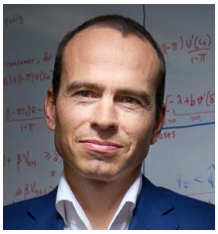
SUERF
The European Money and Finance Forum

SUERF Policy Brief
No 1103, February 2024

Public Liquidity Backstop: Providing Public Collateral, Still Failing on Incentives



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Keywords: PLB, liquidity support, TBTF, distortion

JEL codes: G01, G18, G33, G38

Abstract

Switzerland is discussing the formal establishment of a public liquidity backstop (PLB) for systemically important banks. We examine the implications of a PLB, using the Swiss case as an example. Our goal is twofold: To clarify the effects on fiscal balances, bank shareholder and management incentives, and society at large; and to identify potential distortions and, if needed, appropriate corrective measures.

Note: This policy brief is based on University of Bern, Discussion Papers "Pricing Liquidity Support: A PLB for Switzerland", 25-01 January, 25.

In March 2023, the Swiss Federal Council enacted emergency measures, including the activation of a Public Liquidity Backstop (PLB), to prevent the uncontrolled collapse of Credit Suisse. The regular introduction of a PLB for systemically important banks (SIBs) had long been debated. Later that year, the Federal Council adopted a Dispatch proposing the formal establishment of a PLB for SIBs, which is currently under parliamentary review.[1] In Monnet et al. (2025), we examine the implications of a PLB, using the Swiss case as an example. Our goal is twofold: To clarify the effects on fiscal balances, bank shareholder and management incentives, and society at large; and to identify potential distortions and, if needed, appropriate corrective measures.

A PLB is an instrument to protect the central bank from losses on liquidity support that it extends to an illiquid SIB without sufficient collateral. In the Swiss case, the PLB shifts the risk of losses from the owners of the Swiss National Bank—mainly cantons and the Confederation—to the guarantor, the Confederation. The main rationale for a PLB is that liquidity support, even against insufficient collateral, might be necessary if too-big-to-fail (TBTF) concerns compel the government to orderly resolve a distressed bank rather than letting it fail. The hope is that a TBTF SIB need not be bailed out by the public, as long as the SIB can be dismantled, using the central bank's PLB-backed liquidity support, without causing significant harm to the broader economy.

In the Swiss case, resolution is triggered after equity holders and a first tranche of convertible bondholders have been wiped out, leaving senior bonds, deposits as well as tier 2 convertible bonds as the SIB's liabilities. But resolving a SIB may take time, and during the process, the SIB can bleed more private liquidity. The PLB backs the transfusion of public liquidity in the form of a loan by the central bank, even if the bank lacks suitable collateral.

While a PLB-backed central bank liquidity line does support the resolution process, it also constitutes, de facto, a subsidy on senior debt (and potentially deposits). Without the intervention, a SIB lacking affordable liquidity might have to fire-sale assets and incur losses, endangering solvency and possibly forcing a default on its debt. The liquidity support renders this outcome less likely and, should it still occur, less costly.

This debt subsidy may well be part of a broader, not necessarily explicit package of anticipated support measures that reduce the expected losses for debt holders conditional on resolution. Both conceptually and empirically, it is therefore challenging to distinguish the subsidy component associated with the PLB from the broader subsidy that also reflects other measures tied to a SIB's TBTF status, e.g., recapitalization in case resolution fails.

As a consequence of the TBTF subsidy, debt holders are willing to lend at lower interest rates. This reduces the SIB's relative cost of debt vs. equity financing, and it gives SIBs a funding advantage over smaller banks without TBTF status and access to the PLB. Using standard tools (Merton (1974), Finkelstein et al. (2002)), we conservatively estimate that the overall TBTF subsidy allowed UBS, the largest Swiss bank as of 2025, to benefit from a 1.6% level reduction in the interest rate paid on its senior bonds in 2022, amounting to a funding advantage of USD 2.9 billion on these senior bonds. For comparison, UBS's net profit in 2022 was USD 7.2 billion, so nearly half of the net profit could originate from implicit subsidies on senior debt.

The economically important effect of the subsidy is not that it might shift resources from taxpayers to the banking sector, but that it can distort incentives. Decades of research have shown that high debt and leverage create fertile ground for moral hazard, encouraging excessive risk-taking. By subsidizing debt and reducing its cost, the PLB-backed liquidity support can further incentivize SIBs and their shareholders to increase leverage and foster inefficient investment decisions. To re-align societal and private incentives, the introduction of a PLB framework should therefore be accompanied by corrective measures.

[1] See the Dispatch (in German) and a brief summary.

A tax on debt is an obvious candidate. But how much, and when? Since it is difficult to disentangle the many channels through which leverage, limited liability, and government interventions can distort shareholder incentives, the tax objective should be to correct their combined distortionary effect. That is, and appealing to the theory of the second best, policy makers should adopt a holistic approach to deal with the overall distortions, rather than setting piecemeal levies, each attempting to address different frictions and distortions separately.

Moreover, importantly, the comprehensive tax should be applied before the central bank extends liquidity support, not afterward. Ex-post terms and conditions of a PLB-backed liquidity line, such as high interest rates, fees or penalties, are ineffective, as they have little or no bearing on initial shareholders and management, whose distorted incentives need to be corrected. By the time the PLB is triggered, resolution is underway, these shareholders have been wiped out, and the management is likely replaced. That is, the financing terms for a SIB as a "gone concern" are largely irrelevant to those making today financing and risk decisions under limited liability. A corrective tax thus needs to apply ex ante.

However, corrective measures need not be limited to fiscal levies. Equity requirements may also generate the desired effect of indirectly forcing shareholders and management to internalize the full consequences of their investment decisions, and thus to take decisions more closely aligned with society's interests.

While the choice between a corrective tax and other instruments is secondary, the timing is paramount, as explained above. The measures must apply ex ante, before the liquidity support is extended, to counteract the overall distortionary effect on incentives. Naturally, they should not be made dependent on the SIB's financial performance or other backward-looking indicators as those are irrelevant for the task at hand, which is to align incentives.

Even a resolution process supported by PLB-backed liquidity lines can fail, resulting in fiscal losses for the government as well as significant adverse effects on economic activity, inflation, and the country's international standing. Both public and private sector stakeholders must recognize these risks, particularly in Switzerland considering the length of UBS's balance sheet compared to Swiss GDP.

In light of these risks, both the government and the private sector should engage in additional precautionary saving to build buffers that can help absorb major shocks. This need for additional savings should also be factored into the societal cost-benefit analysis when assessing the merits of hosting SIBs and determining appropriate regulatory measures.

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