Central Bank, lender of last resort assistance: An elusive concept?

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1 Introduction
This article deals predominantly with the ostensibly elusive concept of lender of last resort financial assistance afforded by central banks to banks. The basis for the existence of the measure, as well as the reason behind the general lack of information regarding its availability and functionality is discussed against the background of the business of banks and the financial system. Reference is made to what may be regarded as the classical theoretical foundation of such assistance and how it may find application in the Republic of South Africa (RSA). Examples are cited of how it is applied in practice in the United Kingdom (UK) and the Republic of Bulgaria. Practical problems with the application of such assistance, strictly in accordance with the classical doctrine, are highlighted. Thereafter an endeavour will be made to determine if the concept may be clearly

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defined and whether the circumstances in which it would find practical application can be determined with certainty.

2 Background

In monetary economies, finance is intimately bound to the unique services of money. Finance enables the efficient allocation of real economic resources at any given time and especially across time. It contributes to the performance of the real economy by facilitating the more efficient management of the process of wealth accumulation for individuals, businesses, governments and nations. Finance also aids in the management and diversification of both economic and financial risks. Society’s long-term economic prospects are therefore best served when households and businesses voluntarily save part of their current income. Such a state of affairs is normally facilitated when some reasonably safe institutional mechanism exists whereby society’s savings may be collected and channelled into productive investments. Throughout the developed world the single dominant class of institution that has emerged to play this crucial role is the commercial bank and it has therefore been closely linked with commerce and industry for many centuries.  

2.1 Role of Banks

Banks serve the special function of acting as the custodians of the general public’s money in terms of multi-faceted contractual relationships. They raise the largest portion of their funding by taking deposits from the general public by means of contracts for liquid deposits. In order to attract deposits, banks normally depend upon depositors who have a high degree of confidence that their funds will be available on demand or when they fall due. Therefore, confidence and trust play an essential role in banking business. Whenever the confidence of depositors in the banking system is undermined, society’s ability to collect and deploy its savings is impaired and the principle means to economic growth, namely, intermediation by banks, is seriously jeopardised.


A bank’s economic function is the taking and managing of reasonable financial risks within the financial system for which it is remunerated. Finance and the financial system may be regarded primarily as a large and dynamic network of financial contracts facilitating a vast diversity of economic functions. As an important player in this market, a bank operates as a financial intermediary by placing itself between the ultimate lender and the ultimate borrower and by transferring primary securities into indirect securities. In the process, a bank offers contracts for liquid deposits and uses the proceeds thereof to finance the acquisition of illiquid assets. Owing to their exposures to various risks, the values of these illiquid assets are normally uncertain. The redemption values of the deposit contracts are, however, independent from the performance of the bank and the illiquid assets it acquired.

2.2 Liquidity Risk

The unique service of converting immediately liquid liabilities into less liquid loans, provided by banks to the community, unfortunately renders these institutions particularly vulnerable to liquidity shortages. An important cause of a liquidity shortage with a bank is when an unusually large number of depositors call upon it at the same time to demand repayment of their deposits. Liquidity shortages with banks may also occur when inter-bank and wholesale markets, for various reasons, suddenly and unexpectedly freeze and stop functioning.

In the event of serious liquidity shortages the absence of a proper secondary market where illiquid assets may be disposed of at reasonable market prices may force banks that are experiencing a liquidity squeeze to sell their assets at a loss. This problem is aggravated by the fact that banks, owing to principles of bank confidentiality and secrecy, are prohibited from communicating privileged information about the quality of their borrowers to their depositors and creditors or the secondary market. It may render banks that are perfectly solvent, and who may hold sizable liquid asset portfolios, unable to raise sufficient liquidity to meet their demands and could cause them to fail. Although the failure of a single bank may not necessarily be serious in itself, since the risk of failure

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constitutes an intrinsic feature of market discipline, the danger always exists that an initial bank failure may cause the failure of other healthy banks and, ultimately, the failure of the whole financial system.

The reason for this systemic risk may be ascribed, inter alia, to the fact that banks normally have substantial direct exposures to one another arising from their involvement in payment and settlement systems and through inter-bank credit lines. Moreover, even in the absence of such exposures, banks with similar business profiles to a failing bank may be affected by a loss of confidence on the part of their depositors or other creditors and experience a sudden and unexpected drain on their liquidity.

