Lender of Last Resort and Liquidity Regulation

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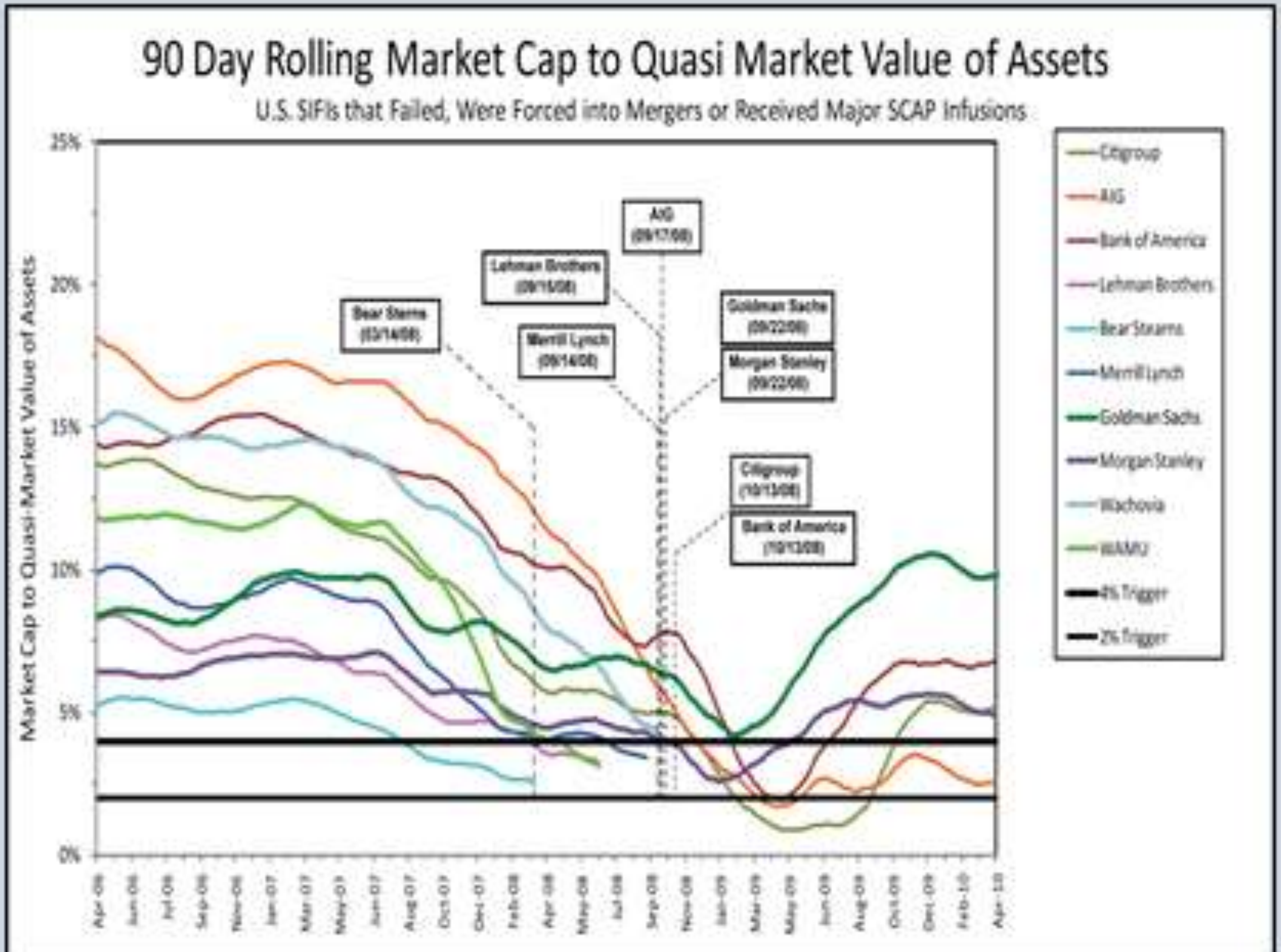
April 30, 2014

