

# Lender of Last Resort: Who should do what? A few points for discussion

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Managing financial crises: Where do we stand?

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# A few points for discussion

- **Bagehot and LOLR provision in the Euro area**
  - ECB as LOLR for market liquidity
- **Who are the borrowers and what they do with LOLR liquidity**
  - Sovereign debt financing in crisis times – “doom loop”?
- **Other forms of liquidity provision**
  - Standard ELA
  - Liquidity in resolution



# Main principles for LOLR

- **Bagehot's principles**
  - Lend freely, to **illiquid** but **solvent** banks, against good collateral (at **pre-crisis** values), at **penalty** rates
- **When should banks borrow from LOLR?**
  - When they face **temporary liquidity needs**, typically due to runs
  - Implications: No changes in bank assets and thus risk taking
- **Same principles apply in general to LOLR as market liquidity provision in the case of systemic liquidity crises**
  - Discussion in 90s: Individual versus market liquidity; illiquid versus insolvent banks; contagion risk; etc.



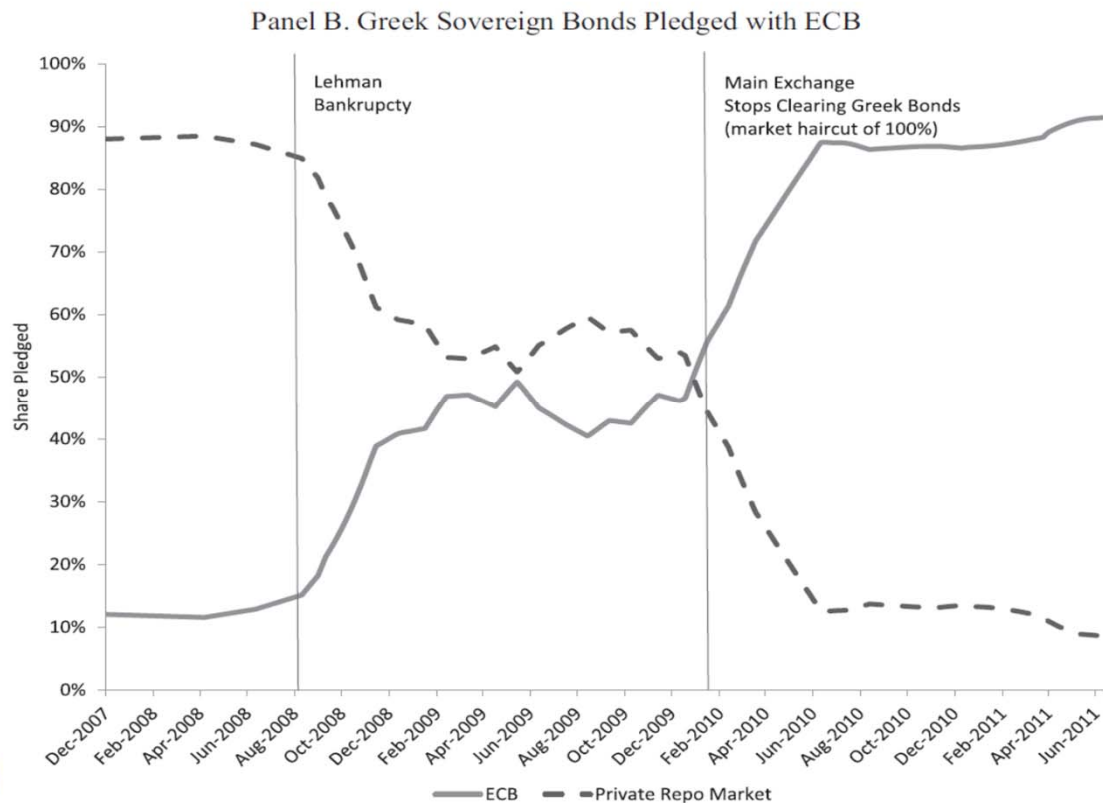
# LOLR provision in the Euro area

- **Move to Fixed Rate Full Allotment (FRFA) in September 2008**
  - Banks can borrow **unlimited amounts** at prevailing (MRO) rate against **suitable** collateral
  - Marginal lending facility was **de facto** made redundant – but not ELA
- **Changed collateral policy**
  - Extended eligible securities and **haircut subsidy**: below market haircuts for risky securities, equal/larger for safer securities
- **Implications (Garcia de Andoain et al., 2016)**
  - ECB acted as a **de facto** LOLR for the whole Euro area, replacing overnight interbank market functioning in 2008-10 and stimulating liquidity supply to banks (especially in **stressed countries**) in 2011-13