2 Remedial Measures

Owing to this inherent potential instability, banks worldwide are generally subjected to stringent formal regulation and supervision. The core objectives of regulation and supervision are usually to sustain systemic stability, maintain the safety and soundness of such financial institutions and protect the consumer. In order to ensure the confidence of the general public in banks and the financial system, as well as to provide a measure of protection of their deposits, regulatory authorities normally have as one of their intermediate targets, acceptable risk exposures within institutions. Minimum standards and prudential requirements are thus enforced in an endeavour to ensure that the businesses of banks are conducted, inter alia, in a transparent manner, by fit and proper management, within acceptable risk parameters. These standards and requirements are

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7 It is based on the presumption that the forces of the free market are a sufficient cogent and adequate influence to discipline internal corporate activities and therefore ensure an acceptable measure of corporate efficiency and responsibility: Bradley & Schipani “The relevance of the duty of care standard in corporate governance” (1989) 75 Iowa Law Review 75; Bamber et al 1; Falkena & Llewellyn 5; De Jager The Management of Banks in South Africa: Legal and Governance Principles (LLD dissertation 2000 RAU) 392; Goodhart 57; Llewellyn 1999 21.

8 Noted historical systemic failures include the 1931–1933 massive financial crisis that devastated the banking system in the US and even led to failures of banks in European countries: World Bank at 28; the so called “Mexican Peso Crisis” that started in Mexico in 1994 as well as the Asian Financial Crisis of 1997. In the latter case the financial system failure started in Thailand and, due to contagion, affected the financial systems of numerous countries in East Asia, resulting in international bailouts for Thailand, Indonesia and South Korea: Norton “The Asian financial crises” 1998 ABLASA 13; Kim “Bank restructuring in Korea” in BIS Bank Restructuring in Practice (1999) 143. The said crisis in East Asia provides a vivid illustration of a full-scale collapse of markets caused by systemic bank failures. See also Lee “Daewoo’s domino effect” 1999 149 Banker 59; De Juan “Clearing the decks: Experiences in banking crisis resolution” 1998 1 Journal of International Banking Regulation 167; Schinasi 13; Kindleberger & Aliber 16.

9 Herring & Wachter Real Estate Booms and Banking Busts – An International Perspective (1990) 16; Odihah Special Report: Insolvency of Banks: Managing the Risks (1996) xi; Fourie et al 78; Doyle Practice of Banking (1972) 26; George 78; Schinasi 184; De Jager part 2 2002 TSAR 714.
predominantly aimed at correcting identified market imperfections and failures.\textsuperscript{10}

Notwithstanding the \textit{ex ante} nature and intensity of their regulation and supervision, it is generally acknowledged that banks may still fail.\textsuperscript{11} Accordingly, certain ex post preventative and remedial measures have been introduced through the years, aimed at proverbially steering the rocky boat [bank] through stormy seas [markets] into calmer waters.\textsuperscript{12} The lender of last resort, associated with central banks, may be regarded as such a measure.

### 3 Lender of Last Resort

The phrase “lender of last resort” (LOLR), evidently owes its origin to Sir Francis Barings, who in 1797 referred to the Bank of England (BOE) in this context as the source from which all banks could obtain liquidity in times of crisis.\textsuperscript{13} Central banks, by their very nature, are deeply involved in systemic risk management and acknowledge that a close correlation exists between monetary and financial stability. Increased market volatility often results in financial instability, which in turn results in institutional distress, increased credit risks and increased insolvencies in general. It may later result in systemic distress and ultimately in greater demands for liquidity through LOLR facilities afforded by central banks. Therefore, irrespective of the role, if any, assigned to a central bank with respect to the prudential regulation and supervision of financial institutions, the central bank always constitutes a dominant agency responsible for the stability of the payment system, liquidity assistance to markets and banks, as well as systemic stability.\textsuperscript{14}

LOLR assistance is therefore distinct from, and should not be confused with, the normal operations of a central bank through its general discount and accommodation window. The latter central bank operations entail the refinancing of the operational liquidity requirements of banks through repurchase agreements and other facilities such as the averaging of cash


\textsuperscript{11} Supervisors generally strive to promote and enhance the safety and soundness of banks. They are generally not in a position to guarantee the safety and soundness of such institutions. See Van Greuning \textit{The Implementation of a Risk-based Approach to Bank Supervision as a Micro-economic Component of Monetary Policy} (D Com dissertation 1993 UP) 101; Kindleberger & Aliber 2.

\textsuperscript{12} Lastra 110.

\textsuperscript{13} Humphrey & Keleher “The lender of last resort: A historical perspective” 1984 4 \textit{Cato Journal} 275; Lastra 113; Kindleberger & Aliber 196.

