

Central Banks as Regulators and Lenders of Last Resort in an International Context: A View from the United States

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The term “lender of last resort” implies a degree of specificity which goes beyond what that function can legitimately claim. I have never seen, in visits to central banks, a door marked “lender-of-last-resort department,” nor met a vice-president in charge of such an activity.

It is true that there are situations in which the function of a central bank is properly described as lender of last resort. It is true also that a market looks to a lender of last resort, functions better when it knows that there is one, and will try to push some existing institution into that role if none has been appointed by higher authority.

At the same time, markets as well as central bankers know that it is unwise to hoist crisis signals before the condition becomes obvious. Neither market stability nor the credit standing of particular institutions has much to gain from the widespread advertising of a lender-of-last-resort operation. But since concealment also is not an acceptable policy, the part of wisdom often has been not to draw a finer line than circumstances require between what is “last resort” and what is not.

My comments here will deal for the most part with Federal Reserve activities and powers.

Federal Reserve Powers

To meet its lender-of-last-resort responsibilities, the Federal Reserve has a variety of powers that reflect, at least in some measure, the variety of cases that may call these responsibilities into action. For a generalized lack of liquidity, open market powers and the ordinary facilities of the discount window are appropriate. A generalized lack of liquidity has been the characteristic feature of some historic crises that were met by central banks and, in line with Bagehot’s rule, were dealt with by lending freely at a high rate. These crises sometimes focused on the failure or near failure of some major firm while in others there was no obvious single focus. The common denominator, however, was that firms perfectly solvent and under ordinary circumstances liquid, both banks and nonbanks, were unable to obtain short-term credit at almost any price. The famous British

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crises of 1867--Overend Gurney--and 1890--Baring Brothers--as well as the U.S. panic of 1907 were of that character. The last named experience finally led to the creation of the Federal Reserve.

A potential crisis of this same type that was successfully forestalled by lender-of-last-resort action was the Penn Central failure in 1970. At that time it appeared that this failure might interfere with the rollover of commercial paper by certain finance companies.

The Federal Reserve assisted a shift of finance company debt to the banks — both by granting liberalized discount window credit to the particular banks involved (under the emergency provisions of Regulation A) and by suspending the Regulation Q ceiling on 30-89 day CDs, enabling such banks to raise funds through the market.¹ These System initiatives provided needed reassurance to the financial community and helped to halt the general scramble of commercial-paper investors for higher-quality assets. At the height of the crisis, special System advances to facilitate transfers out of commercial paper rose to about \$500 million, but by early fall these had been largely repaid.

The specialized emergency lending powers of the Federal Reserve are appropriate particularly for the case where illiquidity focuses upon a particular institution without spreading to the rest of the market. Here the Federal Reserve can supply credit to member banks for maturities of not more than four months and where the credit is secured to the Reserve Bank's satisfaction, at a rate at least one-half percent above the discount rate if the collateral offered is not eligible for discounting at the regular rate. For others (i.e., individuals, partnerships, and corporations that are not member banks) the Federal Reserve can, in unusual and exigent circumstances, by the affirmative vote of not less than five members of the Federal Reserve Board, provide emergency credit. Rates on such credit would be set by the Board of Governors at the time credit was granted. To qualify for such credit, the party in liquidity straits must be unable to secure adequate credit from other banking institutions.

The foregoing provisions provide broad powers to deal with liquidity problems of particular institutions. It should be noted, however, that all types of discounts and advances must be secured by assets and in the manner specified in the Act and the regulations or "to the satisfaction of the Federal Reserve Bank," i.e., to the satisfaction of the Directors of the Federal Reserve Bank making the loan. The requirement that Federal Reserve credit must be secured has meant, in terms of the Board's policies to date, that Federal Reserve lending to any bank can continue only so long as that bank is solvent; the reason for the Board's view has been that collateral obtained from a bank in a state of insolvency might be exposed to legal challenge. Reasonable questions can be asked whether insistence on

¹Under Section 201.2(e) of Regulation A: "Federal Reserve credit is available to assist member banks in unusual and exigent circumstances such as may result from national, regional, or local difficulties, or from exceptional circumstances involving only a particular member bank."

solvency, a criterion which at critical times may be very difficult to apply, really best serves the public interest. I shall nevertheless rest my following discussion on the policies that are in effect at present with regard to the solvency issue.

