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The Lender of Last Resort in the Eurozone

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Abstract

Liquidity supply by a *Lender of Last Resort* (LOLR) can be pivotal for both the conduct of monetary policy and safeguard of financial stability. During the financial crisis, the importance of liquidity provision has significantly increased at both the macro-level – through the European Central Bank (ECB) – and also for individual credit institutions in the guise of Emergency Liquidity Assistance (ELA) through the National Central Banks (NCBs). This article examines the legal framework in which the ECB and the NCBs carry out their respective roles as LOLR. The question of who holds competence for liquidity supply is discussed in light of the LOLR functions pertaining to financial stability and monetary policy, as are the availability of effective measures and the legal prerequisites and limitations, particularly with regard to the prohibition of monetary state financing, the imperative of price stability and state aid rules. In view of recent reforms of banking supervision in the eurozone, the question of centralizing ELA within the ECB also arises.

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I. Introduction

The different types of anti-crises instruments have gradually expanded over the last few years. At the start, there were the bilateral loans from Member States to crisis countries; then, the European Financial Stability Facility (EFSF) was created; later, the European Stability Mechanism (ESM) was added; the European Central Bank's (ECB) Securities Markets Programme (SMP) covering bond purchases since May 2010 and finally the announcement by the ECB that it would purchase an unlimited number of government bonds if necessary.[1] The Court of Justice of the European Union (CJEU) subsequently approved these far-reaching interventions. First, the CJEU had, in the *Pringle* case,[2] paved the way for the creation of the ESM. More recently, in *Gauweiler*, the Court found the European Central Bank's (ECB) Outright Monetary Transactions (OMT) programme to be compatible with EU law.[3]

Less (academic) attention has been given to another tool of crisis management that is as powerful as it is intransparent – liquidity supply to national banks, provided by the national central banks and the ECB.[4] During the Irish banking crisis, the ECB allegedly put pressure on the Irish government, threatening to end liquidity funding unless Ireland sought bailout under EU surveillance.[5] In the case of Cyprus, "the ECB decided […] that ELA would be continued if and only if a programme was in place that would ensure the solvency of the banks concerned".[6] More recently, the ECB froze liquidity support under ELA, exerting pressure on the Greek government to enter into and accept the conditions of an ESM support program.[7]

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[1] Instructively, de Gregorio Merion, "Legal developments in the Economic and Monetary Union During the Debt Crisis: The Mechanisms of Financial Assistance", 49 CML Rev. (2012), 1613-1646.

[2] CJEU Case C-370/12, *Thomas Pringle* v. *Government of Ireland*, *Ireland and The Attorney General*, EU:C:2012:756 (hereinafter *Pringle* case); Adam and Mena Parras, "The European Stability Mechanism through the Legal Meanderings of the Union's Constitutionalism: Comment on Pringle", 38 EL Rev. (2013), 848-865, at 860.

[3] CJEU Case C-62/14, *Peter Gauweiler and Others* v. *Deutscher Bundestag*, judgement of 16 June 2015 (hereinafter *Gauweiler* case). On the compatibility of the OMT programme with EU law, see Steinbach, "The compatibility of the ECB's sovereign bond purchases with EU law and German constitutional law", 39 Yale Journal of International Law (2013), 15.

[4] On the scope of ELA during the crisis, see Domanski, Moessner and Nelson, *Central Banks as Lenders of Last Resort: Experiences During the 2007-10 Crisis and Lessons for the Future*, Bank for International Settlements (BIS) Paper No. 79c, Sept. 2014, at 48.

[5] Financial Times, ECB threatened to end funding unless Ireland sought bailout, 6 Nov. 2014. On 6 Nov. 2014, the Governing Council of the ECB decided to publish the correspondence between the ECB and the Irish authorities, available at <http://www.ecb.europa.eu/press/html/irish-letters.en.html> (last visited 03 Oct. 2015).

[6] Exchange of views with the Economic and Monetary Affairs Committee of the European Parliament on financial assistance to Cyprus. Introductory Statement by Asmussen, Member of the Executive Board of the ECB, Brussels, 8 May 2013, available at https://www.ecb.europa.eu/press/key/date/2013/html/sp130508.en.html (last visited 03 Oct. 2015).

[7] ECB, "ELA to Greek banks maintained at its current level", Press Release, 28 June 2015; ECB, "ELA to Greek banks maintained", Press Release, 6 July 2015.

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In all these cases, the supply of ELA has played a decisive role in influencing the governments' willingness to seek and accept financial assistance under strict conditionality terms.

While among economists the role of liquidity supply for financial stability and monetary policy has been widely debated,[8] legal scholarship has given this topic comparatively less attention.[9] Indeed, liquidity supplied by central banks performs a pivotal element in maintaining financial stability, as can be illustrated by the risks posed by bank runs. In the case of a run on deposits, a bank is forced to acquire additional liquid funds from other commercial banks or the central bank, or else by selling liquid assets. If the bank is unsuccessful in creating sufficient liquidity, the prospect of its insolvency cannot be discarded, should too many customers simultaneously demand high amounts of cash. A bank run ensues, which without intervention leads to the bank's bankruptcy.[10]

In such a situation, one main function of the central bank lies in its capacity as an emergency lender for credit institutions (Lender of Last Resort – LOLR). This concept holds that the central bank should generously provide credit to institutions with liquidity problems in times of crisis, under four conditions.[11] First, financial assistance should generally be supplied to banks in need of liquidity, provided they are solvent.[12] Second, the central bank should lend without limitation, that is, as much as is needed. However, a "penalty rate" should be charged, but there is some disagreement about this.[13] The third condition is that the central bank should require illiquid banks to provide "good" collateral. Fourth, the central bank should signal its readiness to lend but retain discretion as to whether or not to provide assistance on an

[8] See, e.g., Hellwig, "Liquidity Provision, Banking, and the Allocation of Interest Rate Risk", 38 European Economic Review (1994), 1363-1389; Hellwig, *Switzerland and Euroland: European Monetary Union, Monetary Stability and Financial Stability*, Max Planck Institute for Research on Collective Goods (MPI) Research Paper 2007/9, 2007; Hellwig, *Financial Stability, Monetary Policy, Banking Supervision, and Central Banking*, MPI Research Paper 2014/09, 2014; Crockett, "Marrying the micro- and macro-prudential dimensions of financial stability", 76 BIS Review (2000), 1-7; Diamond and Rajan, "Illiquid Banks, Financial Stability, and Interest Rate Policy", 120(3) Journal of Political Economy (2012), 552-591.

[9] Goodhart, "Introduction", in Goodhart (Ed.), *Which Lender of Last Resort for Europe?* (Central Banking Publications, 2000), 3-12, at 3; Smits, *The European Central Bank* (Kluwer Law International, 1997), p. 269; Tumpel-Gugerell, "Lender of Last Resort", in Cheltenham et al. (Eds.), *Stability of the financial system: illusion or feasible concept?* (Edward Elgar, 2013), 513-525, at 516; Lastra, *Legal Foundations of International Monetary Stability* (OUP, 2006), p. 116; Campbell and Lastra, "Revisiting the Lender of Last Resort", 24 Banking & Finance Law Review (2009), 453-497, at 468.