Misconceptions About Liquidity

- Systemic liquidity problems are *not* about *exogenous* shocks to liquidity demand (Diamond-Dybvig is still a model in search of an example), but rather about *endogenous* needs for liquidity as perceived balance sheet conditions decline (raising default risk on risk-intolerant money market instruments like repo, CP, interbank debts).
- Lehman was a replay of all historical banking crises: worsening market perceptions of MBS risks, and uncertainty about exposures to the risk, drove reduced MVE/MVA ratios of banks. Lehman's failure was a match in a tinder box, as it signaled likely weakness elsewhere for banks whose MVE/MVA was already very low.



90 Day Rolling Market Cap to Quasi Market Value of Assets
U.S. SIFIs that Failed, Were Forced into Mergers or Received Major SCAP Infusions
Market Cap to Quasi-Market Value of Assets
25%
20%
15%
10%
5%
0%
Bear Sterns (03/14/08)
Lehman Brothers (09/15/08)
AIG (09/17/08)
Merrill Lynch (09/14/08)
Goldman Sachs (09/22/08)
Morgan Stanley (09/22/08)
Citigroup (10/13/08)
Bank of America (10/13/08)
Apr-06
Jun-06
Jul-06
Sep-06
Nov-06
Jan-07
Mar-07
May-07
Jun-07
Aug-07
Oct-07
Dec-07
Feb-08
Apr-08
May-08
Jul-08
Sep-08
Nov-08
Jan-09
Mar-09
May-09
Jun-09
Aug-09
Oct-09
Dec-09
Feb-10
Apr-10
Citigroup
AIG
Bank of America
Lehman Brothers
Bear Stearns
Merrill Lynch
Goldman Sachs
Morgan Stanley
Wachovia
WAMU
4% Trigger
2% Trigger

Implications

- The current separation of liquidity and capital standards is idiotic. What is needed is a framework that defines the extent of substitutability between capital and liquidity, and its limits (the minima of both).
- That must be defined with a model that takes account of their *similar but different* roles in limiting systemic risk.
  - Observability of capital vs. reserves at Fed
  - Superior risk management incentives of reserves (highly relevant given evidence of risk management in recent crisis).

What LOLR Support Permitted?

- Low-risk collateralized lending for Fed.
- Orderly liquidation with assistance to bridge banks.

- Is that enough?
  - Blanket guarantees of debt?
  - Recapitalization scheme?
  - If one or both of these authorities is needed, where should it be housed?

Case Against

- If capital and cash requirement standards are set properly, systemic risk can be avoided without these measures.
  - Higher book equity and other loss absorption
  - Credibly maintained via CoCos requirement that keeps MVE/MVA high even after a shock
  - Significant cash reserves (paying fed funds rate) as a necessary prudential risk management protection.

Case in Favor

- Ad hoc policy is worse that rules-based policy (delayed and more politicized).
- Having a recapitalization plan on the shelf avoids the chaos of ad hoc policy that occurred after September 2008.
- Early intervention is more desirable (and entails less taxpayer risk absorption).
- Reconstruction Finance Corp. preferred stock injections worked well from 1933-1935 to reduce liquidity risk, spur private recapitalization, limit taxpayers' exposure.

Role of Central Bank?

- By having such a plan on the shelf, and placed outside the central bank (but coordinated with it to take advantage of central bank information), it avoids the counterproductive politicization of the central bank that we are living with now.

Conclusions

- Liquidity regulation should be integrated with capital regulation to focus on managing ***insolvency risk***, with special attention on systemic factors that affect insolvency risk (real estate remains the obvious issue for banks in the U.S.), and on adequacy of capital and cash after a big shock.
- Cash is different from capital because (a) reserves at the central bank are observable, and (b) because cash holdings have favorable consequences for risk management incentives.
- Whether, in addition to proper prudential requirements, and resolution reforms, there is a need for systemic protections (capitalization, or systemic debt guarantees) is open to question. On balance I favor an explicitly stated approach in advance, which is more timely and less prone to politicization.