Illiquidity Versus Insolvency

Power to deal with insolvency situations is in the hands of the Federal Deposit Insurance Corporation (FDIC). The FDIC, as insurer, can accept a loss. Frequently the FDIC finds it less costly to deal with an insolvency by subsidizing a merger or arranging the transfer of the deposits and the sound part of the assets to another bank through a "purchase and assumption" operation, rather than to pay off the insured depositors and liquidate the closed bank. Considerations relating to the welfare of the local community also apply in decisions whether a bank should be saved or wound up.

This dualism of functions and powers between the Federal Reserve and the FDIC is neater, to be sure, than the real world in which illiquidity and insolvency may in some cases be separable, and in other cases may merge. A bank or any other firm may be illiquid but not insolvent. Nevertheless, if illiquidity leads to a run and to the liquidation of assets at distress prices, insolvency may follow. Likewise, an institution may be insolvent but not illiquid. However, as soon as this situation is diagnosed, the bank is likely to be closed by the regulatory authorities to protect the creditors.

An institutional division of different types of rescue functions, such as exists in the United States, prevails only in a limited number of countries. Elsewhere, the central bank as lender of last resort may find it necessary to deal with the distinction between illiquidity and insolvency in a more ad hoc manner.

Interaction of illiquidity and insolvency as presently interpreted is well illustrated by the case of Franklin National Bank. While the Comptroller of the Currency had declared Franklin to be solvent, the Federal Reserve loaned Franklin, on a secured basis, up to about \$1.7 billion. When solvency could no longer be assured, Franklin, under the auspices of the FDIC, was taken over by the bank that had put in the highest bid while the FDIC took over the Federal Reserve loan and that part of the assets not going to the merging bank.

The question is sometimes raised whether banks should be allowed to fail. That is not a meaningful issue. Even the most intensive supervision cannot make sure that no bank will ever suffer losses large enough to wipe out its capital. As far as the stockholders and management are concerned, the bank then has failed. The real question is whether the depositors and other creditors, and in a broader sense the monetary system and borrowers dependent on their banking connection, should be allowed to suffer the consequences. The answer may well have to depend on such

circumstances as the availability of alternative sources of credit in particular regions or local communities. Giving too much advance assurance to management, stockholders, and depositors risks losing some of the discipline of the market upon which regulators rely to some extent to keep banks "in line." Proponents of 100 percent liability insurance must keep this in mind. So must lenders of last resort. In this imperfect world, perfect safety is not an ideal condition. Regulators, central bankers and insurers would soon find the odds they had created being exploited against them. In response, they might find themselves driven to regulate and supervise bank operations to a degree inconsistent with the free flow of credit.

International Aspects

The growing internationalization of banking adds new dimensions to regulatory and lender-of-last-resort responsibilities. National legislation, regulations, and supervisory practices differ widely among countries. Nobody would dream of trying to coordinate laws and practices internationally, but increasing regulatory cooperation is possible, and considerable progress has been made. Regulators meet regularly, under the auspices of the BIS and otherwise. The result has been a better understanding of one another's problems and interests, as well as cooperative policies with respect to particular issues.

The matrix of international banking relationships has been expanded as a result of the growth not only of old established national markets, but through the appearance of new banking centers, frequently referred to as offshore centers. As regards regulation, practices among these centers range widely from technically competent and tight regulation and supervision to virtual nonexistence of such efforts. As far as lender-of-last-resort facilities are concerned, it is, of course, very difficult and often impossible for small political entities to exert such a function.

Accordingly, bank regulators and lenders of last resort will find themselves involved in different degree in the activities of their banks abroad. In the case of the United States, the foreign activities of banks and bank holding companies are closely supervised. Bank holding companies and banks need the approval of the Federal Reserve for foreign acquisitions and branches, and with regard to the nature of the activities conducted overseas. Foreign branches are examined by the Comptroller of the Currency and the Federal Reserve except in a limited number of countries where national laws bar such access. Where regulatory and supervisory laws and institutions exist, as is the case in all countries with significant domestic banking activity, it is, of course, the national authority that is the primary regulator and supervisor within its borders. Because of the special characteristic of American bank examination, which focuses upon appraising the quality of assets in a way few other supervisory systems do, reliance on local banking authorities for the direct supervision of foreign branches and subsidiaries has not yet occurred.

