



Central Bank Contingency Funding in Resolution Plans¹

Bill Nelson | August 1, 2023

The failures of Silicon Valley and Signature Banks in March illustrated that some uninsured demand deposits may flee a bank much more rapidly than had been thought. Consequently, it may be appropriate to adjust upward the outflow rate under stress assumptions for some types of deposits in the liquidity regulations applicable to bank holding companies (BHCs) and banks.² In a recent note – [“CLF Notes – What is a Committed Liquidity Facility?”](#) – we argued that the upward calibration should be combined with a greater recognition of the contingency funding available to commercial banks from the Federal Reserve acting in the capacity for which it was created. Doing so would avoid forcing banks to hold even more Treasury securities and reserve balances, which already make up more than 20 percent of bank balance sheets. Instead, banks could continue to lend to businesses and households, prepositioning those loans as collateral at the Fed’s discount window to secure the additional contingency funding that now seems necessary.

The failures also highlighted the importance of commercial banks being prepared to borrow from the discount window. In [“Improving the Government’s Lender of Last Resort Function: Lessons from SVB and Signature Bank,”](#) we explained that the failure of both banks to prepare to borrow made their failures more disorderly and thereby contributed to making it necessary for the FDIC, Fed and Treasury to invoke the systemic risk exception to guarantee the uninsured deposits of the institutions. Acknowledging, or perhaps even requiring, a role for contingency funding from the Fed to facilitate the success of resolution plans could reduce the likelihood of such failures to prepare to borrow, at least for those banks required to submit such plans.

Our focus to date has been on two specific liquidity requirements, the liquidity coverage ratio (LCR) and internal liquidity stress tests (ILSTs). However, some large BHCs indicate that the most binding liquidity requirements are those associated with resolution planning. Therefore, to avoid the unwanted negative consequences of recalibrating deposit outflow rates, it would be necessary to increase the recognition of Fed contingency funding in resolution liquidity requirements as well. However, doing so raises challenging issues because the Fed will not and should not commit to lend to a failing bank. In this note, we consider the circumstances under which it would be appropriate to count on a greater role for the Fed lending to a bank that has been recapitalized at a well-capitalized level pursuant to a resolution plan.

Resolution Liquidity Requirements

Generally speaking, BHCs with more than \$250 billion in assets are required to prepare and submit for review by the Fed and FDIC plans outlining how they and their material subsidiaries would be resolved in an orderly way should they fail – these plans are known as living wills. The eight largest U.S. banking organizations, i.e., those

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² Any recalibration should also recognize that the speed of the run was the result in part of the concentration of the deposits and likely also influenced by the poor management and poor condition of the institutions and lack of sound contingency arrangements.

designated as U.S. global systemically important banking organizations (GSIBs), are subject to the most stringent and detailed resolution planning guidance of the agencies, while the U.S. operations of non-U.S. GSIBs are subject to different guidance with slightly reduced expectations. (Guidance applicable to large domestic banking organizations that are not GSIBs is expected soon, but not yet issued.)

For U.S. GSIBs, the guidance effectively imposes two liquidity requirements: the Resolution Liquidity Adequacy and Positioning (RLAP) requirement and the Resolution Liquidity Execution Need (RLEN) requirement. The U.S. operations of non-U.S. GSIBs are required to meet RLEN but not RLAP.

RLAP estimates the liquidity needs of each material subsidiary of a GSIB BHC over a period of at least 30 days under the assumption that liquidity from some other subsidiaries has been ringfenced, for instance, by a foreign supervisor. Addressing the potential failure of a large international banking organization can be a complex and fast-moving process, and finding out belatedly that liquidity that had been counted on for a material entity is trapped in another jurisdiction can precipitate a disorderly collapse, potentially with systemic consequences. To develop their RLAP estimate, GSIB BHCs are instructed to use a stress scenario from their internal liquidity stress tests, which in turn are roughly similar to the stress modeled by the LCR. RLAP is not based on a scenario that ends in failure. In practice, the liquidity required under RLAP is close to the liquidity required under the firm's 30-day ILST.