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Discount and accommodation window operations involving central banks constitute important mechanisms by means of which banks manage their day-to-day liquidity requirements in the normal course of business. In contradistinction, LOLR assistance is generally described as the mechanism by means of which a central bank, which has the ability to produce high powered money, supports banks facing liquidity difficulties to create enough base money to off-set public desire to switch into cash during a crisis. It aims to restore confidence, thereby re-establishing credibility in a bank, banks or the market and endeavours to prevent legal insolvency, fire sales and the calling up of loans. LOLR assistance is normally provided when central banks fear that a loss of confidence in the system could prompt a systemic failure. It is entirely at the discretion of the central bank and whenever the failure is deemed isolated or may be easily contained, central banks may elect not to provide any assistance. 

Central bank independence and autonomy is based on the premise, _inter alia_, that the State is tasked with ensuring a sound financial system in a country and LOLR assistance involves public funds. The fiscal authority of a country is therefore almost invariably involved in the process of the granting of LOLR assistance by its central bank, especially whenever such lending is for an extended period, or forms part of an overall crisis management strategy to address the liquidity of banks in the market.

3.1 Classical Doctrine

The classic theoretical foundation of the LOLR doctrine can be traced back to Henry Thornton, who in 1802 was responsible for defining its principles. He suggested that the provision of liquidity to the market was the best way of containing a panic. These principles were later elaborated upon and refined by Walther Bagehot. Both Thornton and Bagehot contended that the LOLR responsibility was owed to the market and the entire financial system and not to specific institutions. It was aimed at restoring confidence and re-establishing credibility in a bank or banks. LOLR assistance should therefore be provided in circumstances where a central bank feared that the loss of confidence in the system could prompt even solvent institutions to fail.

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16 Davis “The lender of last resort and liquidity provision – How much of a departure is the sub-prime crisis?” Paper presented at a Conference entitled “Regulatory Response to the Financial Crisis”, London School of Economics, 19 Jan 2009 5; Lastra 114; Goodhart 96; Brealy _et al_ 2.

17 Any extended lending or recapitalisation of potentially insolvent banks in a systemic crisis becomes the responsibility of the fiscal authority: Lastra 116. See also Davis 2 & 9; Brealey _et al_ 170.

18 Thornton addressed LOLR in a paper published in 1802 titled “An enquiry into the nature and effects of the paper credit of Great Britian”: Lastra 114.

19 Bagehot addressed LOLR in a paper published in 1873 titled “Lombard Street. A description of the money market” Humphrey “The classical concept of the Lender continued on next page
In accordance with the classic doctrine, a central bank should, by means of LOLR support, prevent temporarily illiquid but solvent banks from failing. The lending should thus, by nature, be short-term. The central bank, within its capacity as the only ultimate source of legal tender, should not limit its lending but lend as much money as may be necessary to resolve the issue. The lending must, however, be at a high rate of interest. Whether this includes penal rates is uncertain. LOLR should be extended to any bank with good collateral, valued at pre-crisis prices. Moreover, a central bank should make its willingness to extend such loans to banks, known well in advance. 20

The above doctrine is purported to have three major advantages. Firstly, as loans are granted only to solvent institutions, the central bank is not confronted with the moral hazard of bailing out institutions that do not deserve such assistance. Secondly, since the financial assistance involves secured lending, the balance sheet of the central bank involved is not necessarily adversely affected. Thirdly, because the lending involved is short-term, the inflationary consequences of LOLR assistance are limited. 21

3.2 Scant Public Information

The banking fraternity is well known for its adherence to principles of confidentiality and secrecy. In terms thereof, subject to certain recognised exceptions, banks are under a duty to respect the financial and personal privacy of their customers and not to injure their creditworthiness or personal integrity by disclosing confidential information to third parties or in the public domain. 22 These principles may be applied mutatis mutandis to central banks and the various entities that they serve. 23 Disclosure by a central bank to the general public of details regarding LOLR assistance afforded to a particular bank has the potential of adversely affecting public confidence in that institution. It could result in a run on the bank by depositors anxious to withdraw their deposits, which would most likely either exacerbate any existing liquidity problem that the bank may be experiencing, or may rekindle a crisis of this nature that had in the past

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20 Lastra 114; Kindleberger & Aliber 196. Charles Goodhart maintains that Bagehot’s proposal that LOLR lending be at “high” rates is incorrectly translated into “penalty” rates: Goodhart “Myths about the lender of last resort” 1999 2(3) International Finance 339.