International banking also raises the question of lender-of-last-resort responsibility. Today, that responsibility is exercised in a framework of floating exchange rates. This eliminates one of the problems that have beset lending of last resort and that have led to probably the most spectacular failures to live up to that responsibility. I would count among those failures the unwillingness of the Reichsbank to go to the aid of its banking system in 1931, and the failure of the Federal Reserve to deal with the mass failures of American banks during the depression of the 1930s. In both cases, the constraints of the gold standard impeded, by the lights of those days, action that might have forestalled the respective crises. I would not, today, belittle the very real concerns of those who had to make traumatic decisions in those days. The Reichsbank feared that Germany's international credit would be destroyed if it violated its 40 percent gold cover requirement. The Federal Reserve had no means of knowing that the Supreme Court would some day invalidate the gold clause and in that way avoid the consequences, for many borrowers, of a departure from gold. Nor would I argue that all the superior wisdom is on the side of our days. We have not done well enough in managing paper money to be able to claim that. All I want to say is that today we do not operate under the constraints which, 45 years ago, helped to produce major financial failures.

The multiplicity of possibilities and national circumstances makes it obvious that no general rule can be established for a particular course of action in case of a banking crisis that was not of purely local character. The problem, if it were to arise, could be market-wide or focused on a single institution. It could be a problem of liquidity or of solvency or of both. It could occur in a market with a strong central bank and regulatory system, or in a center where neither exists. It could focus on the home currency, or upon the dollar and other currencies.

The need for concerted action in such a case nevertheless was recognized by the central bankers who meet monthly at the BIS in Basel. After careful examination of the issues, the central bankers arrived at the same conclusion that I have just indicated: that detailed rules and procedures could not be laid down in advance. But since considerable concern existed at that time about the state of the Eurocurrency markets, the following statement was issued: "The Governors . . . had an exchange of views on the problem of the lender of last resort in the Euro-markets. They recognized that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary."

This approach reflects the experience also that the Federal Reserve has had in handling its own lender-of-last-resort responsibility. There are dangers in trying to define and publicize specific rules for emergency assistance to troubled banks, notably the possibility of causing undue reliance on such facilities and possible relaxation of needed caution on the part of

all market participants. The Federal Reserve has always avoided comprehensive statements of conditions for its assistance to member banks. Emergency assistance is inherently a process of negotiation and judgment, with a range of possible actions varying with certain circumstances and need. Therefore, a predetermined set of conditions for emergency lending would be inappropriate.

In the international field, extensive discussions of the role of host and home country central banks for extensions of emergency assistance to subsidiary and multinational financial institutions have produced a common understanding of the problem. Cooperation among central banks is clearly necessary. No central bank can avoid some degree of responsibility for events in its market. No central bank can disinterest itself in the international activities of the banks for which it is responsible at home.

An important aspect of the close cooperation among central bankers and other regulators is being implemented through central bankers' meetings at Basel and through a regulators' committee which meets periodically at other times. There can be no question, of course, of making national legislation homogeneous. The differences are too deeply rooted for that. What is possible is to develop a close understanding of the expectations, intentions, and *modi operandi* of different countries and to make them mesh. That is being achieved through institutions like those under the aegis of the BIS.

Cooperation

Cooperation is particularly important where the supervisory and lender-of-last-resort responsibilities are different. Countries meet in one market increasingly frequently owing to the internationalization of banking. As far as regulation is concerned, the role of the local regulator, in most cases the central bank, under present conditions is bound to be major. The local regulator charts and supervises foreign subsidiaries and joint ventures and where local legislation so provides, examines them. Foreign supervisors and regulators have different degrees of access to local offices of branches, subsidiaries, and joint ventures of banks and bank holding companies of their own countries, depending on local legislation.

Under these circumstances, the local regulatory authority inevitably has a concern with the liquidity and solvency of banks under its jurisdiction. The financial resolution of both types of problems, of course, is in the first instance a concern of the parent organization. For branches this goes without saying, since they are an integral part of a banking organization. For wholly owned subsidiaries, parents have historically demonstrated a strong sense of responsibility. Banks do not cast their foreign operations in the form of subsidiaries rather than branches in order to take advantage of limited liability. Nor would such subsidiaries be able to operate on a large scale if the market suspected that in case of trouble the parent would walk away from them. These foreign operations are cast in the form of subsidiaries rather than of branches principally because in

that form they enjoy broader powers, better tax status, and greater operating flexibility.