RLEN is an estimate of the liquidity that would be necessary to successfully execute a GSIB BHC's resolution plan, including stabilizing each material subsidiary after the parent BHC declares bankruptcy. RLEN is calculated as the sum of the minimum amount of liquidity each subsidiary would need to operate or be wound down in an orderly manner as contemplated by the GSIB BHC's resolution plan, and an estimate of the peak liquidity need of each subsidiary over the time it would take to be stabilized. Because plans typically require a GSIB BHC to file for bankruptcy when their existing and projected liquidity resources fall below some margin above RLEN, GSIB BHCs typically hold a buffer equal to several days of liquidity above RLEN.³

RLAP and RLEN are not added together to determine the material subsidiaries' resolution liquidity need. They are each calculated independently and are freestanding, as is made explicit in the FAQ on Liquidity in the 2019 Final Guidance for U.S. GSIBs.

Q2. How should we distinguish between the runway, resolution, and stabilization periods on the one hand, and RLAP and RLEN on the other, in terms of their length, sequencing, and liquidity thresholds?

A. In the Final Guidance, the Agencies did not specify a direct mathematical relationship between the runway period, the RLAP model, and RLEN model. As noted in prior guidance, firms may assume a runway period of up to 30 days prior to entering bankruptcy provided the period is sufficient for management to contemplate the necessary actions preceding the filing of bankruptcy. The RLAP model should provide for the adequate sizing and positioning of HQLA at material entities for anticipated net liquidity outflows for a period of at least 30 days. The RLEN model estimates the liquidity needed after the parent's bankruptcy filing to stabilize the surviving material entities and to allow those entities to operate post-filing.

³ The severe consequences of falling below a specified margin above RLEN combined with it being in many cases the most binding liquidity requirement indicate that efforts to make the liquidity buffer defined by the LCR usable will fail. See "[Buffer usability and cyclical in the Basel framework](#)," BCBS, 2022 and "[The prudential liquidity framework: Supporting liquid asset usability](#)," BoE and PRA, 2023.

Reportedly, RLEN is in some cases the most binding of all the liquidity requirements imposed on GSIBs. The estimates of how much liquidity could be needed to stabilize a GSIB BHC's material subsidiaries may be revised up because the assumed deposit outflow rates for the LCR and RLAP may be revised up. Consequently, preventing a move toward narrow banking by providing GSIBs with greater certainty about the ability of their recapitalized bank subsidiaries to borrow from the Fed in a resolution scenario can only work if such recognition is reasonable and appropriate under the circumstances envisioned by RLEN.

Committed Liquidity Facilities

Before discussing the scope for including backstop discount window funding in resolution liquidity requirements, it is helpful to introduce the concept of committed liquidity facilities (CLFs). CLFs are defined in the Basel LCR standard, and the Fed said it would consider providing such facilities in the U.S. regulation that implemented the LCR. They are guaranteed lines of credit that could be provided by the Fed to commercial banks. The lines would commit the Fed to provide funds unless the bank became insolvent and was not recapitalized at an adequate level for at least 31 days up to the minimum of the size of the line and the lendable value of prepositioned collateral. Banks would have to be financially sound to qualify for a line; if the bank became financially unsound (but still solvent), it could lose its line with at least 31 days' notice. The interest rate on draws on the line would be set at an above-market rate (i.e., penalty rate) so that banks would have an incentive to use market funding first and to promptly repay any draws on the line. Critically, banks would be required to pay a market-based fee for the line.

For more information on CLFs see the aforementioned BPI note: "[CLF Notes: What is a Committed Liquidity Facility?](#)"

Should resolution liquidity requirements allow for anticipated borrowing from the discount window?

The [guidance](#) provided by the Fed and FDIC for resolution plans indicated that banks are only allowed to assume that they will be allowed to borrow from the Fed for a few days after the failure of the parent:

The firm may assume that its depository institutions will have access to the Discount Window only for a few days after the point of failure to facilitate orderly resolution. However, the firm should not assume its subsidiary depository institutions will have access to the Discount Window while critically undercapitalized, in FDIC receivership, or operating as a bridge bank, nor should it assume any lending from a Federal Reserve credit facility to a non-bank affiliate.

