adjusting the appropriate haircuts.

For example, to facilitate its move to a “full allotment” policy in 2008 as well as subsequent monetary policy measures such as Long Term Refinancing Operations (LTROs), ensuring they were not undermined a shortage of collateral, the ECB has made a number of technical changes to its collateral framework in recent years. The number of specific changes is too long to list here – ECB (2013) contains a detailed description – but a few are worth noting. The credit threshold required for most assets to qualify as eligible collateral has been lowered from A- to BBB-. Various adjustments have been made to make it easier for asset-backed securities (ABS) to become eligible and new criteria were drawn up to allow NCBs to accept nonmarketable bank loans (additional credit claims) as collateral.

Perhaps the more important example to illustrate the discretionary and judgemental nature of the ECB’s eligible collateral list has been the treatment in recent years of various assets either issued by or backed by the Greek government. At various different times in recent years, depending on how negotiations were going between Greece and the troika, the ECB Governing Council has taken various types of Greek assets off the eligible list, with the assets often returning to the list at a later stage.

2.2. Emergency Liquidity Assistance

One might imagine that the ECB’s eligible collateral list and its accompanying set of haircuts together define its policy as a lender of last resort to banks. However, this is not the case. The experience of recent years has shown that in many of the cases where euro area banks have come under severe financial strain, the banks have used up all of their eligible collateral to obtain funds via refinancing operations but still need to borrow more from the Eurosystem.

It turns out banks can still receive credit from the Eurosystem using non-eligible collateral. These loans are called Emergency Liquidity Assistance (ELA). In many cases, the legal basis for provision of ELA pre-dates the euro. The national central banks in the Euro area were founded prior to the start of EMU and thus each have pre-existing legal powers and obligations. Some are given various regulatory and supervisory powers while some are not. More importantly, it is common for national central banks to be given an explicit set of powers related to financial stability.

Despite the existence of numerous ELA programmes in the Eurosystem since 2008, the ECB Governing Council has been extremely tight-lipped in its discussions of these programmes. Only in October 2013 did the Governing Council provide an official description of how ELA programmes work and this description is quite terse.²

² This document can be found at https://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf?e716d1d560392b10142724f50c6bf66a

Based on this description and other sources, my understanding is that ELA programmes operate as follows.

- ELA is not a Eurosystem programme. It can be issued by any NCB without consulting the ECB Governing Council.
- However, procedures exist that require any NCB issuing ELA to inform the ECB within two business days after the operation is carried out and provide detailed information on the nature of the lending, including the collateral pledged.
- The ECB Governing Council can decide via a two-thirds majority vote – consistent with Article 14.4 of the “Protocol on the Statute of the European System of Central Banks and of the European Central Bank – that ELA operations interfere with the objectives and tasks of the Eurosystem. After such a vote, the Governing Council can order the NCB to restrict its ELA programme.
- Unlike regular Eurosystem liquidity-providing operations, all risk associated with ELA falls on the NCB that grants the loans.

These rules are pretty vague. They don’t describe the circumstances under which the ECB considers ELA to be appropriate nor do they make clear the criteria by which the ECB arrives at a decision that an ELA programme “interferes with the objectives and tasks of the Eurosystem.” Vague rules have the potential to lead to confusion and controversy and this is exactly what has happened in recent years.

3. The Eurosystem’s Experience with ELA

Despite its clear (though adjustable) policies on eligible collateral for monetary policy operations, the ECB has no clear procedures for dealing with banks that have used all of their eligible collateral but that still wish to borrow from the Eurosystem. This position is unsatisfactory and has been very damaging to the reputation of the ECB. In this section, I discuss three examples of where ELA has been used and point to a number of questions these examples raise.

3.1 Ireland

From the beginning of Ireland’s banking crisis in late 2008, it was clear that Anglo Irish Bank, which had specialised in commercial property lending, was in serious trouble. The bank was nationalised in early 2009 and was suffering from substantial deposit withdrawals when the Central Bank of Ireland agreed in March 2009 to provide it with €11.5 billion in ELA. As the sovereign debt crisis intensified through 2010, the pace of deposit withdrawals from Anglo Irish intensified and its ELA borrowings moved up sharply. See Figure 3 for a graph of regular Eurosystem lending as well as ELA to the six Irish banks that had been provided with a near-blanket liability guarantee by the Irish government in September 2008.