21 Bamber et al 107.


23 See for example s 33 of the South African Reserve Bank Act, 90 of 1989.
been experienced by the bank and redressed by means of earlier LOLR assistance.

Since a bank normally has as its ultimate objective the maximisation of profits, its lending activities may be regarded as the outcome of expected profit calculations, subject to the constraint that the risk that its capital may be depleted by these activities be no greater than some measure of probability. Accordingly, the management of a bank needs to take lending decisions to maximise expected profits subject to the constraint that the probability that end-of-period asset values may fall short of its liabilities not exceed a specified reasonable probability. Risks taken by management should at all times be reasonably measured against the probability of loss, which requires informed decision-making by bona fide, duly authorised and adequately qualified managers exercising due care and skill. At the same time, situations must be avoided where management may utilise a bank’s intermediary function and corporate personality to frustrate sound legal and commercial principles. This, in turn, requires that a structure be in place, aimed at reducing the severity and variability of losses in order to protect banks, their depositors and the financial system against the adverse consequences of unreasonable and outrageous risks.

Once the impression is created that LOLR assistance may be readily available to all kinds of banks in distress, it may easily give rise to false assurances and unreasonable expectations. LOLR might erroneously be regarded as a form of insurance against bad banking decisions, which could encourage more of the same. This could give rise to the moral hazard that the business of a bank may, by the application of irresponsible, careless or imprudent management practices be conducted in disregard of sound commercial and legal principles. It could potentially result in a bank in distress, in the belief that it could rely on being bailed out by the central bank, making desperate and unsound business decisions. Behaviour of this nature could also induce other sound banks to behave in a similar fashion, thereby increasing the potential for turbulence and instability in the market. Moreover, it could lead to a reduction in the incentive for banks to hold adequate liquidity, thereby passing that risk on to the central bank.

In view of the above considerations, central banks do not as a rule report in the public domain on specific LOLR support provided to designated banks. In general, they rarely provide finer detail and closer

24 As demonstrated by the facts in Northern Rock, where the bank experienced a run on it following upon a BBC broadcast to the general public that Northern Rock had sought and was to be provided with LOLR assistance by the Bank of England. SRM Global Master Fund LP; RAB Special Situations (Master) Fund Ltd and Dennis Grainger & Others v The Commissioners of Her Majesty’s Treasury, an unreported judgment delivered on 28 July 2009 under the Neutral Citation Number: [2009] EWCA Civ 788, par 13.


26 Davis 7; De Jager part 2 (2002) TSAR 716.

27 Davis 7.
guidelines regarding the concept in the public domain. Similarly, the laws relating to many central banks worldwide provide scant guidance with regard to the issue of LOLR operations.  

4 Local Position

The South African Reserve Bank (SARB), in terms of the Constitution of the Republic of South Africa Act (Constitution) read with the South African Reserve Bank Act (SARB Act), functions as the central bank of the RSA. The SARB constitutes one of the central banks worldwide in respect of which scant information regarding LOLR is available in the public domain since neither the Constitution, nor the SARB Act explicitly deals with the issue. Nevertheless, it should not be construed as meaning that the Bank is unfamiliar with the doctrine, since central banks worldwide share more or less the same outlook on monetary and banking matters. Banks and markets in the RSA also share close similarities with other banks and markets throughout the world and are, in general, subject mutatis mutandis to the same influences, forces, risks and failures. The Bank is therefore capable of providing financial support to a bank or banks whenever exceptional circumstances justify central bank assistance of this nature.

In general, with regard to loans, the SARB Act determines that unsecured loans and advances may be granted by the Bank only –

(a) to Government;

(b) to a company formed in terms of the Companies Act for purposes of manufacturing banknotes or coins;

(c) with the approval of its board, to any company formed in terms of the Companies Act in which the SARB has acquired shares, if in the opinion of the board the acquisition of the company was conducive to the attainment of any of the objects of the SARB Act; or

(d) to an officer or employee of the SARB for purposes of purchasing a motor vehicle or a dwelling.