The guidance does not prohibit a BHC from assuming, however, that a material bank subsidiary that has been recapitalized at a well-capitalized level pursuant to a resolution plan and been kept out of an FDIC receivership would be allowed to borrow from the discount window. In practice, however, GSIB BHCs have generally not assumed in their resolution plans that their recapitalized bank subsidiaries would be able to borrow from the discount window during the resolution period. GSIB BHCs may be reluctant to assume that their material bank subsidiaries will have access to such borrowing, even if recapitalized at a well-capitalized level pursuant to a resolution plan, and the Fed and FDIC may look negatively on such an assumption, for several reasons. First, in FDICIA (1991), Congress put limits on the Fed's ability to lend to a troubled commercial bank in large part because such lending was seen as having increased the FDIC's resolution costs in the preceding years.⁴ Second, the financial risk of lending to a troubled commercial bank, even when collateralized, is elevated if the collateral is

⁴ S.543 - Federal Deposit Insurance Corporation Improvement Act of 1991, available here: <https://www.congress.gov/bill/102nd-congress/senate-bill/543>.

poor-quality. Third, the moral hazard associated with discount window lending to a bank whose BHC parent is in resolution may be higher because the banks' short-term creditors could anticipate that the Fed lending would always result in them getting repaid. Lastly, if the bank's resolution plan was simply "borrow from the Fed," the bank would not face the appropriate incentives to limit its liquidity risk.

These concerns can be largely addressed by placing two restrictions on the circumstances under which a GSIB BHC could assume that funding from the Fed would be available to its subsidiary bank during the BHC's bankruptcy proceeding. The first restriction is already satisfied by G-SIB BHCs with resolution plans that have not been jointly rejected as "not credible" by the Fed and the FDIC and that contemplate the recapitalization of their bank subsidiary at a well-capitalized level and do not entail the commercial bank subsidiary going into an FDIC receivership.

1. The bank's parent holding company must have sufficient long-term debt or other gone-concern capital to absorb its losses. It must also have sufficient financial assets to recapitalize its commercial bank subsidiary at a well-capitalized level and a secured support agreement that would require it to do so by contributing such assets to a funding vehicle or directly to the bank subsidiary just before the bank holding company files its bankruptcy petition. The recapitalization must be sufficient to make the commercial bank at least adequately capitalized (as defined by the prompt corrective action standard). The holding company must also have a resolution plan that has not been jointly rejected as "not credible" by the Fed and the FDIC and that includes the recapitalization.
2. The bank must currently have a CLF, and the anticipated contingency funding must be from a CLF.

Regarding RLAP, the considerations are essentially the same as for ILSTs, a topic addressed in the CLF note cited earlier. RLAP is evaluated based on the current condition of the BHC's material subsidiaries for a period of at least 30-day stress. If the BHC's material bank subsidiary had a CLF, it would have guaranteed funding for 30 days, and there is no legal or logical impediment to counting that funding in an assessment of the liquidity needs of that bank subsidiary.

The part of RLEN attributable to the commercial bank subsidiary measures the amount of liquidity necessary to stabilize the bank and successfully carry out the BHC's resolution plan after the failure of the parent BHC. GSIB BHCs that are subject to RLEN are also required to have a credible plan to recapitalize and provide liquidity support to their material subsidiaries and sufficient long-term debt and other gone-concern capital to absorb its losses including arising as a result of contributing assets to its material subsidiaries (including a funding vehicle) pursuant to its resolution plan. Consequently, over the period under consideration, the bank would be sufficiently capitalized to qualify for a CLF.

Nevertheless, it would be unsatisfactory if the plan in the living will was simply "acquire a CLF." Instead, the bank should be required to have a CLF in the ordinary course when its parent's resolution plan and RLEN is evaluated, just as a bank and BHC are required in the ordinary course of business to maintain sufficient liquid assets to execute their resolution plan successfully, not a mere intent to acquire them later. Because a bank would have to pay a market-based fee for the CLF, it would face the correct financial incentives associated with balance sheet decisions that would increase or decrease its liquidity needs after the parent failed.

The banking agencies may wish to limit the share of resolution liquidity that a bank plans on obtaining from a CLF. At a minimum, the funding could roughly match any increase associated with assumed deposit outflow recalibration.