Over the course of 2010, the other main Irish banks also came under pressure from deposit outflows. The September 2008 guarantee had been put in place for two years and the covered banks had issued a large amount of bonds that matured prior to September 2010. As September

2010 came and went, they failed to find new sources of private sector funding. Thus, these banks increased their reliance on ECB funding and eventually also applied for ELA.³

ECB officials had spent much of 2010 publicly discussing their plans to implement an “exit strategy” from their fixed-rate full allotment policy. The developments at Ireland’s banks were clearly working against this plan. In September 2010, ECB officials including Jean-Claude Trichet began making public statements about their unhappiness with (unnamed) “addict banks” that were reliant on Eurosystem funding.⁴

Based on the recent release of letters by the ECB, we know now that Jean-Claude Trichet sent a letter to Ireland’s Finance minister, Brian Lenihan, on October 15, 2010 which warned⁵

I would like to re-emphasize that the current large provision of liquidity by the Eurosystem and the Central Bank of Ireland to entities such as Anglo Irish Bank should not be taken for granted as a long-term solution. Given these principles, the Governing Council cannot commit to maintaining the size of its funding to these institutions on a permanent basis.

By November 2010, total Eurosystem funding for the Irish banks had reached about €140 billion which was around 85% of Irish GDP and almost a quarter of total Eurosystem lending. At this point, the ECB played a crucial role in Ireland’s application for a bailout from the EU and IMF. Jean-Claude Trichet sent a letter to Brian Lenihan threatening to cut off ELA funding unless the Irish government submitted a formal request to the EU for an adjustment programme.⁶ The specific wording of this part of the letter was as follows.

It is the position of the Governing Council that it is only if we receive in writing a commitment from the Irish government vis-a-vis the Eurosystem on the four following points that we can authorise further provisions of ELA to Irish financial institutions:

- 1) The Irish government shall send a request for financial support to the Eurogroup;*
- 2) The request shall include the commitment to undertake decisive actions in the areas of fiscal consolidation, structural reforms and financial sector restructuring, in agreement with the European Commission, the International Monetary Fund and the ECB;*
- 3) The plan for the restructuring of the Irish financial sector shall include the provision of the necessary capital to those Irish banks needing it and will be funded by the financial resources provided at the European and international level to the Irish government as well as by financial means currently available to the Irish government, including existing cash reserves of the Irish government;*

³ See Whelan (2014) for a more detailed discussion of Ireland’s banking crisis.

⁴ See for example, the Financial Times article from September 13, 2010 “Fears grow over banks addicted to ECB funding”

<http://www.ft.com/intl/cms/s/0/580109dc-bf43-11df-a789-00144feab49a.html>

⁵ This letter is available at https://www.ecb.europa.eu/press/shared/pdf/2010-10-15_Letter_ECB_President_to_IE_FinMin.pdf?05f2367e74897b4aa2641f31d639d1c3

⁶ The November letter from Trichet to Lenihan is available at

https://www.ecb.europa.eu/press/shared/pdf/2010-11-19_Letter_ECB_President_to%20IE_FinMin.pdf?83824135ba733b6091e930d3a25314c9

4) *The repayment of the funds provided in the form of ELA shall be fully guaranteed by the Irish government, which would ensure the payment of immediate compensation to the Central Bank of Ireland in the event of missed payments on the side of the recipient institutions.*

Ireland applied for financial assistance and its EU-IMF bailout programme began in late 2010. Deposits continued to flow out of the Irish banking system for a number of months and ELA actually increased significantly over those months, from €43 billion in November 2010 to €68 billion in February 2012. However, the banking system began to stabilise after the release of official stress tests and a large recapitalisation. Ireland's ELA programme ended in February 2013 when Anglo's successor organisation, the Irish Bank Resolution Corporation was put into liquidation.

The ECB's actions in relation to its interactions with the Irish banking system raise many questions.

- Given the size of the emerging solvency problem at Anglo Irish Bank in Spring 2010, why did the Governing Council approve such a large initial ELA programme?
- If the ECB were relying on the Irish state's backing for Anglo as reassurance that the bank's solvency would be maintained, at what point did doubts about the state's ability to provide this assistance emerge?
- If the solvency of the Irish banks was required for continuing ELA programmes, why did the ECB not limit itself to a demand for recapitalisation of these banks? Almost certainly, the Irish government would have had to apply for an official programme to meet this demand. But why not let the government make this decision instead of insisting on "*decisive actions in the areas of fiscal consolidation, structural reforms*"? Which aspects of the ECB's legal mandate allow it to demand fiscal consolidation and structural reforms as a condition to supply funding to individual banks?

Mario Draghi deserves credit for releasing these letters. However, the ECB's response to the release has completely avoided the important questions about ELA programmes that the letters raise.

3.2 Cyprus

If anything, the ECB's role in providing and subsequently restricting ELA to banks in Cyprus is even more murky and problematic.