[10] Illing, *Financial Stability and Monetary Policy – A Framework*, CESifo Working Paper No. 1971, April 2007, at 5; Diamond and Dybvig, 91 Journal of Political Economy 1983, 401-419, at 401; Hellwig (1994), op. cit. *supra* note 8, at 1378.

[11] Thornton, *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain* (1802); Bagehot, *Lombard Street: A Description of the Money Market* (1873); Goodhart, *The evolution of central banks* (MIT Press, 1988); Hellwig (2014), op. cit. *supra* note 8, at 14.

[12] This requirement has been contested in literature; see infra note 62.

[13] See e.g. Goodhart, "Myths about the lender of last resort", 2 International Finance (1999), 339-360, at 339.

individual case basis ("constructive ambiguity").[14] The task of LOLR therefore lies in interrupting the chain reaction caused by a loss of trust on the part of the depositors and lenders, as well as in preventing an aggravation of mutual mistrust and the subsequent drain of the credit market.[15]

Emergency liquidity supply entails a number of problems. First, loans are frequently granted against less valuable collaterals, or even no collateral at all, at times even to insolvent institutions.[16] It is not always a straightforward matter to distinguish illiquidity from insolvency; the distinction may be difficult[17] or even impossible.[18] A situation of bank illiquidity (i.e., a lack of liquid funds) can be an indication of technical insolvency (i.e., the value of liabilities exceeds the market value of assets) or can quickly turn into insolvency if assets are sold at a loss value or "fire-sale" price. In addition, there is a severe problem in the danger of false incentives that weaken market discipline (moral hazard).[19] There is no disciplining action from the investors, as they do not carry the risk themselves, relying instead on state support.

Against this background, the question arises as to the legal framework within which the ECB and the NCBs can assume a role of LOLR. This includes issues of competence for liquidity supply and the availability of effective instruments, as well as the main legal requirements and limitations. This article is structured as follows: Section II) discusses the competencies of the ECB and the NCBs in the allocation of liquidity supply under EU law. We distinguish between liquidity aid to alleviate liquidity shortages at the macro level and the liquidity supplied to individual credit institutions through ELA. Building on this, Section III) discusses Member-State ELA and examines the main legal requirements, in particular with regard to the prohibition of monetary state financing and the requirement of price stability. Section IV) examines the legal dimension of ELA credits in light of the EU Commission's state aid practice. Section V) then explores possibilities of centralising ELA within the ECB, given the recent supervisory reforms in the banking sector. Section VI) concludes.

[14] Lastra, "Central bank independence and financial stability", 18 Banco de Espana Estabilidad Financiera (2010), 51-66, at 62.
[15]Freixas, Giannini, Hoggarth and Soussa, "Lender of last resort: A review of the literature", 11 *The Financial Stability Review* (1999), 151-167.
[16] Bordo, "The Lender of Last Resort: Alternative Views and Historical Experience,, in Goodhart and Illing (Eds.), *Financial Crises, Contagion, and the Lender of Last Resort, a Reader* (OUP, 2002), 109-125, at 121f.; Domanski, Moessner, and Nelson, op. cit. *supra* note 4, at 48.
[17] Hellwig (2014), op. cit. *supra* note 8, at 22; Tumpel-Gugerell, op. cit. *supra* note 9, at 516; Campbell and Lastra, op. cit. *supra* note 9.
[18] Goodhart, op. cit. *supra* note 13, at 317, 320.
[19] On the moral hazard problem involved with central banking activities, see Hellwig (2014), op. cit. *supra* note 8, at 7; Goodhart, "Myths about the Lender of Last Resort", in Goodhart and Illing (Eds.), *Financial Crises, Contagion, and the Lender of Last Resort, a Reader* (OUP, 2002), 227-245, at 238.

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II. Competence for Liquidity Supply in the Eurozone

Regarding liquidity supply, a central bank typically has two options whenever it provides the finance sector with the necessary liquidity. One option is to provide liquidity for the entire system, via its monetary-policy operations (macro-level liquidity supply). The other option is for the central bank to use bilateral transactions to provide individual institutions with liquidity aid in the guise of ELA (micro-level liquidity supply). Both macro-level and micro-level liquidity supply follow different sets of rules.

1. Task-sharing among the ECB and the NCBs

The monetary union is based upon a two-level monetary system consisting of the ECB and the NCBs (Article 282, para. 1, sent. 2 TFEU). The core task of this European System of Central Banks (ESCB) is determining and operating a standard monetary policy for the Eurosystem (Article 127 para. 2 TFEU). The internal organisation of the ESCB follows strict hierarchical principles; the NCB is bound by instructions from the hierarchically superior ECB (Article 129 para. 1 TFEU). The task distribution within the ESCB follows from the general decentralisation principle laid out in Article 12.1 of the ESCB Statute. According to Article 14.3. sent. 1 of the ESCB Statute, the NCB follows the guidelines and instructions of the ECB in executing monetary policy. In this regard, the relationship between the ECB and the NCB is designed as one of subordination.

However, the national central banks are only subject to the directives of the ECB within the framework of the ESCB exercising its tasks. If an NCB conducts purely national tasks, the ECB has no right to give instructions in this regard. In such cases, Article 14.4. of the ESCB Statute applies: Tasks that are not ESCB tasks may be performed by an NCB as long as the ECB Council does not reach the conclusion, with a two-thirds majority, that they are incompatible with the goals and tasks of the ESCB. In the institutional structure of the monetary union, the national central banks thus occupy a hybrid position: On the one hand, they are an integral part of the ESCB, while they remain, on the other hand, independent legal entities with purely national authority.[20]

2. Liquidity Shortages at the Macro Level

In principle, two situations can be distinguished where the supply of liquidity assistance can be pivotal. The first is a general shortage of liquidity in several national financial markets. There is agreement that macro-level liquidity supply falls to the ESCB. What is unclear is the legal basis, due to disagreement about considering liquidity as monetary policy or financial stability measure.[21]

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[20] Lastra, op. cit. *supra* note 9, at 211; Haentjens and de Gioia-Carabellese, *European Banking and Financial Law* (Taylor & Francis, 2015), p. 95; Smits, *The ECB – Institutional Aspects* (Kluwer Law International, 1997), p. 271.