It is therefore evident that potential LOLR assistance by the SARB to banks must be in the form of secured loans or advances, unless the shares in the

28 Lastra 115.
29 Act 108 of 1996 s 223.
31 De Kock 2.
33 S10(1)(f).
relevant bank are taken over by the SARB in circumstances as envisaged in (c), above. Since the SARB is a non-profit public institution with a public interest role, any LOLR assistance will typically be at the eventual cost of the taxpaying general public. Of any surplus remaining at the end of a financial year of the Bank, after provision has been made for bad and doubtful debts, a depreciation in assets, gratuities or other pension benefits for its officers and employees, all other items usually provided for by bankers and the payment to shareholders of a dividend of ten per cent per annum on their shares, one tenth is allocated to the reserves of the SARB and the rest to Government.

5 Other Jurisdictions
Owing to the scarcity of public information with regard to the application of LOLR assistance in the RSA, and since central banks worldwide tend to share the same outlook on banking matters, it could be of significance that note be taken of public information in respect of the application of LOLR assistance in jurisdictions other than the RSA. In this regard, the UK and the Republic of Bulgaria constitute noteworthy jurisdictions in respect of which public information of the nature under discussion is available. The importance of the UK lies not only in the fact that its central bank was the first bank of issue to assume the position of a central bank and to develop what are generally recognised as the fundamentals of the art of central banking, but also in that country’s historical association with the establishment of the SARB. The Republic of Bulgaria, in turn, is like the RSA, classified as an emerging market and its central bank qualifies as one of the oldest central banks in the world.

5.1 UK
The Bank of England (BOE), the central bank of the UK, functions in terms of the Bank of England Act 1998. Since its functions under the Banking Act 1987 were transferred to the Financial Services Authority (FSA), the FSA functions, inter alia, as the official regulator of banks registered in

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36 SARB Act s 24. The Bank is also subject to the tax levied by Government on companies.
terms of the Banking Act.\textsuperscript{40} The BOE, the FSA and the Treasury, jointly known as the “Tripartite Authorities”, by means of a memorandum of understanding (MOU) set procedures in terms of which LOLR assistance would be provided by the BOE.\textsuperscript{41}

Late in July 2007 global financial markets became severely disrupted in the UK, partly because of concerns about the value of financial products which had been created based on mortgage loans made in the sub-prime sector of the United States housing market (US sub-prime crisis). It led to the virtual closing down of wholesale money markets in the UK and resulted in severe liquidity problems, \emph{inter alia}, for Northern Rock plc (NR – a bank registered in terms of the Banking Act), the fifth largest UK mortgage lender and the eight largest UK bank by market capitalisation.

As a result of the acute credit shortage experienced by NR it was unable to raise liquidity. Despite its assets exceeding its liabilities and it being solvent in balance sheet terms, NR became unable to meet its debts as and when they fell due. It alerted the FSA on 13 August 2007 and LOLR assistance was subsequently provided by the BOE as envisaged in terms of the MOU between the Tripartite Authorities. NR was eventually nationalised on 22 February 2008, when its entire share capital was transferred to the Treasury Solicitor as nominee of the Treasury in terms of legislation.

As part of the nationalisation scheme, the compensation payable to shareholders of NR was assessed on the basis of the position that they would have been in had no LOLR support been provided to it. As it appeared that they would get virtually nothing for their shares, aggrieved shareholders of NR unsuccessfully approached the High Court in the UK for a judicial review of the basis of the assessment.\textsuperscript{42} On appeal of that judgment by the shareholders, the UK Court of Appeal referred with

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\textsuperscript{40} Since 1 June 1998, in terms of the Financial Services and Markets Act 2000: Blair \textit{et al} 40.

\textsuperscript{41} The relevant provisions of the MOU read as follows: “14. In exceptional circumstances, there may be a need for an operation which goes beyond the Bank’s published framework for operations in the money market. Such a support operation is expected to happen very rarely and would normally only be undertaken in the case of a genuine threat to the stability of the financial system to avoid a serious disturbance in the UK economy. If the Bank or the FSA identified a situation where such a support operation might become necessary, they would immediately inform the other authorities and invoke the co-ordination framework outlined in paragraph 16 below. Ultimate responsibility for authorisation of support operations in exceptional circumstances rests with the Chancellor. Thereafter they would keep the Treasury informed about the developing situation, as far as circumstances allowed. 15. In any such exceptional circumstances, the authorities’ main aim would be to reduce the risk of a serious problem causing wider financial or economic disruption. In acting to do this, they would seek to minimise both moral hazard in the private sector and financial risk to the taxpayer arising from any support operation.”

