

# Containing a Systemic Crisis: Is There Really No Playbook?



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\*But the views expressed are my own and not necessarily shared by anyone else.

# Is there a playbook?

- Yes there is, Bagehot wrote it
- Not in the way Fed officials currently invoke it
  - The distinction between illiquidity and insolvency is blurry in the presence of fire sales
  - But it is an important one to make so as to apply the appropriate policy
- Having set the precedent, there's no scope for redrawing the lines without wholesale changes
- A legalistic interpretation of the Fed's balance sheet does not change the fact that those actions facilitate unappropriated risk of taxpayer funds

# Bagehot's dictum

“central banks should lend early and freely, to solvent firms, against good collateral, and at high rates.”

# Five parts to this advice: Lend

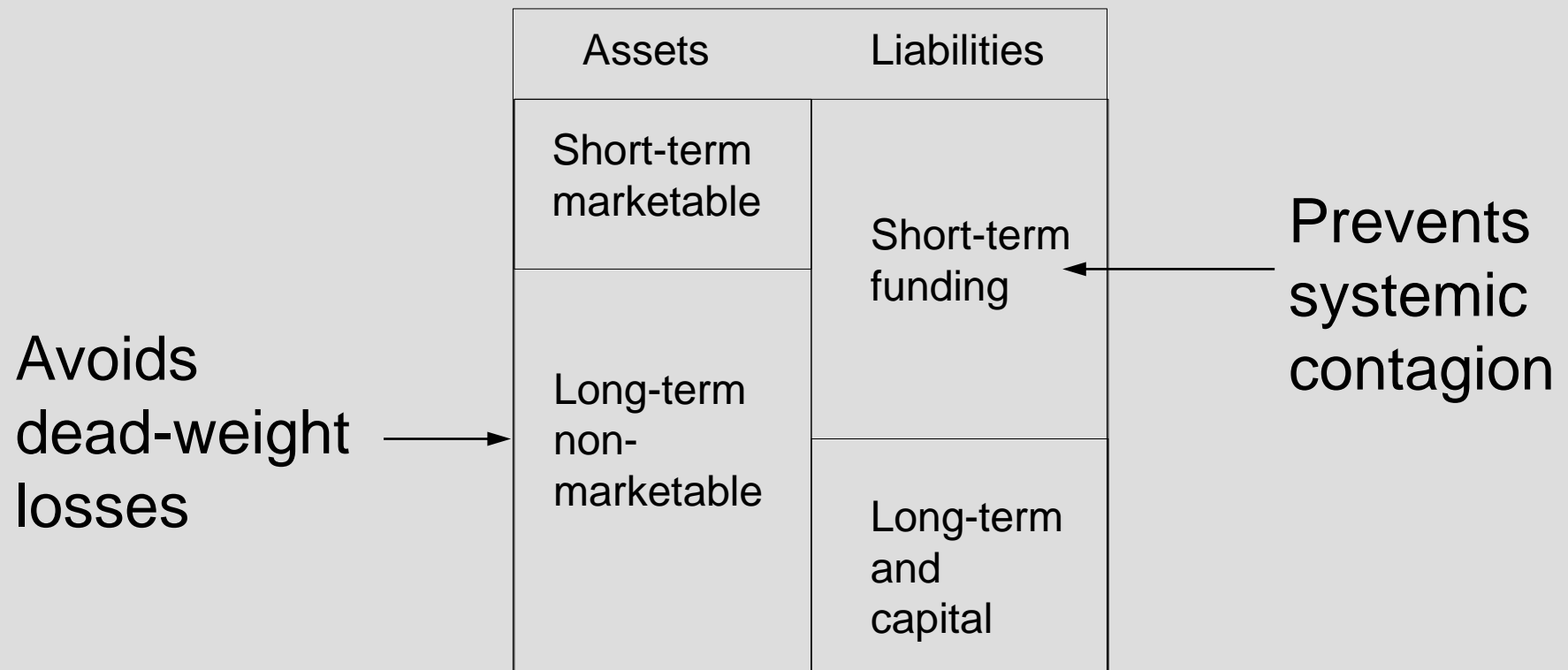
- Early
- Freely
- To solvent firms
- Against good collateral
- At a high rate

# Bagehot's dictum generate benefits in a simple model of banking

- A bank has a mismatch between the **maturity** and **marketability** of assets and liabilities
- **Maturity** mismatch
  - Loans have to be called-in early in event of a run
- **Marketability** mismatch
  - Deadweight loss from calling a loan in early

Assets	Liabilities
Short-term marketable	Short-term funding
Long-term non-marketable	Long-term and capital