While the situation with Cyprus's two largest banks became known to the wider European public in March 2013, it was clear to closer observers from early 2012 that these banks were in severe difficulties. Due to ill-advised purchases of Greek government bonds, poorly-timed expansions into the Greek market and a weakening Cypriot economy, both Bank of Cyprus (BoC) and Laiki Bank were effectively insolvent from early 2011 onwards.

The restructuring of Greek sovereign bonds sharply reduced Laiki's stock of assets that could be used as collateral for regular Eurosystem monetary policy operations. In October 2011, Laiki applied to the Central Bank of Cyprus (CBC) for emergency liquidity assistance (ELA) which is a form of central bank funding on non-standard terms. By November 2011, Laiki had €2.5 billion in ELA funding from the CBC and the amount of this funding increased significantly over the first seven months of 2012.

Because no other bank in Cyprus appears to have been receiving ELA at the time, we can track the evolution of Laiki's ELA in late 2011 and 2012 using publicly-available information on the CBC's balance sheet. This balance sheet recorded ELA under the heading "Other Assets" until April 2013 when it began recording it under "Other Claims". (There have been some small other items recorded under these entries but they are tiny relative to the ELA funding.)

In February 2012, the European Banking Authority (EBA) communicated that Laiki needed a recapitalisation of €1.97 billion while BoC required €1.56 billion. The government of Cyprus was effectively shut out of the sovereign bond market at this point and against a background of a worsening economy, it was not possible for BoC and Laiki to raise the private investment required to meet the EBA's core equity requirements by June 2012.

In May 2012, the government of Cyprus agreed to underwrite a €1.8 billion capital raising exercise for Laiki. On June 25, 2012, Fitch became the final ratings agency to downgrade Cyprus to below investment-grade. On the same day, the government of Cyprus submitted an application for financial assistance from the Eurozone's bailout funds. Two days later, BoC requested state aid of €500 million to allow it to meet its EBA core equity requirements.

During the period following the application for financial assistance and the final agreement on this assistance in March 2013, the capital position of the Cypriot banks continued to worsen. BoC booked new provisions for bad loans of €2.3 billion in 2012 and by the end of the year, the bank was insolvent with core equity of minus €407 million. The EBA assessed Laiki's accounts again in June 2012 and found an additional capital shortfall of €1.1 billion. Laiki did not publish year-end accounts for 2012 but their final published results for the first nine months of the year showed an additional €1.67 billion in losses, again leaving the bank on the brink of balance sheet insolvency.

As information circulated on Laiki's capital shortfall and its failure to obtain any private equity, deposit outflows increased, particularly at its Greek branches. The CBC's "Other Claims" series shows an increase from €3.9 billion in April 2012 to €5.9 billion in May 2012 and €8.2 billion in June 2012. (See Figure 4 for a graph of lending from the Central Bank of Cyprus).

The increase in ELA in May 2012 reflected deposit outflows. The June increase, however, also reflected decisions by the ECB that further reduced Laiki's ability to take part in normal Eurosystem operations. Its Greek covered bonds were downgraded and deemed ineligible as collateral while Fitch's downgrade of Cypriot government bonds led to these bonds also being taken off the ECB's collateral list. As a result of these decisions, regular Eurosystem lending by the CBC declined by €1 billion in June 2012.

In July 2012, the ECB removed Laiki from its list of eligible counterparties due to concerns about its solvency, a decision that it can take on the basis of the rules governing its risk control framework. By the end of July 2012, Laiki had no regular Eurosystem funding and its ELA was about €9.6 billion. This seems to have been about as much ELA as the Eurosystem was willing to lend the bank. The former Governor of the CBC, Panicos Demetriades, has explained that "*after the Eurogroup of 21 January*

2013, Laiki Bank's ability to raise emergency liquidity reached a plateau due to the reduction in the value of its available collateral.”⁷

After a long period of delay, which included an election in February 2013, a financial assistance package for Cyprus was agreed in March under extremely stressed circumstances.

At a meeting of the Eurogroup of finance ministers that ended in the early hours of March 16, the ECB's representative Jörg Asmussen stated that the Governing Council was unwilling to continue authorising ELA to Cypriot banks unless these banks were restored to solvency by the end of March via writing down the value of customer deposits. It had been established by this point that the euro area member states and the IMF were only willing to provide €10 billion in funding which meant there was not enough money available to finance Cyprus's fiscal deficits and sovereign bond rollovers and also recapitalise its banks.