\textsuperscript{42} Divisional Court, Queen’s Bench Division of the High Court [2009] EWHC Adm 227.
approval to the following principles of LOLR assistance as previously elucidated by Lord Eddie George, a former Governor of the BOE.\footnote{SRM Global Master Fund LP; RAB Special Situations (Master) Fund Ltd and Dennis Grainger & Others v The Commissioners of Her Majesty’s Treasury supra par 8.}

(a) LOLR assistance, in whatever form, was directed at safeguarding the financial system (thereby preventing damage to the wider economy) and not aimed at protecting the institution itself.

(b) All options to find a commercial solution would first be explored before the commitment of central bank funds. Major shareholders would be called upon to provide financial support. In the absence thereof, the bank in distress would be encouraged to attempt to find a buyer.

(c) Central banks were not in the business of providing public support to private shareholders. Whenever support was provided, a central bank would attempt to structure it in such a manner that any losses first fall on the shareholders and that any benefits accrue to the central bank. Any support provided by the central bank would be on terms that are as penal as the central bank may make them, without precipitating the collapse of the bank that the central bank is attempting to avoid.

(d) Since the aim is to provide liquidity, in normal circumstances, the BOE will not support a bank that is insolvent.

(e) The BOE seeks a clear exit. The bank in question may be required to run down or restructure its operations, under surveillance of the central bank, to the point where it could do without central bank support within a given period. An advantage of making central bank support as unattractive as possible was that it encouraged this process. The aim was to protect the system, not to maintain unviable banking and so to unnecessarily interfere in the market process.

In respect of the LOLR provided by the BOE to NR, the Court of Appeal held that the above principles were adhered to strictly and exclusively for the protection of the banking system (and thus the general economy) as a whole, and not at all for the protection of the stricken institution (NR).\footnote{Idem par 9.} The LOLR assistance was always intended as a short-term operation and the exit chosen was the nationalisation of the company. This decision by the authorities to take the company into public ownership was ruled by the Court of Appeal as a strategic exercise of government policy intended to preserve, for the sake of the national economy, the benefits won by the LOLR operation at the least cost to the tax payer.\footnote{Idem par 61.}

The Court of Appeal held that the correct method of assessing shareholders’ value was on the basis of the position that shareholders would have been in if no LOLR had been provided. Otherwise, shareholders would have received more favourable treatment and the LOLR assistance would have been the source of this benefit. That would not have been
consistent with a governing principle of LOLR, namely its deployment only in the interest of the financial system as a whole. Furthermore, the Court of Appeal held that such a practice would or might potentially in the future encourage the very moral hazard, of an institution in trouble making poor decisions based on the belief that it will be bailed out by the State, which the LOLR scheme was carefully constructed to avoid.\textsuperscript{46} The appeal was consequently dismissed.\textsuperscript{47}

\section*{5.2 Republic of Bulgaria (“Bulgaria”)}

The Bulgarian National Bank (BNB) functions as the central bank of Bulgaria in terms of the Law on the Bulgarian National Bank 1997 (BNB Act). It is managed by a Governing Council consisting of a Governor, three Deputy Governors and three other members. The BNB consists of three basic departments, namely an Issue Department, a Banking Department and a Banking Supervision Department, each headed by a Deputy Governor.\textsuperscript{48}

Article 20(2) of the BNB Act determines that whenever any systemic risk arises in respect of the banking system, the Banking Department shall perform the LOLR function. Such LOLR assistance may be extended under the following general conditions:\textsuperscript{49}

(a) In the event of a liquidity risk affecting the stability of the banking system;

(b) assistance may be provided only to solvent banks experiencing an acute need for liquidity that cannot be obtained from other sources;

(c) only against collateral of liquid assets; and

(d) maturity of the loans shall not exceed three months.

The amount of LOLR assistance available for the provision of assistance may not be more than the lev\textsuperscript{50} equivalent of the amount whereby the gross international reserves exceed the total amount of the monetary liabilities of the BNB.\textsuperscript{51} Collateral against which the BNB will extend LOLR assistance consists of monetary gold, foreign currency (Euro, US dollars or Swiss francs), paper or book-entry liquid securities issued by the Government of Bulgaria or guaranteed by it, and prime-rate liquid securities issued by foreign governments and central banks, or guaranteed by them.