Parents, therefore, expect to back their subsidiaries, even though ultimately that must be a business decision and where the regulatory framework so provides, a decision of the regulatory authorities of the parent as well as, of course, of the host country regulator. This is one of the reasons for the Federal Reserve's requirements that adequate financial data for both branches and subsidiaries abroad be kept and made available to examiners in the United States.

As far as American banks are concerned, the great bulk of foreign operations, in dollar terms, is carried out through branches. Subsidiaries typically are small relative to the size of their parents, and usually well capitalized except in the special case of shell organizations.

Minority participations, accompanied by a management interest, so-called joint ventures, are usually those of large banks which historically have shown readiness to back their offspring, although they may want to limit their support to their own share in the venture. The Federal Reserve, in an interpretation issued in 1976, has made clear that for American banks, which by law must obtain Board approval for this as any other type of acquisition, the Board would take into account the ability of the applicant to support more than its own share in a joint venture. The Board also said that it would give great weight to the potential risks in cases where the joint venture was closely identified with its American parent by name or through managerial relationships.

The Evolving Role of the IMF

This talk has been burdened by much technical detail. I would like to end it by taking a broader and more evolutionary look at the lender-of-last-resort problem. It has often been pointed out that the function of the International Monetary Fund in helping countries in balance-of-payments difficulties has some of the characteristics of a lender-of-last-resort operation. In the course of time, this role of the IMF may expand. It is important to note where the similarities and the differences are likely to manifest themselves.

Central bank lending to money markets for particular banks in crisis conditions and IMF lending to national governments have in common that the objective is mainly to protect the monetary system, rather than to help individual banks. Neither should engage in bail-out operations for banks.

The Fund's ability to help countries with balance-of-payments problems, however, depends on the willingness of the borrowing country to meet the Fund's policy conditions. It is not an unconditional form of assistance. For that reason, banks that have lent to a country cannot take for granted that the Fund will come to the country's rescue.

An important difference between central bank and IMF lending is that the IMF, unlike central banks, need not and should not wait for a

crisis to develop. In fact, the earlier a country applies for assistance to the IMF in the upper tranches, the sooner a set of policies will be in place that should help the country overcome its difficulties. In that sense, the IMF need not be a lender of last resort.

The IMF role in imposing conditionality and guiding the policies of the borrowing country finds a counterpart in the regulatory activities of central banks. Good national policies, like sound banking policies, should reduce greatly, if not altogether eliminate, the need for lender-of-last-resort activity.

Still another difference between the lending of the IMF and the classical lender-of-last-resort operation may be noted: the Fund's normal technique is not to lend freely at a high rate, but on the contrary to pay out limited funds on a phased basis upon a showing that performance criteria are being met.

These differences reflect, of course, the inherent distinction between a country borrower and a money market or single bank. A country is inherently a stronger debtor, not because it controls a printing press, but because adequate policies will make it possible to pay except perhaps temporarily in the direst of circumstances. A country cannot go out of business after the manner of a bank or other business enterprise. Solvency is represented by the existence of the political will to deal with economic difficulties.

Given the great potentialities of the IMF's role, its further strengthening is obviously desirable. This is currently underway through the proposed Witteveen facility, and through quota increases already decided and still to be decided. More adequate resources will not only enable the Fund to meet better such needs as may arise, but also to be more effective in influencing the policies of borrowing countries and in that manner enhance the willingness to lend of the private market. In that sense, too, the activities of the Fund could come to constitute a parallel to those of national lenders of last resort — to create conditions of confidence in which the private market can again function adequately.

Discussion

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Governor Henry Wallich's paper provides a narrow and circumspect view from the United States of the role of central banks as regulators and lenders of last resort. Presumably such cautious treatment reflects the weight of responsibility borne by a Governor of the Federal Reserve System not to undermine the central bank's effectiveness by stipulating its tactics in advance of their use nor to spread panic by viewing with alarm. It may also reflect a certain modesty concerning the role of the central bank in the formulation of national economic policy.