The final deal that was agreed with the Cypriot government required that the large amounts of ELA provided to the insolvent banks and deposits at Greek branches of the Cypriot banks be repaid in full: These requirements greatly increased the size of the “haircut” for depositors with the Cypriot banks. Laiki Bank was wound down and the large amount of ELA owed by Laiki was transferred to BoC.

While the deposit write-downs restored BoC to solvency, the ECB then placed hard limits on the amount of Eurosystem funding for this bank. This refusal to provide further funding for the bank was the key factor in the imposition of capital controls that are prevented people from transferring their money out of banks in Cyprus to elsewhere in the EU.

The ECB's decisions in relation to the Cypriot banks raise a number of questions

- Did the ECB realise that Laiki was heading towards being highly insolvent when it provided it with ELA in late 2011?
- As the ECB provided more funds to Laiki in 2012, were they assuming the Cypriot government would provide the money that would restore the bank to solvency? In the end, the government did not have the capacity to do this.
- On what grounds did the ECB delay its demand for a recapitalisation of the Cypriot banks until after the 2013 election?
- At what point did ECB and the European authorities decide that the recapitalisation in Cyprus should take place via deposit write-downs?
- Why did the wind-down of Laiki bank not see the Central Bank of Cyprus take the underlying collateral that had been pledged? In other words, why was Laiki's ELA transferred to be the responsibility of another bank?
- Did the ECB play a role in the decision to limit deposit write-downs to customers in Cyprus while leaving depositors in Greece protected?

⁷ Introductory statement before the Investigation Committee on the Economy, 13 August 2013.
http://www.centralbank.gov.cy/nqcontent.cfm?a_id=12928&lang=en

- Given that Bank of Cyprus is now solvent, why does the ECB continue to place limits on its ELA funding, limits that have the repercussion of keeping international capital controls in place?

It is to be hoped that, as with the Irish case, the ECB will also release documents that will explain its actions in Cyprus. I suspect, however, we may be waiting a long time for such a release.

3.3 Greece

A consistent theme of the Greek debt crisis has been the ECB's regular threats (either implicit or explicit) to withdraw or cap funding for the Greek banking system. Greek government bonds and other assets backed by government guarantees were regularly withdrawn and then added again to the eligible collateral list and while they were withdrawn, the Greek banks relied on Emergency Liquidity Assistance from the Bank of Greece. These ELA programmes were constantly reviewed by the ECB Governing Council and could be cancelled at short notice if the Council decided. The issue came to a head in 2015 as negotiations between the new Syriza government and the European creditors went poorly.

One of the more interesting aspects of the Greek banking crisis of 2015 is that the major great banks had featured in the comprehensive assessment and stress test undertaken by the ECB in 2014 as it took over as the single supervisor for the euro area's banks. The results of this test, announced in October 2014, showed the Greek banks to be solvent and to have very limited need for recapitalisation to meet the ECB's requirements. Indeed, the Financial Times reported about the Greek banks *"If the final capital needs are indeed nil or very small, this could pave the way for converting €11.4bn set aside for bank recapitalisation into a precautionary credit line to help Greece exit smoothly from its bailout program."*⁸

Despite this positive conclusion, the political uncertainty surrounding the January 2015 election led to increased speculation that the new government would default on its debts and that this could result in Greece leaving the euro. Afraid that their deposits would be redenominated into a new, weaker currency, deposits began to flow out of the Greek banking system and there was a sharp increase in ELA to the banking system to finance these outflows.

After the election of the new government, the ECB insisted that the successful negotiation of a new programme would be a necessary condition for continuing to provide more ELA. After a number of meetings in which the Governing Council raised a cap on the amount of ELA to provided, the ECB responded to the announcement by the Greek government of a referendum on the terms of a deal offered by the EU and IMF by announcing that it was placing a hard cap on the amount of ELA that could be provided.⁹ Effectively, the ECB announced that it would not facilitate further deposit outflows from the Greek banking system. This led to the imposition of capital controls, controls that remained in place even after the Greek government agreed a new programme with the EU and IMF.

Did the ECB have to take the course of action that it chose? Consider the following alternative version of how the Greek crisis could have played out.

⁸ See <http://www.ft.com/intl/cms/s/0/27fe630a-5d1f-11e4-873e-00144feabdc0.html>

⁹ The announcement can be found at <http://www.ecb.europa.eu/press/pr/date/2015/html/pr150628.en.html>

1. As tension builds up in Greece prior to the Greek election in early 2015, Mario Draghi assures depositors in Greece that the ECB has fully tested the Greek banks and they do not have capital shortfalls. For this reason, their money is safe.
2. Draghi announces that the ECB will thus provide full support to the Greek banks even if the government defaults on its debts, subject to those banks remaining solvent.
3. Eurozone governments agree that, should Greek banks require recapitalisation to maintain solvency, the European Stabilisation Mechanism (ESM) will provide the capital in return for an ownership stake in the banks.
4. Provided with assurances of liquidity and solvency support, there is no bank run as Greek citizens believe their banking system is safe even if the government's negotiations with creditors go badly. The ECB stays out of the negotiations for a new creditor deal for Greece (because they are not a political organisation and are not involved in directly loaning money to the government) and its officials assure everyone that the integrity of the common currency is in no way at stake.