[21] See Lastra and Louis, “European Economic and Monetary Union: History, trends, and prospects”, 32 YEL (2013), 1-150, at 144; de Tomasi, “Sistema dei pagamenti e credito di ultima istanza” in Carriero

Article 127 para. 2 TFEU could be considered as a basis if LOLR operations in favour of the entire financial system were assigned to monetary-policy measures – by contrast, Article 127 para. 5 TFEU would be decisive if the macro-level LOLR operations would be classified purely as financial stability policy. The relation between monetary policy and financial stability policy has been controversially debated.[22] On the one hand, there are significant differences with regard to the goals of these policies: The use of monetary-policy instruments is directed at the goal of price stability (Article 127 para.1 sent. 1 TFEU), while macro-level LOLR interventions serve as short-term, irregular measures to take the pressure off the financial markets and calm the situation in the case of exogenous shocks – in this regard, macro-level liquidity interventions serve the safeguarding of financial stability.[23] In addition, it has been shown that it is not enough merely to secure price stability in order to guarantee financial stability.[24] Financial imbalances can also appear in a stable environment.[25] Thus, price stability is a necessary, albeit not a sufficient condition for financial stability.[26]

On the other hand, there is a strong interdependence between monetary policy and financial stability. One finds that price stability correlates with the stability of the financial system in the long term, as price stability cannot be achieved without a stable financial system;[27] price stability also benefits financial stability,[28] even though there may be conflicts between monetary and financial stability goals in the short term.[29] The interdependence between policy areas and the impracticality to pursue monetary policy in isolation of other areas has also been recognized by the CJEU in its *Gauweiler* judgment. The Court observed that the

and Santoro (Eds.), *Il diritto del sistema dei pagamenti* (Giuffrè, 2005), 375, p. 411; Schoenmaker, "What kind of financial stability for Europe?" in Goodhart, op. cit. *supra* note 9, 215-223, at 218.

[22] See, e.g. cit. *supra* note 8; Stein, *Monetary Policy as Financial-Stability Regulation*, National Bureau of Economic Research (NBER) Working Paper No. 16883, 2011; Borio, *Monetary policy and financial stability: what role in prevention and recovery?*, BIS Working Papers No. 440, 2014.

[23] de Grauwe, "The European Central Bank as Lender of Last Resort in the Government Bond Markets", 59(3) CESifo Economic Studies (2013), 520-535; Hadjiemmanuil, *The ECB and Banking Supervisions* (University of London, 1996), p. 24; Padoa-Schioppa, *Regulating Finance* (OUP, 2004), p. 124.

[24] Goodhart, The changing role of central banks, BIS Working Papers No. 326, 2010, at 135, 145.

[25] Issing, "Monetary and Financial Stability", in Monetary and Economic Department, *Monetary stability, financial stability and the business cycle: five views*, BIS Working Papers No. 18, 2003, 16-23.

[26] García-Herrero and del Rio, *Central Banks as Monetary Authorities and Financial Stability* (September 2005). Forthcoming in The Handbook of Central Banking and Financial Authorities in Europe, Edward Elgar, Cheltenham. Available at SSRN: http://ssrn.com/abstract=1468105 (last visited 3 Oct. 2015), p. 7; Noyer, "Central banking in a context of high public debt", 16 Financial Stability Review (2012), 9-13, at 11.

[27] Schwartz, "Why financial stability depends on price stability", in Wood (Ed.), *Money, Prices and the Real Economy* (Edgar Elgar, 1998), 34-41, at 41; Sinclair, "Financial stability and central bank: an introduction", in Healey and Sinclair (Eds.), *Financial Stability and Central Banks* (Routledge, 2001), 1-18, at 14.

[28] García-Herrero and del Rio, op. cit. *supra* note 25, at 7; Schwartz, "Why Financial Stability Depends on Price Stability", 15 Economic Affairs (1995), 21-25, at 21.

[29] Hellwig (2014), op. cit. *supra* note 8, at 19; de Graeve, Kick and Koetter, Monetary Policy and Financial (In)Stability: An Integrated Micro-Macro Approach (February 2007). Available at SSRN: http://ssrn.com/abstract=966252 (last visited on 3 Oct. 2015) p. 205.

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OMT programme motivated by monetary policy purposes "might also be capable of contributing to the stability of the euro area, which is a matter of economic policy"[30]. One does not need to go as far as Advocate General *Villalón* stating that "any monetary policy measure is ultimately encompassed by the broader category of general economic policy".[31] However, both conceptual and factual overlaps of monetary policy and financial stability appear inevitable. Fiscal policy measures as well as liquidity shortages may have an impact on the transmission mechanism feeding directly into the effectiveness of monetary policy.

Particularly where a liquidity dry-up occurs across the euro area rather than on individual bank level, there is likely to be an interaction with monetary policy parameters. In instances of a widespread and generalized questioning of the liquidity of financial institutions, liquidity supply thus falls within the scope of monetary policy entitling the ECB to take liquidity measures based on Article 18 of the ECSB Statute.[32] The ECB has employed these instruments extensively in the course of the crisis. As from September 2007, the ECB provided additional liquidity as well as liquidity in foreign currency.[33] As a consequence of the breakdown of Lehman Brothers in October 2008, the ECB launched further liquidity measures including weekly refinancing operations with a fixed rate tender procedure with full allotment. In June 2009, the ECB initiated a purchase programme of covered bonds, which aimed at improving banks' refinancing situation.[34] In May 2010, the Securities Markets Programme was established on the basis of Article 18.1. of the ECSB Statute. And in December 2011, the ECB adopted further enhanced credit support measures, which stimulated lending and liquidity in the money market.[35] In sum, these operations offered relief to credit institutions both in peripheral countries and core euro countries. The volume of deposits with the ECB increased. As a result, financial institutions were able to buy sovereign bonds leading to a significant decline in their interest rate.[36]

In addition and under certain circumstances, Article 127 para. 2 TFEU may also become relevant to the extent that under this norm the ECB promotes the "smooth operation of payment systems". This tasks typically relates to the technical functioning of cross-border payment operations by offering facilities for Community-wide payment systems such as the TARGET system. However, in a liquidity crisis involving financial institutions of systemic

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[30] *Gauweiler* case, para 51 by referring to *Pringle* case, para 56.

[31] Opinion of Advocate General Villalón delivered on 14 January 2015, CJEU Case C-62/14, *Peter Gauweiler and Others v. Deutscher Bundestag*, ECLI:EU:C:2015:7, para 129.

[32] Lastra, International Financial and Monetary Law, 2nd ed. (OUP, 2015), p. 377.

[33] See Guideline of the ECB of 31 Aug. 2000 on monetary policy instruments and procedures of the Eurosystem (ECB/2000/7), O.J. 2000, L 310/1, ECB, "Tender Procedure for the Provision of US Dollars to Eurosystem counterparties", Press Release, 6 Dec. 2011, and Annex I of Guideline ECB/2007/7 of 31 Aug. 2000 on monetary policy instruments and procedures of the Eurosystem, 11 Dec. 2000, at 1.

[34] Lastra and Louis, op. cit. *supra* note 21, at 91; Autori, "The impact of the Eurosystem's covered bond purchase programme on the primary and secondary markets", ECB Occasional Paper Series No. 122, Jan. 2011.

[35] ECB, "ECB announces measures to support bank lending and money market activity", Press Release, 8 Jan. 2011.