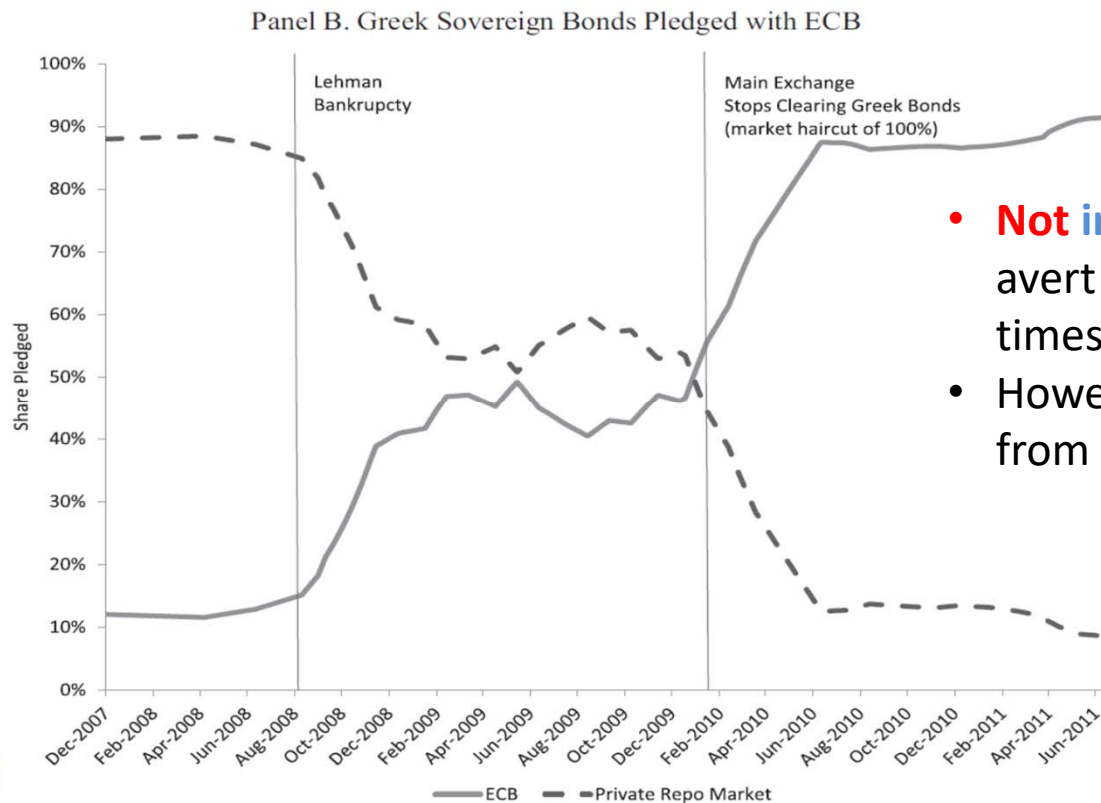
# Who are the borrowers

- **Drechsler et al. (2016):**
  - **Weakly capitalized** banks took out **more** LOLR liquidity and used **riskier securities** as collateral than strongly capitalized banks
  - **Haircut subsidy** induced banks to pledge risky securities ECB



# Who are the borrowers

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- **Not in contrast** with Bagehot principles: “to avert crisis, **against good collateral** (in good times)”
- However, **redistribution** of risky collateral from strongly to weakly capitalized banks

# What borrowers do with LOLR liquidity

- **Use of LOLR borrowing (Drechsler et al., 2016):**
  - **Weakly capitalized** banks borrowed at least in part to buy risky assets such as **distressed sovereign debt**
  - A 10% increase in a bank pledging of distressed sovereign debt is associated with a 4.5% increase in its holdings – relationship is stronger for **domestic** pledged distressed sovereign debt
- **Unintended consequence of LOLR?**
  - While this is **in contrast** with classic LOLR principles, it is **in line** with **risk shifting** theories
  - And in line with other literature on “collateral trade” in LTRO (Crosignani et al., 2018) and distressed sovereign debt financing (e.g., Acharya et al., 2015; Acharya and Steffen, 2015 )



# Sovereign debt financing in crisis times – a doom loop?

- **Risk shifting theories**
  - Domestic **bailouts** and sovereign debt **forgiveness** by international creditors (Fahri and Tirole, 2018)
  - Domestic banks **prefer risk profile** of domestic sovereign bond, particularly in bad times (Crosignani, 2017; Gennaioli et al. 2014)
- **Is re-nationalization of sovereign debt a “doom loop”?**
  - **Not necessarily**, if it **reduces funding costs** of the sovereign in stress (Crosignani, 2017; Livshits and Schoors, 2009) or **increases** sovereign **willingness to pay** (Gennaioli et al., 2014), thus **reducing sovereign default probability**
  - Need to distinguish between **stress** (inevitable and desirable?) and **normal** times





# Other forms of liquidity provision

- **Emergency liquidity assistance (ELA)**

- Its use **reduced** but **not fully eliminated** - why?
- Need of **centralization**, also to minimize unintended consequences and bring it in line with market liquidity provision?

- **Liquidity in resolution**

- Need of **external liquidity provision** beyond BRRD/SRM fund
- Need of a **credible solution** and **minimize bank-sovereign** loop
- Reform needed: ECB funding supported by “European guarantees” (SRM fund plus fiscal backstop or ESM)