The total value of the assets rendered by the bank in distress as security, assessed at their market value, is required to cover a minimum of 125 percent of the LOLR amount provided as assistance by the BNB to the

\textsuperscript{46} Idem par 62.
\textsuperscript{47} Idem par 86.
\textsuperscript{48} BNB Act arts 1, 10, 11 & 19.
\textsuperscript{49} BNB Act arts 33(1) & (2); Atanassova “Some aspects of the legal relations between the central bank and the commercial banks in Bulgaria” in Kluwer Legal Issues in Banking Field (2009) 146.
\textsuperscript{50} Bulgaria’s official currency.
\textsuperscript{51} BNB Act art 33(3).
bank in distress. At any stage, if the value of the collateral becomes inadequate, the BNB may give the relevant bank three days to rectify the situation. In the event of any failure by the bank to redress the situation, the BNB may, without interference by a court of law, call up the loan and proceed with its collection (including the sale of the collateral). This applies *mutatis mutandis* to any default by the bank in question in repayment of the loan.

6 Evaluation

Banks lie at the centre of modern economies and therefore policies and measures applied to them by the relevant authorities may have far-reaching implications, both politically and economically. Often measures implemented by such authorities must be decided on the spur of the moment, sometimes at the height of a crisis. Since the core business of banks is based on confidentiality and various persons involved may have the incentive to provide distorted or incorrect information, decisions of the authorities could almost invariably be guided by imperfect information. Moreover, LOLR assistance to banks normally involves the balancing of short-term concerns such as the avoidance or stifling of bank runs and the redressing of liquidity crunches, with longer term concerns, such as the limitation of moral hazard and the fostering of a robust banking system with well functioning banks.

Despite a number of differences, a measure of conformity evidently exists with regard to the application of the LOLR principle in general, as evidenced by the approaches of the UK and Bulgaria in their application of the LOLR doctrine. Similarities in the approach of both countries with the principles of LOLR assistance as embraced in the classical doctrine confirm that this doctrine could in general be considered as the ideal in respect of the rendering of LOLR assistance to banks in circumstances of inordinate liquidity stress.

Banks however, unfortunately do not always function in ideal circumstances and a number of factors may complicate the strict implementation of the principles of LOLR assistance as embraced in the classic doctrine. Some of the important complications experienced relate to the requirements that LOLR assistance should be –

(a) **afforded to solvent banks only**

Owing to the imperfect nature of financial information, the solvency of a bank may be virtually impossible to determine, in the midst of a crisis,

52 Atanassova 152; BNB Act art 33(1).  
53 Atanassova 154.  
54 Circumstances that are apparently often ignored by lawyers when they, in the quiet, orderly and dignified ambience of a court, endeavour to dissect, second-guess and question the decisions of the regulatory authorities taken in respect of a failed bank during a stormy period of financial crisis and turmoil.  
56 *Idem* 8.  
57 Bamber *et al* 107; Lastra 114.
with certainty. In times of crisis, the value of bank assets may be subject to sudden and drastic downward adjustments and it is normally difficult to assess their true value. It is therefore usually difficult to distinguish illiquid and insolvent banks from the rest. This unfortunate situation is further complicated by the fact that a bank that may initially be solvent but illiquid can rapidly become insolvent.\footnote{Goodhart regards the suggestion that it is possible to distinguish between illiquidity and insolvency as a myth: Goodhart 339. See also Lastra 116.} Accordingly, central banks display a tendency of providing LOLR assistance even to insolvent banks with liquidity problems whenever such banks are regarded as systemically important enough to pose a risk to the financial system if they should fail. It is known as the “too big to fail” concept. Moreover, in times of a systemic crisis, a central bank may need to provide uniform support to all banks short of liquidity, even if they are suspected to be insolvent, in order to protect the payment system and macro-economy.\footnote{Davis 7; Bamber et al 108; Lastra 116; Brealey et al 172.} In such times, judgment on the systemic importance of banks may even be suspended and liquidity assistance could form part of an overall crisis management strategy involving the central bank, the supervisors and the fiscal authorities.\footnote{Davis 9.}

(b) \textit{at a high interest rate}

The imposition of penalty rates by central banks on banks may impact negatively on the solvency of such banks and could precipitate their collapse.\footnote{Brealey et al 170; Bamber et al 108.} Furthermore, a stigma may be associated with banks accessing penalty rate facilities which may increase the risk of runs on them. Large-scale interventions by central banks in markets at penalty rates may worsen inter-bank market tensions, resulting in a negative impact on liquidity.\footnote{Davis 18.}