[36] Lastra and Louis, op. cit. *supra* note 21, at 93.

relevance for a Member State's national economies, the supply of liquidity may become pivotal for the safeguarding of the stability of the payment system as such in order to eliminate systemic risks.[37]

3. Liquidity Shortages at the Micro Level

Beyond the general liquidity tools available to the ECB, the classic case of LOLR assistance refers to collateralized loans to an illiquid bank, commonly referred to as ELA. With regard to the issue of competence, a number of Memoranda of Understanding (MoU) were concluded in the early 2000s setting certain rules on how to deal with banks in difficulties.[38] Accordingly, national governments should deal with solvency problems of banks, national central banks were in charge to address liquidity problems of individual institutions, and the ECB should take care of the liquidity situation of the entire system by the ECB.[39] Also, the ECB has considered the NCBs to be responsible for the provision of ELA.[40]

a. ELA as financial stability measure

In the literature, however, the question of competence for ELA is discussed rather controversially.[41] While liquidity supply at the macro-level is largely agreed to be assigned to the ECB (albeit disagreeing about the legal basis as seen above), in relation to ELA for individual financial institutions both central banking practice and legal scholarship have denied the ECB's responsibility for the individual liquidity supply based on Article 127 para. 5 TFEU up until recently.[42] According to this understanding, supplying liquidity for the financial

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[37] Similarly, Waldhoff, in Siekmann, *Kommentar zur Europäischen Währungsunion* (Mohr Siebeck, 2013), Art. 127 TFEU, para. 78; Lastra, "The Role of the European Central Bank with regard to Financial Stability and Lender of Last Resort Operations", in Goodhart, Which Lender of Last Resort for Europe (Central Banking Publications, 2000), 197-212, 203.

[38] See e.g. the ECB, "Memorandum of Understanding on cooperation between the financial supervisory authorities, central banks and finance ministries of the European Union on cross-border financial stability", Press Release, 1 June 2008, at 30: "If there is a liquidity crisis, the home country Central Bank, in close cooperation with the Group Supervisor and the other relevant Financial Supervisory Authorities and other Central Banks concerned, will manage the situation, including a possible Emergency Liquidity Assistance (ELA) intervention."

[39] Hellwig (2014), op cit. *supra* note 8, at 4; Hellwig "Switzerland and Euroland: European Monetary Union, monetary stability and financial stability" in Swiss National Bank (Ed.), *The Swiss National Bank 1907-2007* (Neue Zürcher Zeitung Publishing, 2007), pp. 741-779.

[40] ECB, Annual Report, 1999, at 98; ECB, Monthly Bulletin, Feb. 2007, at 80; ECB, Financial Stability Review, Dec. 2006, at 172.

[41] Arguing in favor of exclusive ECB competence: Aglietta, "A Lender of Last Resort for Europe", in Goodhart (Ed.), Which Lender of Last resort for Europe? (Central Banking Publications, 2000), at 61; Harden, "The European Central Bank and the Role of National Central Banks in Economics and Monetary Union", in Gretschmann (Ed.), *Economic and Monetary Union: Implications for National Policy-Makers*, 149-167, at 160; based on the subsidiarity principle Lastra, op. cit. *supra* note 36, at 204.

[42] Bini Smaghi, "Who Takes Care of Financial Stability in Europe?", in Goodhart, *Which Lender of Last Resort for Europe?* (Central Banking Publications, 2000), 225-256, at 227, 228; Linzert and Smets,

sector is therefore not an instrument of monetary policy, but rather a means to secure the stability of the financial system. Article 127 para. 5 TFEU provides the legal basis for financial stability stating that the ESCB "contributes to the smooth conduct of policies pursued by the competent authorities" in the field of financial-system stability. This provision gives the ESCB shared competence alongside the (national) NCBs that are also in charge.[43] Hence, the principle of subsidiarity applies, according to which the ECB gains competence only if the goals of the measure in question cannot be realised just as effectively at Member-State level (Article 5 para. 3 subpara. 1 TEU). Unlike the liquidity supply at macro-level, the assessment of the liquidity of individual credit institutions has typically been carried most effectively out by national authorities. NCBs used to have both all relevant factual information about the institution's current state as well as supervisory powers over the institutions.

b. The monetary policy relevance of ELA

While in the majority of cases of individual institution's liquidity dry-up Member States' primary competence for ELA may be well-founded on the basis of Article 127 para. 5 TFEU, the above discussion on the interdependence of monetary policy and financial stability may render the ECB more appropriate to deal with certain cases. More specifically, there shows that there are incidents in which ELA would be of such scope and significance that an uncoordinated disbursement of liquidity by the NCB to the financial institutions would impair the standardised monetary policy of the ESCB. Given that national financial stability policy must not put the functioning of monetary policy at risk, it appears consequent to link the allocation of competence to the impact ELA has on the monetary policy's transmission mechanism operating in the national economy at stake.

Hence, the respective competence for ELA would depend on a case-by-case assessment. Assignment of competence would be straightforward in cases where ELA is granted to comparatively insignificant institutions, as only (nationally controlled) financial stability issues are at stake. However, in cases where some of the largest institutions of a national banking sector depend on ELA (as was the case with respect to Ireland, Greece and Cyprus, as referred to above), effects of ELA on monetary policy aggregates could be noticeable, rendering supply of ELA at EU level more appropriate. This is further highlighted by the impact government debt has on financial stability through the monetary transmission mechanism. Banks in crisis countries have been exposed to sovereign debt, demonstrating that yields and spreads on sovereign bonds influence those on bank credit causing contagion of financial stress.[44] This has been explicitly acknowledged by the ECJ in *Gauweiler,* which stated that eliminating or reducing the excessive risk premia of the government bonds is likely to prevent the the

"Monetary Policy in a Banking Union", in Hackethal et al. (Eds.), *Financial Regulation* (Cambridge University Press, 2015), 61-88, at 68; Plender, "Crisis in the Making", 14 Butterworths Journal of International Banking and Financial Law (1999), 227-229, at 227.

[43] Stasch, *Lender of Last Resort* (Nomos, 2009), p. 152; Lastra, op. cit. *supra* note 31, at 378.

[44] European Systemic Risk Board, "ESRB report on the regulatory treatment of sovereign exposures", March 2015, at 67.

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transmission mechanism being hindered by the volatility and level of those premia.[45] Banks in crisis countries have been exposed to sovereign debt demonstrating that yields and spreads on sovereign bonds can strongly drive those on bank credit, creating a potent channel for the spread of financial stress.[46] This has been explicitly acknowledged by the CJEU in *Gauweiler* stating that eliminating or reducing the excessive risk premia of the government bonds is likely to avoid the volatility and level of those premia from hindering the transmission mechanism.[47] Since banks' liquidity situation is largely influenced by sovereign debt exposure and considering the impact sovereign debt spreads have on the function of the transmission scheme, monetary policy concerns thus can be at the core of an individual bank's liquidity situation. This underscores the need to assign ELA competence to the ECB where such significant monetary policy impact is at stake giving rise to the ECB's competence based on Article 127 para. 2 TFEU.