In his paper Governor Wallich touches on a variety of themes principal among which are the limits to the Federal Reserve's legal powers to provide assistance to meet the threat of illiquidity, the complementary role of the Federal Deposit Insurance Corporation in cases of insolvency, the presumed greater freedom of a central bank to provide liquidity when exchange rates are floating (Is this equally true when rates are managed?), the inevitable intertwining of the responsibilities of different national central banks and thus the need for cooperation, and the useful conditionality of IMF loans in influencing borrowing countries to adopt more creditworthy national economic policies.

Most of these observations and reflections can be accepted. But they do not meet the challenges which developments in international banking are posing for commercial bankers, central bankers, and national authorities.

The central problem is how to cope with the implications of the greatly expanded role of commercial banks in managing international capital flows at a time when these flows themselves have greatly increased in volume due to the activities of OPEC and the needs of the less developed countries. What is unique is the degree to which microeconomic commercial interests have become intertwined with national macroeconomic and political issues. Bankers have responded more promptly and flexibly to channel funds from capital surplus to capital deficit nations than have national governments or international organizations. The difficulty with this situation is that bankers cannot cope with the attendant macroeconomic issues involved. Among these issues are the balance-of-payments problems of borrowing nations, the stability of the Eurocurrency market and the international financial system, the risk exposure of national banking systems, and the effects of capital flows on national monetary and

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credit conditions and exchange rates. These macroeconomic phenomena provide the environment for the microeconomic activities of commercial bankers. It is myopic and unrealistic for a central bank to conceive its responsibilities toward international banking as limited to the role of lender of last resort, cautiously defined, and to the microeconomic aspects of bank regulation.

Governor Wallich's paper says little about the role of the Federal Reserve Board as regulator in an international environment. He notes the diversity of national regulatory codes and of the extent of national supervisory efforts — a diversity which recommends "cooperation" among national authorities. He does not explore the nature of such cooperation nor of the regulatory objectives to be served.

What should the U.S. central bank's regulatory objectives be in an international banking context? Here is a suggested list of concerns: First, the soundness of banks which influence its domestic economy including activities of U.S. banks abroad and commitments of U.S. banks to foreigners as well as activities of foreign banks in the United States. Second, equity of regulatory treatment of U.S. and foreign banks. Third, the influence of the international activities of U.S. banks and of foreign banks located in the United States on the effectiveness of U.S. monetary and credit policy. Fourth, the effects of U.S. offshore banking on monetary and credit conditions in other countries. This last point would involve a degree of multilateral international monetary cooperation that is far beyond the level of current achievement. A fifth objective of regulation, broadly viewed, is to strengthen the international financial system by preventing the overexposure of banks to illiquidity and insolvency leading possibly to international financial panic and eventually to increased reliance on national exchange controls. Regulatory supervision alone clearly cannot achieve most of these objectives, so that a narrow focus on regulation does not constitute an adequate response to the problems at hand.

It may be the part of wisdom for prominent central bankers to refrain from public discussion of the dangers to national and international banking and the international monetary system that can accompany the failure of one or more major banks. But surely participants in a conference devoted to international banking and the related responsibilities of central banks would be remiss to ignore this problem.

Suppose an important public sector borrower in a less developed country defaults. Indeed, can such a borrower be permitted to default? Options for the national authorities of the creditor nations include guaranteeing interest payments while rescheduling repayment of the principal, assumption of the defaulted loan to relieve banks of the burden, and imposition of unilateral or multilateral sanctions against the nation in default. What are the national and international economic consequences of such actions? The political consequences? How far are central banks prepared or authorized to go in dealing with such contingencies? At what point does broader governmental responsibility supplant or replace central bank responsibility? How does the character of government intervention

affect the allocation of the creditor nation's loss of real resources among domestic groups and individuals? These are some of the difficult problems that need to be addressed.

Increased roles in international lending for the IMF, World Bank, OECD or other international agencies may elevate negotiations between borrowers and lenders from a commercial to an official level. But this does nothing to reduce the scale of the capital transfer problem within the international economy. The chief hope of this approach is to require governments of debtor nations to adopt more effective national economic policies. An increased role for international lending agencies also spreads the risk among contributing nations and thus has an actuarial insurance feature for creditors.

Governor Wallich confines his discussion to more conventional regulatory and lender-of-last-resort functions of a central bank in the Federal Reserve tradition. My purpose is to stress that this approach does not suffice to meet today's needs for public policy in the sphere of international banking. Needed is greater attention to the international macroeconomic environment for commercial banking and greater reliance on inter-governmental policy cooperation to regulate that environment.