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Will The Federal Reserve be able to serve as Lender of Last Resort in the Next Financial Crisis?

I will address the topic for this panel, but in a somewhat broader context. Dodd-Frank made far-reaching changes in the techniques available to the Federal Reserve and other government authorities to deal with a systemic financial crisis. Many of these could well affect the dynamics of both private and public sector provision of liquidity in a developing crisis. It's this broader context that we need to think about and be prepared for.

I start from a couple of key premises. One is that the response to the last crisis in D-F and other actions taken by the regulators is making the onset of the next systemic crisis less likely. Banks and other regulated institutions will have more capital, greater liquidity, and better risk management systems than they had in 2007; interconnections among institutions will be less complex and risk easier to monitor, especially in derivative markets; elements of countercyclicality will be introduced into regulation—macroprudential regulation—that should help ameliorate the build up of risk in expansions; private sector market discipline will be aided by additional transparency and efforts to roll back TBTF.

But, second, assets still will be mispriced from time to time and then correct suddenly and unexpectedly; bad loans will be made in good times; and the financial system will continue to be based on leverage and maturity mismatches, which will build when confidence is high. Financial systems therefore will continue to be subject to shocks, some originating elsewhere in globally connected financial and

product markets, that can threaten a general drying up of liquidity and have the potential to seriously disrupt credit flows and economic activity. Some complex interactions and connections will can transmit such shocks in unexpected directions will not be detected until those asset corrections or other shocks occur. Thus, although runs, panics, and systemic events in the financial sector are less likely, we can't rule them out.

And third, susceptibility to runs and panics will continue to persist outside the banking system with potential systemic implications, as in 2008. We found then that a safety net focused on depository institutions for liquidity and orderly resolution was not adequate to deal with a systemic crisis in the 21st century. The increasing importance of securities and securitization markets meant that impairment in those markets and in key participants in them threatened the intermediation functions that are the lifeblood of our market system. The effects of various new laws and regulations on the relative importance of particular channels of intermediation are unclear, but it's highly likely that nonbank institutions and markets will remain systemically important in the U.S. financial system.

In the midst of a run, access to funding is critical to stabilizing the system. In panics, the distinction between liquidity and solvency becomes quite blurred. As funding becomes more expensive and less available market-making dries up and institutions are forced to sell assets, driving down asset prices and calling the solvency of more institutions into question, which further impairs the ability to access private funding. This is the classic problem that central banks since the middle of the nineteenth century have been expected to counter by making loans

freely available to solvent institutions at a penalty rate against good collateral. In the recent crisis, the Federal Reserve judged that providing liquidity to both banks and nonbanks, broadly and also narrowly to a few systemically important institutions, was essential to arresting the downward spiral and limiting its effects on the real economy. The Federal Reserve's actions were supplemented by those of other agencies in the crisis, notably the FDIC with its debt and deposit guarantee programs and participation in the Citi and Bank of America ringfences under the systemic risk exception to least cost resolution. An unfortunate byproduct was that some troubled systemically important institutions could not be allowed to fail. In general, their shareholders were severely penalized and management changed, but creditors were made whole; they did not have to bear the full consequences of their investment decisions.

In reaction—especially to the assistance to some large troubled institutions—Congress eliminated or constrained a number of the tools used to stabilize the financial system. It substantially limited the elements that made TBTF possible—systemic risk exception to least cost resolution by the FDIC and the use of 13-3 for individual nonbank institutions, including to bank holding companies. But it also constrained other broader liquidity tools: the Treasury cannot guarantee money market funds; the FDIC cannot guarantee senior debt without getting the explicit approval of Congress; the Federal Reserve needs to get the approval of the Secretary of the Treasury before it can establish a widely available liquidity facility for non depository institutions; the Federal Reserve must get explicit approval of the FDIC to loosen the restrictions of 23A, which was used in the crisis to allow

banks to help fund their affiliates; and the unlimited insurance of noninterest bearing transactions deposits expires at the end of next year.