(c) \textit{against good collateral provided by the receiving bank}

Central bank assistance is normally considered after banks were unsuccessful in gaining liquidity support and all market sources of funds were exhausted. Accordingly, when the stage of LOLR assistance is reached, a bank may already have encumbered, or disposed of all its most marketable assets. This, coupled with the difficulty in a crisis to determine the true value of assets, may result in an absence of good collateral being available to cover the exposure of a central bank loan with complete certainty. Under similar circumstances, central banks respond to a loss of market liquidity by easing and reducing collateral standards and accepting virtually any available assets of the banks as security.\footnote{Kindleburger & Aliber 207; Davis 18.} In a systemic market crisis, solvency and collateral requirements may even be relaxed by means of a guarantee in favour of the central bank issued by government.\footnote{Davis 9.}
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(d) short-term
Practice has shown that banks normally find it difficult to redeem LOLR loans, which could inevitably lead to an extension of their repayment terms. In times of financial crisis the funding of risks interacts with market liquidity risk and LOLR assistance needs to be extended for longer maturities. When liquidity problems were being experienced during the US sub-prime crisis, the LOLR policies of central banks were adapted to not merely fund the liquidity requirement of banks but also market liquidity. Moreover, in the event of a bank failing despite LOLR assistance, the subsequent unwinding and possible restructuring of the institution, with the intervention of the regulatory authorities, could last a considerable period of time. Depending on the nature of the exit strategy followed in respect of the bank, it could result in the relevant central bank’s loan not being repaid, either in part or in full; or being repaid over an extended period of time. In times of a serious market crisis, fiscal authorities may need to bear the cost of bank recapitalisation.

(e) made widely known
As indicated above, central banks normally do not widely advocate any supposed willingness on their part to afford LOLR assistance to banks. In respect of specific LOLR assistance to banks, it is acknowledged that confidentiality with regard to such operations helps to prevent knowledge of the specific LOLR operations from giving rise to panic, a rise in borrowing costs or a loss of reputation on the part of the banks receiving the financial assistance. In the wake of such adverse circumstances, banks may be unwilling to access LOLR assistance for fear of reputational risk and thereby worsen an already tight liquidity situation in the market.

Situations may therefore arise where the strict application of the classical principles of LOLR support may defeat the ends they were designed to achieve.

7 Conclusion
The proper management of a bank in a liquidity crisis may be considered one of the most difficult tasks to confront central banks, regulatory authorities and policymakers. Depending on the extent of the challenge, one or more of a diversity of approaches may need to be followed to adequately address a particular liquidity problem. Although the classical doctrine may to some extent constitute the conventional wisdom on LOLR, practice has shown that it does not serve as an absolute blueprint for all financial assistance of this nature. Since the central bank and other relevant national authorities of a country are, in principle, better placed to

65 Bamber et al 108.
66 Davis 12.
67 Idem 9.
68 See par 3.2 supra.
69 Davis 8.
evaluate and address their local needs in a liquidity crisis, the possibility of LOLR assistance to a bank or banks needs to be considered by them on a case by case basis.\(^7^1\) Depending on the particular circumstances, it could involve the possible adaptation or relaxation of, or a deviation from acknowledged principles of LOLR assistance to suit the peculiar challenges presented by the crisis.

Some countries, like the RSA, elect not to publicly set specific rules and procedures in respect of potential LOLR assistance to banks, but rather leave the application thereof in the discretion of their relevant authorities. In such circumstances, the moral hazard commensurate with LOLR assistance is reduced by the uncertainty created by the authorities with regard to access to such facilities, since it prevents the market from taking for granted that the central bank would readily provide assistance of this nature. Other countries, like Bulgaria, elect to provide for LOLR assistance in terms of set rules and legal prescriptions.\(^7^2\) Despite the benefit of legal certainty that prescriptions and set rules in respect of LOLR assistance are likely to provide, they could increase moral hazard, and, as indicated above, in certain circumstances may serve as legal impediments to effectively resolving a financial crisis. In practice, the more stringent, encompassing and prescriptive rules are, the less flexibility the regulatory authorities are afforded to address peculiar issues pertaining to inordinate liquidity shortages experienced by banks in times of crisis.

Whatever the situation may be, central banks, in circumstances where banks experience inordinate liquidity shortages, are undoubtedly guided by cardinal rules pertaining to potential LOLR assistance, based to some extent on the classical doctrine. However, past events have indicated that when these rules cannot easily be broken, there may be frequent trouble in a crisis of this nature.\(^7^3\)

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\(^7^1\) *SRM Global Master Fund LP and Others* par 57.

\(^7^2\) Bamber *et al* 107. See the examples of the UK (par 5.1) and Bulgaria (par 5.2) *supra*.

\(^7^3\) Kindleberger & Aliber 205; Davis 9.