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Recommendations of the Governing Council of the European Central Bank on government guarantees for bank debt

European Central Bank (ECB)

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EUROPEAN CENTRAL BANK

EUROSYSTEM

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Recommendations of the Governing Council of the European Central Bank on government guarantees for bank debt

The declaration of the euro area summit in Paris of 12 October 2008 states under section (8) that:

“With a view to complementing the actions taken by the ECB in the interbank money market, the Governments of the Euro Area are ready to take proper action in a concerted and coordinated manner to improve market functioning over longer term maturities. The objective of such initiatives should be to address funding problems of liquidity constrained solvent banks. [...] To this aim, Governments would make available for an interim period and on appropriate commercial terms, directly or indirectly, a Government guarantee, insurance, or other similar arrangements of new medium-term (up to 5 years) bank senior debt issuance. Depending on domestic market conditions in each country, actions could be targeted at some specific and relevant types of debt issuance.”

The declaration furthermore states that:

“In all cases, these actions will be designed in order to avoid any distortion in the level-playing field and possible abuse at the expense of non beneficiaries of these arrangements”.

It was moreover noted that:

“While acting quickly as required by circumstances, we will coordinate in providing these guarantees as significant differences in national implementation could have a counter-productive effect, creating distortions in the global banking markets. We will also work in cooperation with the European Central Bank so as to ensure consistency with the management of liquidity by the Eurosystem and compatibility with the operational framework of the Eurosystem”.

In accordance with the Paris summit declaration, as confirmed by the European Council of 15 and 16 October 2008, the Governing Council of the European Central Bank (ECB) has considered the appropriate framework for the granting of government guarantees on bank debt issuance, and agreed on the following recommendations:

1. The framework for the granting of government guarantees on bank debt should aim at: (i) addressing the funding problems of liquidity-constrained solvent banks by improving the functioning of the market for bank debt of longer term maturities; (ii) preserving the level-playing field among financial institutions and avoiding market distortions; and (iii) ensuring consistency

with the management of liquidity by the Eurosystem and with its operational framework, so as not to impair the implementation of the single monetary policy.

2. With regard to the scope of the bank debt guarantee scheme, government guarantees on interbank deposits should not be provided.

Government guarantees on short-term bank debt with maturity of 3 to 12 months could be provided, so as to help revitalise the short-term bank debt market.

3. The pricing of credit guarantees on bank debt with maturities exceeding 1 year should be based on banks' CDS spreads.

CDS spreads are widely available and reflect the perceived market assessment of the credit risk associated with individual banks. As such, CDS spreads provide a good reference to ensure that governments get a fair compensation and to minimise market distortions.

4. In order to recover the operational costs and to help preserve the level playing field, an add-on fee of 50 basis points should be included in the pricing of the government guarantees on bank debt with maturities exceeding 1 year. In Member States where government guarantees may be collateralised, the add-on fee can be lower than 50 basis points.

5. The pricing of credit guarantees on bank debt with maturities of less than or equal to 1 year should be based on an overall flat fee of 50 basis points, without an add-on fee.

A flat fee on short-term debt is considered appropriate, as CDS spreads may not provide an adequate measure of credit risk for such debt.

6. For banks with CDS data, the calculation of CDS spreads should be based on (i) the median value of 5 year CDS spreads over a sample period starting on 1 January 2007 and ending on 31 August 2008, or (ii) the median value of the 5 year CDS spreads during the same sample period for the rating category of the bank concerned, whichever is the lowest.

The 5 year CDS are selected since they represent the most liquid CDS instruments and should be applied regardless of the maturity of the debt instruments which are guaranteed. The choice of the sample period aims at reducing the impact of extremely high CDS values that emerged especially during the past two months.

7. For banks without CDS data, or without representative CDS data, but with a credit rating, an equivalent CDS spread should be derived from the median value of 5 year CDS spreads during the same sample period for the rating category of the bank concerned, based on a representative sample of euro area large banks, which will be defined by the Eurosystem. The total price of the credit guarantee should also include the add-on fee of 50 basis points. The supervisory authority will assess whether the CDS data of a bank are representative.

8. For banks without CDS data and without a credit rating, an equivalent CDS spread should be derived from the median value of 5 year CDS spreads during the same sample period for the lowest rating category,¹ based on a representative sample of euro area large banks, which will be defined by the Eurosystem. The calculated CDS spread, for this category of banks, may be adapted on the basis of a supervisory assessment. The total price of the credit guarantee should also include the add-on fee of 50 basis points.
9. The parameters of the pricing system, including the CDS spreads, could be revised after a period of 6 months, to reflect changes in market conditions.
10. The conditions set by governments for the provision of guarantees on bank debt should include compliance with capital adequacy requirements in the eligibility criteria of institutions and safeguards to ensure that banks provide adequate support to the real economy, in line with the Paris declaration. Governments may abstain from setting additional conditions, if such conditions make credit guarantees less acceptable and hence hinder the effectiveness of the measures to improve the functioning of the bank debt market.

¹ The lowest rating category to be considered is A, as there is no sufficient data available for the rating category BBB.