One new power was created—the ability for the authorities to place systemically important institutions into resolution by the FDIC. That authority allows the FDIC to keep key elements of these institutions operating, but it also anticipates that any losses will be borne by those who supplied capital and credit to the institution—not by the taxpayers. And even depository institutions must be put into resolution before the FDIC deals with them—there is no open bank assistance. In addition, however, Congress gave the Federal Reserve another new power, explicit authority to use 13 (3) to lend to one type of individual nonbank institution—a designated financial market utility.

In a crisis, there will always be tension between stability and avoiding taxpayer support and moral hazard. On balance, the Congress has changed the rules of the game to tilt more towards avoiding moral hazard and less toward stabilizing the system. That change in tilt included restrictions on liquidity provision by the central bank and the deposit insurer even though those activities did not by themselves in the end entail taxpayer support. Nonetheless, they were perceived as putting taxpayer funds at risk and keeping alive some firms that should have been allowed to fail.

No one knows what the effect of the new resolution regime and the constraints on liquidity will be on the shape of the next crisis and the authorities' ability to limit the damage it may cause to the economy. I suspect one effect may well be to speed the transition from early signs of trouble to generalized liquidity

problems when a systemic shock occurs. Because of the uncertainty of who will bear the costs in resolution, troubled firms will lose access at a minimum to longer-term unsecured senior credit and potentially to shorter-term credit as well. And when systemically important firms are placed into resolution, contagion to other firms, even if solvent under most circumstances, will remain a threat. As I noted before, when markets begin to seize up and people become frightened the liquidity/solvency distinction becomes blurred. For example, I doubt orderly liquidation of Lehman and AIG in September 2008 would have stopped the generalized runs that ensued. And the Congress is unlikely to approve a new guarantee program for the FDIC until after it can see that a systemic crisis is well underway and threatens the economy. The experience of the most recent crisis, especially after the bankruptcy of Lehman, will induce private creditors to be quite sensitive to early signs of failure. That same experience may also influence foreign governments to become concerned about affiliates of troubled institutions in their own jurisdictions, possibly leading to efforts to block the transfer of funds and force the sale or wind down of branches and affiliates, further constricting the flow of liquidity.

Another factor that may affect the dynamics of future problems in financial markets are transparency requirements for Federal Reserve lending. The Federal Reserve needs to be quite forthcoming about the decisions it makes, their rationale, and the expected consequences. But releasing names of borrowers can have consequences. Under Dodd-Frank, the names and amounts of borrowing of non depositories are to be sent to the House and Senate oversight committees almost

immediately, though confidentiality can be requested. The names and loan details for depository institution borrowers are to be made public within two years of the quarter in which loans are made; the names of 13(3) borrowers may be made public as soon as a little more than one year. Experience in the U.S. and abroad is that institutions are very concerned about their borrowing being made public because counterparties see such borrowing as a sign of weakness. Our experience from the fall of 2007 on was that concerns about stigma were a major impediment to use of the discount window, and that was under circumstances in which such borrowing had to be inferred by market participants and before institutions needed to consider political risk of being subject to public hearings or leaked information. Of course, in the midst of a systemic event when choices are severely limited, institutions will borrow from the Federal Reserve if the alternative is failure. And a one- to two-year lag may be enough to allay the concerns of many borrowers. But others might hesitate and the Federal Reserve's ability to head off problems by injecting liquidity through the discount window when interbank and other funding markets begin to suffer from illiquidity, as in the fall of 2007, could be diminished. It is exactly under such circumstances that discount window lending is most important because troubled money markets will not be up to the task of distributing liquidity supplied by open market operations throughout the financial system.