# In these circumstances, lender of last resort (LOLR)...



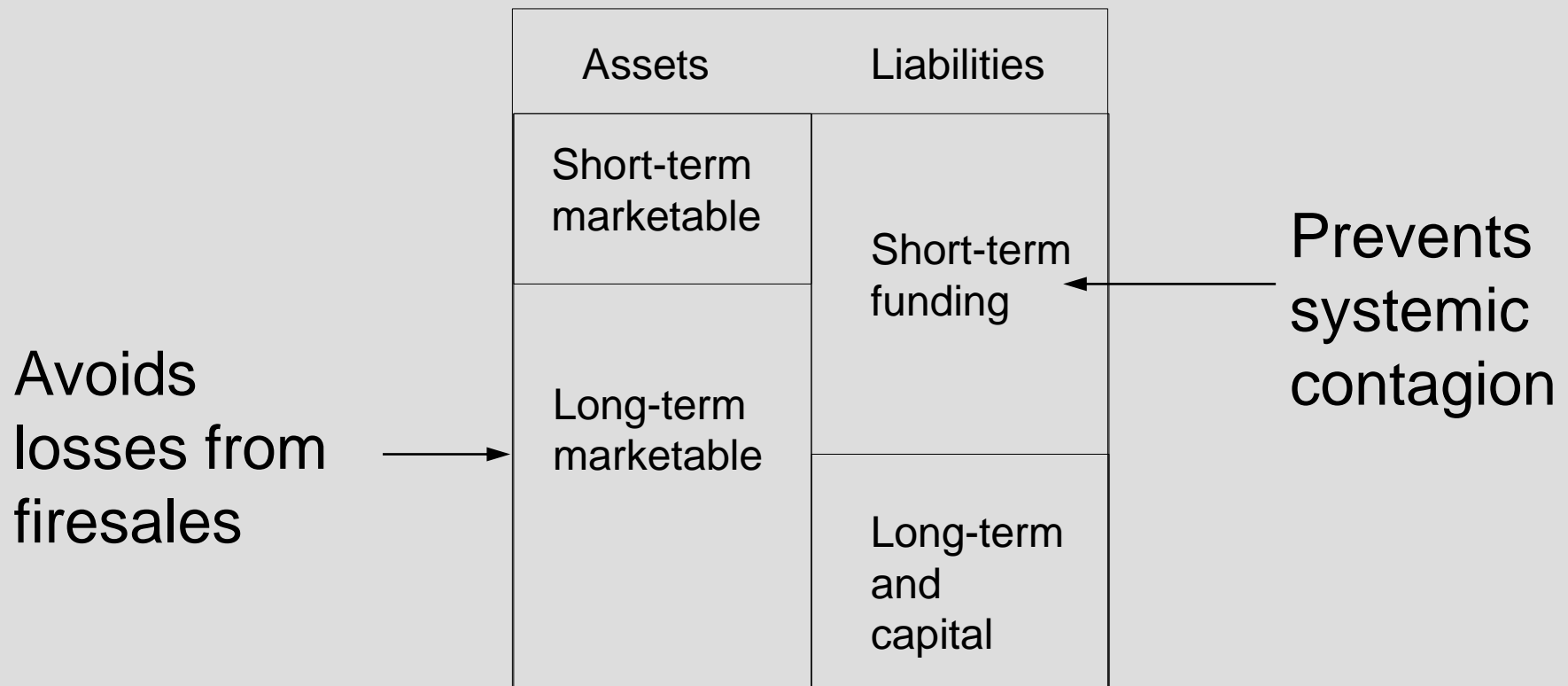
# Bagehot's back

- Brian Madigan described the past two years as “Bagehot’s Dictum in Practice.”
- Fed Vice Chairman Donald Kohn said, “The liquidity measures we took during the financial crisis ... were generally consistent with Bagehot’s principles.”
- Fed Chairman Bernanke said, “Bagehot instructed central banks ... to respond to panics by lending freely against sound collateral.”

# Non-bank financial institutions are subject to runs

- Non-bank institutions may have a maturity mismatch. They rely on short-term funding from investors to purchase long-term assets
- When investors worry about the credit risk of the long-term assets,
  - They demand larger collateral haircuts and higher borrowing rates,
  - This leads to the need to sell assets at fire-sale prices
- But non-bank financial institutions don't have the marketability mismatch

# Thus, the application of Bagehot's dictum to nonbank financial firms is problematic



The distinction between illiquidity and insolvency is blurry for a firm marked to market

# To justify lender of last resort

- Market values must be wrong *temporally*
  - Elevated uncertainty
  - Unusual aversion to risk
  - Adverse market dynamics in a fire-sale
- Losses to the firm are a transfer, not a dead-weight loss to society
- Why share the reward of government action with existing owners?
  - The government can acquire the assets or the firm directly, without the asymmetric payout associated with LOLR
  - This is a **fiscal**, not **monetary**, policy decision

# LOLR intervention has costs...

- To the economy
  - Dilutes market discipline
  - Protects existing managers
  - Discourages private capital from entering
- For the political economy
  - Encourages intervention in other sectors
  - Puts supervisory reform toward more regulation
- Crossing a distinct line by lending to a non-bank firm
  - Sets a precedent that cannot easily be rolled back
  - Limits the scope for other action: The Fed is a principal, not an agent henceforth

# The Federal Reserve emphasizes its credit protections

- Good collateral
- In some case, Treasury provides a first-loss tranche
- Earning profits on its activity
- Valuation is hard
  - That is why there is a crisis
- Exposure should be consolidated across the government
- The Fed didn't always charge the highest rate it could
  - It waved Reg A for Maiden Lane

# The Fed was not alone: Other interventions were flawed

- Resolutions in 2008 mostly
  - Wiped out shareholders
  - Fully protected debt-holders
- As a result, discouraging funding runs encouraged speculative attacks
  - Short the equity of the next-weakest antelope
  - Buy its debt (or credit protection)
- In general, the perimeter of the safety net was ambiguous and the forms of protection inconsistent

# In general, financial authorities

- Do not intervene
  - Effectively
  - Consistently
  - Fairly
- So why do we do it so much?
- But having done so, it will be almost impossible to push back the perimeter of protection