From a legal security perspective, an allocation of competence depending on the peculiarities of the specific case may be undesirable. However, this approach is not alien to EU law as it corresponds to the recent concept under EU banking supervision to establish EU competence only for "significant" and retain Member States' competence for "less significant" banks. Thus, there are already mechanisms under banking supervision at place allowing a delineation of competences based on significance, which could also be used for purposes of ELA competence.

III. The Framework of EU Law for granting ELA

Irrespective of the above finding that ECB competence for ELA may be warranted in specific cases, hitherto, the NCBs have been operating ELA under their sole responsibility on the basis of Article 14.4. of the ESCB Statute. This norm was adopted into the ESCB Statute as a kind of safeguard clause in favour of the NCBs, which feared that already being a part of the ESCB could mean complete dissolution and that they would not be able to perform any tasks that are not also listed in the Statute.[48] Since the NCBs have relinquished their individual responsibility to the ESCB in matters of monetary policy, the main application of Article 14.4. of the ESCB Statute has been in the provision with emergency liquidity.

In practice, NCBs enjoy wide leeway, for ELA is usually not normed at national level.[49] One of the four pillars of traditional LOLR practice is that the institution receiving assistance should

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[45] Case C-62/14, *Gauweiler*, para 78.
[46] European Systemic Risk Board, ESRB report on the regulatory treatment of sovereign exposures, March 2015, p. 67.
[47] *Gauweiler* case, para 78.
[48] Van den Berg, *The Making of the Statute of the European System of Central Banks* (Purdue University Press, 2005), p. 319.
[49] Monetary and Economic Department, *Re-thinking the lender of last resort*, BIS Papers No. 79, p. 47.

provide "good" collateral.[50] How exactly this has been applied has varied from country to country and from crisis to crisis. The national practice alone dictate the individual requirements. In some instances, collateral has not been provided at all, while in others only the best quality collateral has been considered acceptable, for example treasury bonds. As speed is invariably of the essence when a request for ELA is received, it will often be difficult to assess accurately the value of any collateral that is being offered, or the suitability of the type of asset.[51]

According to Article 14.4. of the ESCB Statute, the ECB Council can prohibit ELA in case of incompatibility with the goals and tasks of the ESCB. The relevance of this rule was negligible for a long time – until the crisis, the ECB Council appears not to have made any decision. Only with the onset of the financial crisis has the ECB Council had to deal frequently with the NCB's ELA loans.[52] At the same time, the requirement of an ECB Council decision, reached with a two-thirds majority, protects the NCBs from the ECB's instructions and guidelines laid out in Article 12.1. and 14.3. of the ESCB Statute – any possibility for the ECB to influence is limited to the ECB Council decision and can only occur if the ESCB tasks are endangered.

1. Prohibition of Monetary Financing in Article 123 TFEU

Article 123 para. 1 TFEU entails a prohibition of financing public budgets in the Union and its Member States through the ECB and the NCB. The limitations arising from Article 123 TFEU for the NCBs have been specified by recent jurisprudence. In *Gauweiler*, the CJEU's judgement on the ECB's OMT programme, the Court stressed, in regard to the intention of Article 123 TFEU, that it "*is apparent from the preparatory work relating to the Treaty of Maastricht that the aim of Article 123 TFEU is to encourage the Member States to follow a sound budgetary policy, not allowing monetary financing of public deficits or privileged access by public authorities to the financial markets to lead to excessively high levels of debt or excessive Member State deficits […]*".[53] Given the intention of Article 123 TFEU, an anti-circumvention provision can be derived from this norm: Central bank instruments of monetary and financial stability policy must not be used towards a stabilisation of refinancing situation of individual states, unless this effect would occur just indirectly of the monetary policy or financial stability measure.[54] In line with this judgement, loans to publicly-owned credit institutions are prohibited if they ensue immediate relief of public budgets.

According to the ECB, national legal provisions providing for a national central bank to give liquidity assistance to insolvent credit institutions are incompatible with the prohibition of monetary state financing, even though ELA is about providing liquidity assistance to *private*

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[50] According to Bagehot, "[T]hese advances should be made on all good banking securities..." op. cit. *supra* note 11, at 197.
[51] Campbell and Lastra, op. cit. *supra* note 9, at 471.
[52] On ELA and Greek banks, cf. ECB, "ELA to Greek banks maintained at its current level", Press release, 28 June 2015, and "ELA to Greek banks maintained", Press release, 6 July 2015.
[53] *Gauweiler* case, para 100.
[54] *Gauweiler* case, para 52.

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credit institutions.[55] The reason for this lies in the view that solvency aid to credit institutions is a genuinely fiscal policy measure falling in states' policy domain, and states must not be financed by central bank money. This is why most of the literature[56] and the ECB[57] posit that the solvency of credit institutions should be a central condition for ELA.

Is such an extensive interpretation of Article 123 TFEU covered by the goals of this norm? According to the CJEU in *Gauweiler*, Article 123 TFEU intends to keep market pressure on states with regard to budget consolidation. If solvency aid for credit institutions is understood primarily as a fiscal policy task, the granting of ELA to an insolvent institution would relieve the state budget. On the other hand, neither monetary policy measures nor financial stability policy measures assigned to NCB's competence cannot simply be re-assigned to the (government's) fiscal policy domain. In respect of monetary policy, this has clearly been stated by the Court in *Gauweiler* finding that just "because [monetary policy] may have indirect effects on the stability of the euro area"[58], it cannot be treated as equivalent to an economic policy measure. To the extent that the ECB avails of its monetary policy instruments discussed above, it should be able to grant ELA regardless of the solvency of a bank. Similar considerations apply if ELA is provided by NCBs for financial stability purposes under Article 127 para. 5 TFEU. The securing of financial stability would be impaired if financial-stability policy measures were made dependent on solvency requirement as a fiscal policy rule. There are cases in which the granting of credit to an insolvent bank may be necessary for reasons of financial stability policy.[59] In theory, the reason for this is that financial stability is not in any functional relation with the solvency of an institution. If we understand financial stability as the capacity of a financial system to fulfil its central functions in the national economy, such as the allocation of financial resources as well as the processing of payments and securities transactions, particularly in times of shock and stress, then the question of an institution's solvency within the system is irrelevant. Financial stability is judged independently of whether a credit institution is still just about solvent or already insolvent.[60]

Also, the CJEU judgement in *Pringle* dealing with the ESM can be interpreted as rejecting a strict solvency requirement. The judgement discussed the compatibility of the ESM with EU law specifying the intention of the no-bailout principle enshrined in Article 125 TFEU. As in Article 123 TFEU, Article125 TFEU is also about keeping the budget pressure on the Member States.[61] However, the CJEU found that Article 125 TFEU could be restricted to safeguard financial stability. Financial support under the ESM could be granted "*when such support is indispensable to safeguard the financial stability of the euro area as a whole and of its Member States and the grant of the support is subject to strict conditionality appropriate to*

[55] ECB, Convergence Report, June 2013, p. 41; ECB, Convergence Report, May 2012, p. 33.
[56] Such as the initial LOLR concept of Bagehot, op. cit. *supra* note 11, chapter VII.
[57] ECB, Opinion CON/2008/46; Communication from the Commission, C(2013) 216/01.
[58] *Gauweiler* case, para. 52.
[59] Similarly, Campbell and Lastra, op. cit. *supra* note 9, 467.
[60] Hellwig (2014), op. cit. *supra* note 8, at 20-21.
[61] *Pringle* case, para 136; Craig, "Pringle: Legal Reasoning, Text, Purpose and Teleology", 20 Maastricht Journal of European and Comparative Law (2013), 3-11.

the financial assistance instrument chosen".[62] The high value of financial stability and its exceptional priority before other legal principles have hence been recognised in principle by the CJEU. If we transfer this logic to the guarantee of financial stability through ELA, then Article 123 TFEU – which has the same intention as Article 125 TFEU in this regard – must stand back, at least when we are dealing with averting severe danger to financial stability.[63] In these cases, the ESCB has no call to forbid the NCB from using ELA in accordance with Article 14.4 of the ESCB Statute.