I have emphasized the risks and problems, but I don't want to leave the impression that I think the Federal Reserve and other authorities have lost the ability to supply liquidity into a potential systemic crisis and head it off. The Federal Reserve can advance credit to depository institutions without new restrictions on

traditional types of lending. And it can open facilities that aimed at making funds available to broad classes of nondepositories. If a systemic crisis threatens, the requirement for the approval of the secretary of the Treasury should not be a serious impediment. The Federal Reserve works closely with the Treasury under ordinary circumstances and communication is especially close when problems loom. The Federal Reserve can be the lender of last resort—but not to troubled institutions, especially if they are not banks. Taking those institutions into resolution, preserving their systemically important functions and making credit readily available to others could well serve to keep enough liquidity flowing to avert a major systemic meltdown. But there is less room to maneuver for the authorities, including the Federal Reserve, and we won't know until we face the situation.

As a consequence, we need to take steps to avoid such a situation arising. The authorities are already working along a number of lines, and this review of constraints on liquidity provision underlines just how important it may be to avoid broad instabilities in financial markets.

Don't let weaknesses build; stay out of resolution or the threat of resolution. First, insist on high levels of loss-absorbing capital and liquidity, especially for systemically important institutions. Capital and liquidity do have costs that need to be considered, and those costs will ultimately be borne mostly by customers—lenders and borrowers—but the cost of the systemic event has also been very high and persistent. Second, intervene early in weaker institutions before they can endanger the system. Among other things, that implies tough but fair supervision that is willing to hold individual institutions to high standards. And

third, work on a macro level to spot developing systemic vulnerabilities and build resilience into the system in good times that can be drawn on to support lending when cycles turn down—macroprudential regulation.

Make resolution as consistent as possible with maintaining financial stability. Preparation will be key. Among other things, this entails using the living wills to simplify complex enterprises so that the systemically important pieces can be isolated. And it involves working internationally to achieve more compatible resolution regimes in various countries and understandings of how these would work in a crisis so as to minimize the incentives and opportunities for individual jurisdictions to work at cross purposes.

Work to strengthen the non-depository sectors of the financial markets, even for non systemically important institutions. In the crisis, systemic risk arose in several market sectors in which obligations were very short and investors looked to them for safety and liquidity--for example money market funds and tri-party RPs. Once safety and liquidity were called into question damaging runs occurred. Other segments of the credit markets may tend to become more systemic as some functions are pushed out of banks by higher capital and liquidity requirements or new regulations such as the Volcker Rule. Attention only to systemically important institutions in the nonbank world will not be enough to contain systemic risk; some markets and broad sectors also deserve attention. More can be done working within existing regulatory regimes for these and the regulators should watch carefully for any need to go to Congress for additional legal authorities over more lightly supervised areas.

Strengthen the incentives and the ability of the private sector to better monitor risk in counterparties. The private sector did a very poor job of monitoring and pricing risk in the lead up to the crisis in the U.S. and in Europe as well. Given the externalities involved private sector discipline will never be enough. But it can be better and can work with the regulators to make the financial system more resilient. Two things are required at a minimum. First, private lenders must perceive that their funds may be at risk—that they will not be made whole by the government. The new orderly resolution authority and the rules proposed to implement it are important steps in that direction. Once they have the incentive, private investors must have the information to improve the pricing of risks. Steps toward greater transparency, for example in pillar three of the Basel Capital Standards and in the release of aggregate positions from the information warehouses for derivative markets, should be helpful. Greater transparency on an institution-by-institution basis is also a potential help in avoiding generalized runs and the need for Federal Reserve liquidity. One of the problems in the crisis was that lenders did not know which of their counterparties were potentially threatened, so they withdrew from all of them. In those circumstances markets tend to freeze up and all borrowers find credit in short supply.

This is a formidable to-do list, but work along most of these lines is already underway. Our examination of the possible effects of Dodd-Frank on the behavior of private and public liquidity in a developing systemic crisis has highlighted the imperative to continue making progress in strengthening the financial system and

making it more resilient to adverse shocks so that the implications of the new restrictions are not tested.