At the same time, it may be desirable to *require* a bank to have a CLF for its parent's resolution plan to be approved. Part of the value of a CLF is that it would ensure a bank was ready to use the discount window if necessary, and that the bank was paying for the option to borrow in contingencies.

Financial Stability Board on Public Sector Backstop Funding in Resolution

International standards for the resolution of GSIBs are established by the Financial Stability Board. On July 6, 2023, the FSB [announced](#) that it was reprioritizing its work plan to draw lessons from the bank failures that occurred in the Spring. The FSB stated that it will engage in an "...in depth review of lessons learnt..." including "...explor[ing] public backstop arrangements..." The FSB's "[Guiding principles on the temporary funding needed to support the orderly resolution of a global systemically important bank \("G-SIB"\)](#)" (2016) " state:

An effective public sector backstop funding mechanism should be available for use when necessary and appropriate in order to promote market confidence and to encourage private sector counterparties to provide or to continue to provide funding to the material operating entities of a G-SIB in resolution.

The principles note that, in the United States, the "Orderly Liquidation Fund" established by the Dodd-Frank Act, not the Federal Reserve, is the source of backstop funding for a GSIB being liquidated under the Orderly Liquidation Authority. However, the FSB's "[Funding Strategy Elements of an Implementable Resolution Plan](#) (2018)," also addresses the importance of material operating subsidiaries maintaining access to ordinary central bank facilities. In particular, the FSB states that resolution plans should:

"(i) identify the material operating entities that provide critical functions and which should maintain access to central bank facilities; ...

(iii) identify the requirements to comply with local requirements and conditions for access; And

(iv) premised upon the adequate recapitalisation of the firm and its material operating entities, set out a strategy and the implementing steps necessary for such material operating entities to retain ongoing access during the resolution of the firm.

To support the development of the resolution funding plan and its implementation, home and host authorities should discuss and share information *ex ante* on the conditions for access to ordinary central bank facilities by material operating entities of a firm in resolution, such as minimum conditions to be satisfied, collateral requirements, duration, or other terms."

Consequently, recognition of the funding available from the central bank to a commercial bank, in particular through a standing arrangement, is an appropriate, arguably even required, component of resolution requirements.

Moral Hazard, Risk-Shifting, Self-Insurance

How would incorporating a recognition of contingency funding from the Fed through CLFs address the concerns about risks and incentives listed above that might account for discount window borrowing generally not being incorporated into resolution plans? Economically, there is little difference between requiring a commercial bank to maintain its liquidity as a deposit at its Federal Reserve Bank (reserve balances) or acquiring a committed line of credit from its Federal Reserve Bank. Both are promises of the Fed to provide funds in the future on demand. Consequently, the moral hazard risk and incentives created by either approach are also similar. What is necessary is that the two approaches be priced appropriately and that the risk to the Fed of the line is extremely low. In the case of CLFs, the risk is controlled by the requirement that banks receiving lines be financially sound and that the lines be overcollateralized. The haircuts the Fed calculates for discount window collateral are already premised on the condition that the pledging bank had failed – that is the only situation in which the collateral matters. The only difference is that in this situation the bank would have just been recapitalized.

Moreover, the consequences of a resolution plan that involves the commercial bank running down its reserve balances or other high-quality liquid assets to repay departing short-term creditors are identical to the bank drawing on a CLF to do so. In both cases, risk is concentrated on the remaining creditors and the FDIC in exactly the same way. While undesirable, that is the contingency being planned for in RLEN – an outflow may occur as the bank’s situation stabilizes after the parent fails.

The legal constraints on the Fed’s ability to lend to troubled banks would be addressed by the requirement that the use of a CLF be part of a plan under which the bank is recapitalized at a well-capitalized level by the contribution of a sufficient amount of financial assets from its parent BHC or an affiliate pursuant to a secured support agreement. As noted, FDICIA (1991) creates strong disincentives for the Fed to lend to an undercapitalized and especially a critically undercapitalized bank. In this proposal, the plans would only involve the Fed lending to a bank that has been recapitalized at a well-capitalized level.