2. *Securing Price Stability*

According to Article 123 TFEU, securing price stability is a central legal requirement and, as such, ought not to be endangered in any way by ELA. In principle, the dangers to price levels, if ELA is granted, must be assessed empirically and according to each specific situation – here, given the complex and technical nature of the judgment, the ESCB has a genuine margin of judgement as has been found by the Court in *Gauweiler* in relation to the exercise of monetary policy.[64]

As mentioned above, financial stability and price stability can be at odds with each other, namely when the liquidity injections promote inflationary tendencies. However, if liquidity supply is provided on the macro-level, the ECB takes the liquidity injection into account for her overall assessment of the monetary environment and weighs the potential inflationary impact of liquidity supply against the monetary risks resulting from liquidity shortage in the system. Moreover, monetary policy can neutralise the money increase that is the result of emergency loans, in particular by inverted repurchase agreements, foreign-currency swaps and higher minimum reserve requirements.[65] Finally, the inflationary impact on case of ELA for individual institutions are small compared to liquidity on the macro-level.

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[62] *Pringle* case, para 142.

[63] Hellwig, op. cit. *supra* note 8, at 20-21 describing such situation as tradeoff, that is "the actual decisions will depend on assessments of costs and benefits in the given situation, and, if the situation is serious enough, concerns for damage prevention may justifiably outweigh the concerns about moral hazard and credibility." Similarly, Campbell and Lastra, op. cit. *supra* note 9, at 467.

[64] *Gauweiler* case, para 68.

[65] De Bandt and Hartmann, "System risk in banking: a survey", in Goodhart and Illing (Eds.), *Financial Crises, Contagion, and the Lender of Last resort, a Reader* (OUP, 2002), 242-297, at 249, 260.

IV. ELA and EU State Aid Law

Ordinary activities of central banks related to monetary policy, such as open market operations and standing facilities, do not fall within the scope of the state aid rules.[66] In principle, however, the state aid rules, in particular Article 107 TFEU, apply to the financial sector.[67] In this regard, the EU Commission recognised at an early stage during the crisis that – given the dangers that the insolvency of a credit institution can have for the stability of the financial system – the peculiarities of this economic sector must be taken into account in order to prevent system crises and bank runs.[68] This led the Commission to adapt its state aid practice:[69] Short-term aid to credit institutions, the insolvency of which would have meant a systemic risk in the context of the general financial crisis, were declared compatible with the internal market by the Commission in several cases.[70]

If ELA financial aid is qualified as state aid[71], the question arises if it is viable for approval in line with Article 107 para. 3 lit.b Var. 2 TFEU. It is acknowledged that the requirement of remedying "a serious disturbance in the economy of a Member State" must not benefit merely a single market participant or economic sector,[72] but should be a boon to the entire economy of a Member State as a whole.[73] The central-bank loan must therefore be granted to a system-relevant bank and be necessary for maintaining financial stability.[74] After a gloomy situation arose in October 2008, the Commission adopted a much more flexible

[66] Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication'), 2013/C 216/01, para. 62. Open market operations and standing facilities lack the selectivity required by Article 107 para. 1 TFEU; cf. O.J. 2008, C 270/8, Communication from the Commission of 13 Oct. 2008, 25 Oct. 2008, para. 51.

[67] CJEU, Case 172/80, *Züchner* v. *Bayerische Vereinbank*, EU:C:1981:178, 2021, para 8; on the application of state aid rules during the financial crisis see, e.g., Gilliams, "Stress Testing the Regulator: Review of State aid to Financial Institutions after the Collapse of Lehman", 36 European Law Review (2011), 3-25; Editorial comment, "From rescue to restructuring: the role of state aid control for the financial sector, 47 CML Rev. (2010), 313-318.

[68] See an earlier O.J. 1998, L 221, Commission Decision (98/490/EC) Crédit Lyonnais, 08 August 1998, para. 94.

[69] Decision to initiate a formal investigation in O.J. 2012, L 60, Commission Decision C 15/09 Hypo Real Estate, 1 March 2012; see also Gerard, "Managing the Financial Crisis in Europe: The Role of EU State Aid Law Enforcement", in Derenne and Rivas (Eds.), *Competition Law at Times of Economic Crisis – in need for Adjustment?*, (Bruylant, 2013), at 231.

[70] Cf. European Commission, Press release (IP/08/1745), 20 November 2008.

[71] For a comprehensive analysis see Stasch, op. cit. *supra* note 42, p. 177.

[72] CJEU Case 730/79, *Philip Morris* v. *Commission*, EU:C:1980:209, 2671, para 24.

[73] On the only application of this norm before the financial crisis, see SA NN 11/91, Greek Privatization Aid, 31 July 1991. See also the restrictive position of the CJEU in CJEU Case C-301/96, *Germany* v. *Commission*, EU:C:2002:306, I-9919, para 106.

[74] O.J. 1998, L 221, Commission Decision (98/490/EC) Crédit Lyonnais, 8 August 1998, para 28; O.J. 2009, L 104, Commission Decision (2009/341/EC) State aid C 9/08 for Sachsen LB, 24 April 2009, paras 94-95; O.J. 2008, C 189, Commission Decision NN 25/08, West LB, 26 July 2008; O.J. C 43, 2008, Case NN70/07 Northern Rock, 16 Feb. 2008.

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attitude with regard to accepting Article 107 para. 3 lit. b TFEU.[75] It also adopted provisional measures in favour of providing the real economy with the necessary financial resources, in order to make it easier for companies to obtain access to liquidity.[76]

For the Commission, the granting of ELA does not qualify as state aid if the following conditions take effect: a) the credit institution is temporarily illiquid, but solvent; b) the facility is fully secured by collateral, to which appropriate haircuts are applied; c) the central bank charges a penal interest rate to the beneficiary; and d) the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the State.[77]

These four conditions are in line with EU primary law. Unlike in the above assessment of Article 123 TFEU, the distinction between illiquidity and insolvency is plausible from a state-aid perspective. The goal is to sustain fair competition conditions.[78] Solvency aid impairs structural changes much more significantly than liquidity aid to otherwise solvent credit institutions does. Consequently, the Commission's requirements for restructuring aid are particularly high. Practice so far has shown that the Commission's authorisation decisions to financial institutions typically include three kinds of restructuring measures: *financial contribution*, *structural remedies* and *behavioural remedies*.[79] If ELA is granted to an insolvent bank for financial stability purposes, restructuring measures must be adopted in line with these requirements.