There were no legal impediments to this scenario. Despite ECB officials consistently delivering speeches during this period that they were forced to act in the way they did by their own rules, the reality is that the ECB could have pursued this approach. Supporting banks that you have deemed solvent is pretty standard central banking practice. So Draghi's ECB could have provided full and unequivocal support to the Greek banks if they wished. They just chose not to. Similarly, procedures are in place for the ESM to invest directly in banks so a credible assurance of solvency could have been offered.

Why did this not happen? Politics is the most likely answer. European governments did not want to provide assurances to Greek citizens about their banking system at the same time as their government was openly discussing the possibility of not paying back existing loans from European governments. Indeed, the ability to unleash a bank-driven "Grexit" mechanism proved to be the ace in the creditors' pack when negotiating with Greece. Faced with massive political opposition in Germany and other Northern European countries to their existing monetary policy programmes, Mario Draghi and the ECB Governing Council decided it is better for them to play along with the creditor country squeeze on Greece than to stabilise the Greek banking system.

4. The Need for a New Approach

Central banks were put on this earth to be lenders of last resort. Dealing with complex situations in which banks are running out of liquidity and may or may not be solvent should be a core part of every central bank's tasks. The ECB, however, does not currently play this role in a coherent and comprehensive manner.

Consider this ECB statement from 2014 in response to a *New York Times* story that revealed leaked minutes of the ECB's discussion of the Cypriot banking situation.¹⁰

¹⁰ The ECB statement can be found at http://www.ecb.europa.eu/press/pr/date/2014/html/pr141017_1.en.html

The ECB neither provides nor approves emergency liquidity assistance. It is the national central bank, in this case the Central Bank of Cyprus, that provides ELA to an institution that it judges to be solvent at its own risks and under its own terms and conditions. The ECB can object on monetary policy grounds; in order to do so at least two thirds of the Governing Council must see the provision of emergency liquidity as interfering with the tasks and objectives of euro area monetary policy.

So the ECB's official line is that it doesn't provide or approve ELA but also that it sort of does. This is a recipe for the kinds of incoherent policy that we have seen in recent years. Even more worryingly, there is plenty of evidence that political considerations have played a key role in the ECB's decisions about whether and when to provide or cap the provision of emergency liquidity.

It is time to develop a completely new approach for the ECB as lender of last resort. The ECB has taken over as the supervisor of the euro area's banks. This removes most of the previous arguments that were in place for the current system of ELA provision. Previously, banks were overseen by national supervisors. As such, it could be argued that those banks that got into trouble and required ELA were the responsibility of national central banks and that the risk associated with lending to these banks should be borne at a national level.

This point no longer holds. Once all of the euro area's banks have complied with the capital raising requirements from the comprehensive assessment, then they will all have an official diagnosis of good health from the ECB. If further problems arise, they should be considered the joint responsibility of all central banks in the Eurosystem.

For this reasons, I believe it is time to change the system in which lending against eligible collateral is a Eurosystem concern while ELA is a national concern. The ECB should be required to approve each and every ELA programme and have the risk shared among the Eurosystem. As an independent regulator, the ECB should also be a position to assess whether the liquidity problems for a bank applying for ELA reflect temporary problems or else reflect deeper structural issues (it is usually the latter). This should help with speeding up the process of restructuring problem banks, via recapitalisation or bail-in and the passing of the Bank Recovery and Resolution Directive now means that the tools to implement these kinds of restructuring are now largely in place. A speedier response of this sort would help to avoid a repeat of long-term ELA programmes in which Eurosystem funding is used to allow private creditors to gradually get their money safely out of insolvent banks.

Of course, this proposal will mean the ECB will have to take on more explicit responsibility for dealing with financial instability. But the two-thirds majority voting on ELA at Governing Council has already meant that the ECB is effectively taking on this responsibility already.

One complication with this proposal is that many of the NCBs have been given a financial stability responsibility to provide emergency lending to banks that is enshrined in national law. I would argue that the ECB should establish a protocol that all ELA programmes are centrally approved and subsequently request amendments to national central bank legislation if this is required.

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