Opposition to counting CLFs as viable sources of liquidity in RLAP and RLEN could be based on the view that banks should “self-insure” against their liquidity risks.⁵ If “self-insurance” means not anticipating liquidity support from the central bank under any circumstances, then recognizing CLFs is tautologically ruled out. However, if “self-insurance” means you have purchased the resources necessary to meet liquidity stress situations so that you are not counting on the government to bail you out for free when you run out of funds, then CLFs *are* self-insurance. Banks would be required to have and pay for a CLF now, not just plan on having or paying for one in the future; they would be purchasing liquidity insurance, and therefore self-insuring in the sense that matters. Moreover, as noted, the FSB’s resolution guidelines require plans for the surviving and recapitalized commercial bank to retain access to central bank funding, so at least the FSB does not see pristine self-insurance to be a desirable object.

The Rub

There is, however, a conceptual and perhaps practical problem with incorporating CLFs into resolution plans that needs further consideration. In the LCR and ILSTs, the regulator and supervisor’s job is to consider whether the bank would be able to withstand a deterioration in its financial condition and in market liquidity. In theory for the LCR, and in reality for ILSTs, if the bank’s current financial condition is stronger, for instance, if it has higher capital, the liquidity it would need to weather the deterioration should be lower. In resolution liquidity requirements, the situation being planned for is *conditioned* on the parent BHC failing, quite possibly because of losses at the commercial bank subsidiary. Under such circumstances, the bank might have a CLF now, and could be expected to

⁵ For further discussion see “[Against What Liquidity Risks should a Bank Self-insure?](#)”

have a CLF after it is recapitalized following the bankruptcy of the parent, but there may be a period prior to the parent's bankruptcy where it was not financially sound and so would not qualify for the CLF.

To be sure, this is already an issue with the existing framework. As noted, RLAP is conditioned on a liquidity stress scenario from the bank's ILST, which would not be a scenario in which the holding company failed. Indeed, if it were, it might be the case that more liquidity was required of stronger institutions because it would take a more severe shock to lead to their failure.

In practice, if CLFs were incorporated into RLAP and RLEN, losing access to the CLF would effectively be an event that could trigger the activation of a resolution plan. We have recommended that the financial soundness criteria for CLFs be the same as for primary credit and access to daylight credit – adequately capitalized and CAMELS 3 rated. Perhaps the resolution plan would already be triggered if a commercial bank were under or critically undercapitalized or CAMELS 4 or 5 rated; unfortunately, that information is secret.

Conclusion

Plans for future bank failures and resolutions must adjust in light of the experiences of SVB and Signature Bank. In part, the adjustment should include a recognition that certain uninsured depositors may rapidly flee a bank in trouble. Because resolution liquidity requirements are for many BHCs and banks the most binding, any significant recalibration upward will add further to the share of their balance sheets that must be devoted to lending to the government by holding Treasury securities and deposits at the Fed rather than to lending to businesses and households.

In part, the adjustment should recognize that because SVB and Signature Bank were unprepared to borrow from the discount window, their failures were more disorderly and costly than they could have been. The fact that neither SVB nor Signature Bank were prepared to borrow contributed to exactly the outcome those concerned about moral hazard and "self-insurance" most feared. To prevent a cascading run, the FDIC, Fed and Treasury bailed out the uninsured depositors of the two banks and essentially promised to do so for any other bank that experienced a run. It would not be an exaggeration to say that the linchpin to the entire post-GFC regulatory regime was making it feasible for banks to fail safely. The need for the government to bail out the uninsured depositors of SVB and Signature Bank at a time when the economy and banking system were strong was a catastrophic failure to implement that regime properly.

Both these considerations – avoiding the economic cost of reducing bank credit and encouraging banks to be prepared to use the discount window when under stress – augur for increasing the role of contingency funding from the Fed in resolution planning, perhaps at least to the extent that projected liquidity needs rise in response to a deposit outflow recalibration. Because the change would only apply to BHCs with credible resolution plans to recapitalize and provide liquidity support to their material subsidiaries, and because it would only apply to BHCs whose material bank subsidiaries had currently purchased a CLF, the financial and adverse incentive risks should be limited. Doing so would increase banks' preparedness to use the discount window in contingencies, especially if a CLF were a required component of a resolution plan, and allow banks to continue to devote most of their balance sheets to lending to businesses and households.

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