Also, the Commission's requirement of full securisation by collateral to which haircuts are applied serves as a means of guaranteeing the quality and market value of the respective collaterals, ensuring a level playing field among competitors. However, there is some leeway for NCBs. They can lower the average quality of collaterals banks have to post, but require a larger "haircut" – or discount – to counterbalance some of the risks. Similarly, the charging of penal interest rates on top of the regular ECB's overnight lending rate ensures the market economic lender principle in a pro-competitive environment. In sum, these conditions ensure

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[75] See Lo Schiavo, "The Impact of the EU Crisis-Related Framework on State Aids to Financial Institutions: From Past Practice to Future Prospects", 9(2) The Competition Law Review (2013), 135-168, at 142.

[76] Communication from the Commission amending the Temporary Community Framework for State aid measures to support access to finance in the current financial and economic crisis (2009/C 303/04), C 303/6, 15 Dec. 2009.

[77] Communication from the Commission on the application, on 1 August 2013, of state aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication'), 2013/C 216/01, para. 62.

[78] The Commission emphasized the risks of financial aid for structural adjustment processes: Commission Communication, on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, O.J. 2009, C195, 19 August 2009, para 28.

[79] Arhold, "Financial Sector", in Hancher, Ottervanger and Slot (Eds.), *EU State Aids*, 4th ed. (London: Sweet & Maxwell, 2012), 702-707. See, e.g., SA.29590, Monitoring of winding down of WestLB, 16 April 2012; SA.31945, Rescue of EIK Bank, 6 June 2011; SA.33485, Restructuring plan of Amagerbanken, 25 January 2012; SA.34539, Amendment of restructuring plan of Commerzbank, 30 March 2012.

that the granting of liquidity does not constitute a monetary advantage for which no consideration is provided.

Finally, requiring the central bank's own initiative and independence guarantees that liquidity support is not misused for economic policy purposes by the government. In this respect, it seems problematic that in some countries the independence of a central bank is not guaranteed for the granting of ELA. The Bank of England, for instance, is bound by instructions in its decision concerning ELA; in order to operate such a measure, it requires the consent of the Chancellor of the Exchequer.[80] In other countries, for example in Germany,[81] the central bank acts independently in the granting of ELA, without being bound by instructions. Due to this heterogeneity in the central banks' independence with regard to the degree of dependence on national legal provisions, it has been submitted that the independence principle in Article 130 TFEU should also apply to the NCB's granting of ELA.[82] This would mean that the independence requirement of this norm would have precedence over national law, and it would secure the independence of all Member-State central banks. Although the applicability of this norm is limited, in principle, to the realm of ESCB tasks (and does not include NCB tasks), a further area of application of Article 130 TFEU may be justified teleologically. Measures of financial stability policy may have an impact on price stability, even if they can be sterilised.[83] If the independence principle is about securing price stability at all costs, then Article 130 TFEU must consequently also be applied to the measures of financial stability policy operated by the central banks.[84]

V. Scope for Reform: Centralized Competence for ELA?

The analysis above suggested to recognize ECB's competence for ELA where the liquidity supply is of such significance that it follows monetary policy considerations. By contrast, until today current practice views ELA to fall in Member States' competence under Article 127 para. 5 TFEU as an instrument of financial-stability policy. In any case, due to recent reforms of banking supervision, the issue of competence may require re-examination.[85] Many observers think that the competencies for both monetary policy and the safeguarding of financial stability falling apart, i.e., supervision over the credit institutions, bears a lot of potential for

[80] Memorandum of Understanding on financial crisis management, para. 12.
[81] See § 12 Bundesbankgesetz.
[82] Radtke, *Liquiditätshilfen im Euro-System*, (Jenaer Wiss. Verl., 2010), p. 180.
[83] Ferguson, Hartmann, Panetta, Portes, *International Financial Stability*, (CEPR, 2007), p. 9.
[84] ECB, Convergence Report, p. 28; Zilioli and Selmayr, "The Constitutional Status of the European Central Bank", 44 CML Rev. (2007), 355-399, at 369.
[85] Goodhart and Schoenmaker, *The new European Banking Union landscape*, Duisenberg school of finance (DSF) Policy Briefs No. 36/October 2014.

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upheaval, given that cross-border activity by credit institutions are increasing, and hence the risk of cross-border contagion.[86]

1. *Synchronizing Banking Supervision and Liquidity Supply*

In the past, one main argument often brought forward against the ESCB being responsible for ELA was that the ECB did not have the necessary information and supervision rights over individual credit institutions, since the supervision competencies lay with the Member States. There is consensus that effectively exercising the LOLR depends on both the quality and scope of banking supervision, as well as on the supervision of the liquidity situation on the market.[87] The central bank must have the best possible information as to what the state of the financial system actually is. This is an argument for having the two activities in one institution.[88] Since a credit institution is unable to obtain a loan on the interbank market if the market has already been expecting this bank's insolvency, a central bank has to be empowered, if it acts as LOLR, to exercise supervision over the credit institutions, particularly in order to be able to assess the solvency of the respective market participant. Since supervision of credit institutions, including their cross-border activities, was carried out for a long time by the Member State in which a particular institution was registered, the ECB would depend, in its ELA activities, on the national authorities supplying it with all available information – something that would have encountered problems in practice.

The centralisation of banking supervision at European level set the scene for a stronger pooling of supervision rights and information with the ECB.[89] In the future, in the euro area, supervision will be handled by the Single Supervisory Mechanism (SSM) aiming at stronger European harmonisation, granting the ECB far-reaching supervisory competences.[90] In order to guarantee effective supervision, the credit institutions are divided into "significant" and "less significant" banks; the ECB is then directly responsible for supervising the significant banks, while the NCBs take charge of supervising the less significant banks. Within the EU law framework, the ECB can demand to be supplied by the institutions subject to SSM supervision with all information it requires for exercising its tasks within the SSM.

[86] Hellwig, *Financial Stability and Monetary Policy*, MPI Research Paper 2015/10, 2015; Sarcinelli, "State Aids in Rescuing and Restructuring Operations: Should banks be treated differently from other businesses?", in Ehlermann and Everson (Eds.), *European Competition Law Annual*, (Hart Publishing, 1999), 305-322, 320; Bini Smaghi, op. cit. *supra* note 41, at 234; Prati and Schinasi, "Financial Stability in European Economic and Monetary Union", in Goodhart (Ed.), *Which Lender of Last Resort for Europe?* (Central Banking Publications, 2000), 69-117, at 71, 110.
[87] Goodhart and Schoenmaker, op. cit. *supra* note 82; Aglietta, op. cit. *supra* note 40, at 47.
[88] Hellwig (2014), op. cit. *supra* note 8, at 28.
[89] See, e.g., Kern, "European Banking Union: a Legal and institutional analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism", 2 European law review (2015), 154-187; Hellwig (2014), op. cit. *supra* note 8, at 13.
[90] EU Council Regulation No. 1024/2013, 15 Oct. 2013, on the transfer of special banking-supervision tasks to the European Central bank (O.J. 2013, L 287, 29 Oct. 2013, p. 63).

