Toward a New Framework for Exceptional Access

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The Future Role of Central Banking:
Urgent and Precedent-Setting Next Steps

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Overview

- Recent unprecedented policy actions…
  - New lending facilities, access for I-banks
    - Term Securities Lending Facility (TSLF)
    - Primary Dealer Credit Facility (PDCF)
  - And actions to support specific failing or stressed financial institutions
    - Bear Stearns
    - Fannie Mae, Freddie Mac.
- …require the implementation of a new transparent framework for future policy actions.

The Pressing Need for a Framework

- Best considered as part of a complete regulatory overhaul
  - Treasury's proposed new role for Fed: "market stability regulator."
- But comprehensive reform will take many years
- Return to stability requires a policy framework sooner. Why?
  - Expectations now are that Fed will intervene again if it feels it is needed
    - But there is considerable uncertainty about what are the "unusual and exigent circumstances"
  - Unless clarified, reduces due diligence, adds to market instability
  - Unpredictability of the response creates uncertainty and risk.
- The issues are complex, interdisciplinary.
  - Classic monetary economics, micro-finance, legal, political issues
  - Agenda for this workshop shows the many moving pieces.
- Lay out the elements. Focus on practical implementation.
- Confront the difficult issues discussed by Joe Grundfest
  - but with optimism based on similar recent experiences….

Lessons from Creating Another Exceptional Access Framework

- Mexican financial crisis 1994-95
  - Capital account. First of 21st century. Securities, not bank loans.
  - Unprecedented intervention by IMF, Treasury <u>to prevent default</u>.
    - Mexican government bond (tesobonos) holders were bailed out
  - Analogous to current bailouts of creditors of Bear Stearns?
- Concerns about moral hazard, unpredictability, future crises
- Proposals to establish a new framework.
  - U.K., Canada suggest access limits, but resisted by U.S.
- Doubts the framework could be credible. More discretion?
  - The classic time inconsistency, rules versus discretion debate.
- Without a framework, interventions were erratic, emerging market crises got worse, continued for 8 years
  - Asian financial crisis, (Korea, Thailand, Indonesia, Malaysia)
  - Russia with world wide contagion (Brazil, Romania, Argentina, US)
  - Turkey, Argentina, Uruguay in 2001-2002

The Importance of an Alternative

- Solution: the framework needed an alternative to default
  - "Collective action clauses" in the sovereign bonds.
    - Workouts of sovereign debt, rather than defaults, are believable
  - IMF could say no; guidelines are credible.
- Once clauses were in, IMF passed the new framework
  - Guidelines with criteria for exceeding limits
  - Exceptional access report
- After the new framework was imposed, stability restored, EM crises ended. Cause? Change in EM policies too.
- Relevant today:
  - Points to 3 practical elements of a framework
    1. Guidelines or criteria for intervention
    2. Exceptional Access Reports for transparency, accountability
    3. Alternatives to make the framework credible.
  - Lessons for practical implementation of these elements

Guidelines

- Guidelines for supporting failing financial institutions
  - Goal: transparent guidelines describing, in a practical way, the "unusual and exigent circumstances" when the Fed would intervene.
  - Examples (more research like Darrell Duffie's is needed)
    - Highly likely spillover to depository institutions: cut in money supply.
    - Highly likely cascading to other non-depository financial institutions; <u>and</u> probable major credit crunch on real economy.
    - Probable need for fire sale of collateral of failing institution.
- Guidelines for creating or extending a new credit facility
  - Similar goal: transparency, accountability
  - Different from supporting a single troubled institution.
  - Examples (more research like Williams and McAndrews needed)
    - Reduce spillover effects to healthy institutions after a financial firm's bankruptcy.
    - Reduce spreads by providing more liquidity
  - The firm-specific support and the implementation of credit facility may or may not occur at the same time.

Exceptional Access Report

- Analogous to existing *Inflation Reports* or *Monetary Policy Reports* to increase transparency, accountability
- Could be drafted while the intervention was being contemplated or even worked out
  - Preliminary report issued along with the announcement.
  - Contrast with the days after the Bear Stearns intervention when little information was released and rumors spread:
    - Death spiral in CDS market, fire sale of collateral, failure in repo market?
- Revised or final report would be issued later.
  - Ex post evaluations of the intervention.
  - Counterfactual simulations of what would have happened.
- Report also required for creation or extension of credit facility
  - Report would focus on the purpose, a method for evaluating effectiveness, assessment of the costs and benefits.
  - Example, for the TAF a preliminary report would have stated the goal was to reduce the spread between Libor and federal funds. The revised or final report would then examine the actual impacts.

Alternatives to Intervention

- Even if we could agree on guidelines, no guarantee that they would be followed.
- Neither pledges to stick to guidelines nor on-the-record votes will prevent bailouts, as Stern and Feldman argue.
- Have to strengthen the resolve to say no
  - The existence of widely-known alternatives can help
- Examples:
  - Central counterparty clearing mechanisms
  - Payment system reform to reduce the impact of one firm on the system
  - New resolution process for securities firms, including bridge banks
    - In the case of Bear Stearns "no other tools were available to the Federal Reserve or any other government body for ensuring an orderly liquidation in a fragile market environment" Ben Bernanke
    - FDIC-like entity becomes a receiver, then sets up a bridge bank
    - Minimize cost to government unless risk is systemic
    - But spillover effects are quite different for I-banks