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This step towards centralisation at the level of banking supervision also created the conditions for implementing ELA centrally: The ECB now has the instruments at its disposal to observe the liquidity situation of the significant banks continuously, thus being in a position to make accurate decisions as regards necessary ELA as well as other supervisory measures.[91] We argued above that due to the monetary policy impact of liquidity supply to significant financial institutions ELA competence should be based on Article 127 para. 2 TFEU already today. However, if Article 127 para. 5 TFEU is taken recourse to for ELA as financial stability measure, this norm requires the subsidiarity principle to assign the appropriate level of governance. On that basis, in the past liquidity provided to individual institutions was more effectively dealt with by national authorities as information and supervisory tools were available on national level. Given the recent shift in supervisory responsability for significant banks, the ECB should gain competence for ELA at least for these institutions (while all other institutions remain in the Member States' liquidity competence).[92]

2. *Synchronizing Control and Costs*

The potential scenario of central banks ending up making substantial losses – or merely earning substantially less than they could – looms large in the discussion.[93] Two issues must be distinguished here: First, central banks cannot go into default for obligations that are denominated in euros. Nor is there necessarily a risk that losses on assets might impose an obligation on taxpayers,[94] in contrast to what has occasionally been argued.[95] The principles in the ESCB Statute on bearing losses in the Eurosystem provide for only the monetary income – i.e., the "income accruing to the national central banks in the performance of the ESCB's monetary policy function" (Article 32.1 of the ESCB Statute) – from being distributed amongst the NCBs according to their share in ECB capital, in accordance with Article 32.5 of the ESCB Statute. Any losses suffered by the NCB in its conduct of monetary-policy tasks (e.g., if the securities given for open-market operations are cancelled) are principally borne by the NCB itself; only under extraordinary circumstances can it be compensated for such losses by a decision of the ECB Council (Article 32.4, subpara. 2 ESCB Statute).[96]

For ELA, which has been implemented in accordance with Article 14.4 of the ESCB Statute and under the individual responsibility of the Member States, it follows that responsibility and the bearing of costs coincide. The Member States bear both.[97] This means that possible losses resulting from ELA transactions cannot be mutualized. This results not only from the clear

[91] Goodhart and Schoenmaker, op. cit. *supra* note 82.
[92] See also Lastra, op. cit. *supra* note 31, at 378.
[93] Deutsche Bundesbank, Statement to the German Constitutional Court in the proceedings concerning the ECB's OMT programme, 2012.
[94] Hellwig (2014), op. cit. *supra* note 8, at 10.
[95] Fuest and Sinn, "Die Risiken der Notkredite", Handelsblatt (10 July 2015), 64.
[96] The ECB Council votes are distributed according to the capital held by the national central banks with the ECB; this is in line with 10.3. of the ESCB Statute. The votes of members of the directorate are counted as zero in this case.
[97] ECB, op. cit. *supra* note 39, at 102.

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responsibility allocation and the implicit cost-bearing allocation laid out in Article 14.4 of the ESCB Statute, but also from Article 32.4. of the ECB Statute, which specifies a mutualisation of losses occurring in ESCB transactions. The Member-State cost-bearing principle is particularly pertinent if the NCB acts under its own responsibility, such as is the case with ELA.

Against this background, a transfer of ELA competencies to EU level would appear problematic if this led to a divergence between the decision-making authority and the cost-bearing obligation, which would then both fall apart. For this reason, a transfer of ELA competencies to the ESCB should go hand in hand with a mutualisation of the costs incurred with ELA. However, (political) difficulties may occur when the banks of some countries benefit more from such liquidity interventions than banks in other countries. It may hence appear necessary to adapt the allocation of the cost burden according to the benefits drawn from the intervention between the Eurosystem and the respective Member-State central banks that are affected.

VI. Conclusion

Liquidity supply by a *Lender of Last Resort* is of paramount importance for both the conduct of monetary policy and the safeguard of financial stability. During the European financial crisis, liquidity provision for distressed banks proved to be a central instrument for ensuring the survival not only of many financial institutions, but also of the affected national economies. And yet, the importance of emergency liquidity supply went beyond this: The dependence of the national economies on liquidity provision has given the ECB a powerful means to bring not only banks, but also governments to heel, by dint of its veto power against national liquidity provision.[98]

From a legal perspective, there is a tense relation between the NCBs bound by European law, on the one hand, and their mandate as national banks to safeguard financial stability, on the other. A distinction is made between macro-level and micro-level supply of liquidity. Regarding the former, the ECB hast enacted liquidity interventions on various occasions during the crisis – its monetary policy mandate offers the legal basis for this practice. By contrast, micro-level ELA is regularly not an instrument of monetary policy, but rather a means of securing financial stability and has thus been within the competency of the Member States leading to an unstandardised patchwork of Member-State ELA practice. However, in cases of ELA supplied to significant financial institutions the impact on monetary policy parameters may warrant ECB competence.

ELA reaches its limits in the prohibition of monetary state financing and the price stability obligation. The interaction with insolvent credit companies is particularly problematic in this

[98] The questions of democratic theory arising in this context could not be dealt with here. However, see, inter alia, Scharpf, *Monetary Union, Fiscal Crisis and the Preemption of Democracy*, LEQS Paper No. 36, 2011.

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context, the survival of which can be crucial to securing financial stability and thus exceptionally justify the supply of ELA. Risks to price stability have to be evaluated in light of the specific effects – the ECB enjoys wide discretion in this regard. Further, liquidity aid is subject to EU state aid rules. In accordance with the EU Commission's state aid practice during the financial crisis, ELA must meet a number of conditions to comply with state aid rule.

The stability of the financial system is an indispensable condition for a stable level of prices, and vice versa. The current structure of the competencies of the economic and monetary union does not do justice to this interdependence. Monetary policy and macro-level liquidity provision by the ESCB, micro-level emergency liquidity aid by the national central banks, supervision by independent authorities or central banks, solvency aid by the governments – much as this fragmentation of the assignments is useful for avoiding unwanted dependencies, it is also the cause of inconsistencies.

While initial steps have been taken in the meantime, at the level of banking supervision, towards a convergence of monetary policy and banking supervision, there is still a divergence at the level of liquidity provision – individual emergency liquidity continues to be allotted by the NCBs, while the macro-level LOLR function is looked after by the ECB. With the transition of supervisory rights for important banks to the ECB, the means have been installed there to enable an accurate assessment of the liquidity needs of individual credit institutions. Beyond that point, what is required is a cost-bearing arrangement, for ELA transactions, that would provide for fair burden-sharing within ESCB.