THE FUTURE ROLE OF CENTRAL BANKING POLICY: URGENT AND PRECEDENT-SETTING NEXT STEPS

A One-Day Policy Workshop
July 22, 2008 – 10:30 am to 4:30 pm
Bechtel Conference Center, Encina Hall, Stanford University

BACKGROUND

Severe stress in the financial markets has given rise to a host of new Federal Reserve actions and lending facilities. Last December, the Fed introduced a new lending facility, the Term Auction Facility, enabling banks to borrow from the Fed without using the discount window. In March, it created a Term Securities Lending Facility (TSLF) for primary dealers, announced an unprecedented loan to investment bank Bear Stearns, and eventually intervened financially in Bear's purchase by JP Morgan. The Fed then created a primary dealer credit facility (PDCF), opening its discount window to investment banks. This month, the Fed offered to open the discount window to Fannie Mae and Freddie Mac.

Regardless of one's views about the appropriateness of these unprecedented actions, they raise important policy questions about the future role of the Fed. Many of the policy questions are best considered as part of an overhaul of the complex regulatory structure of the U.S., and perhaps even the global, financial system. This will take time. In the meantime, however, there are urgent policy issues to address. The primary dealer credit facility was initially authorized for a period of six months, but there are new proposals to extend it and make it permanent. There is also the pressing need to define as clearly as possible the circumstances in which the Fed would intervene again to prevent the failure of a financial institution, considering in particular whether it is too big or too inter-connected to fail. Further, policymakers face questions about how to respond to challenges facing Fannie Mae and Freddie Mac. In addition to their urgency, these decisions will likely affect the course of the larger regulatory reform in the future. Indeed, they are the first steps toward reform and will set precedents.

OVERVIEW AND PURPOSE

This one-day policy workshop will bring together economic, financial, and legal experts to present and discuss research on these immediate policy issues, with the purpose of considering alternative policy recommendations. The discussion will be divided into five sessions. Based on presentations and discussions with participants, the plan is to prepare a summary of the workshop's findings, preliminary conclusions, and suggestions for additional research. An agenda is provided overleaf.

SPONSORSHIP

The workshop is co-sponsored by:

- The Global Markets Working Group, Hoover Institution;
- The Rock Center on Corporate Governance, Stanford Law School; and
- The Stanford Graduate School of Business.

DRAFT WORKSHOP AGENDA

Welcome and Opening Remarks on the Purpose of the Workshop (10:30-10:40am)

George P. Shultz, Hoover Institution, Stanford University

SESSION I
Financial Market Functioning and the Effectiveness of the New Credit Facilities
(10:40 am –12:00 pm)

Chair: David Wessel, Wall Street Journal
Presenters: Darrel Duffie, Graduate School of Business, Stanford University
On the efficiency and stability of credit transfer markets
Jamie McAndrews, Federal Reserve Bank of New York
On the rationale for and impact of the new facilities
John Williams, Federal Reserve Bank of San Francisco
On the effectiveness of the new facilities

The first session will focus on two interrelated issues: (1) possible efficiency or stability problems in the markets for credit risk transfer, including cascading and interconnectedness, and (2) the purpose and effectiveness of the Fed's new loan facilities. Questions to address are: What systemic problems has recent turmoil revealed in the CDS and other markets? How can market participants address those problems? What is the goal of the PDCF and other Fed intervention? How can we measure whether the goal has been achieved? Have the actions had undesired consequences?

Lunch/Coffee Break (12:00-12:10pm)

SESSION II
Policy Interventions and Lessons Learned from the Fannie Mae, Freddie Mac, and Bear Stearns Crises
(12:10–1:10pm)

Chair: John Cogan, Hoover Institution, Stanford University
Presenters: Peter Wallison, American Enterprise Institute
John Gunn, Dodge & Cox

In this session, panelists will address the crisis of confidence in Fannie and Freddie this summer and compare it with the Bear Stearns crisis last spring. What caused these particular crises and the broader market decline? What is the rationale, effect, and precedent of the Fed's lending to support these institutions or their creditors? What kinds of financial reforms are needed to prevent such crises in the future? What are the lessons of the implicit or explicit government guarantees of Freddie and Fannie for proposals for the Fed to supervise and lend to investment banks in the future?

<u>SESSION III</u>

Are There Alternatives to Fed Intervention beyond Depository Institutions?

(1:10-2:00pm)

Chair: Michael Boskin, Hoover Institution, Stanford University

Presenter: Frank Edwards, Columbia University

This session will focus on possible alternatives to Fed intervention in supporting particular financial institutions or their creditors. For example, can the legal system be modified—perhaps through a change in the bankruptcy law for financial firms—in order to alleviate the systemic impact of the failure of a financial institution and thereby reduce the need for Federal Reserve intervention? What has been the impact of the changes in the bankruptcy law in 2005, and what can we learn from those changes?

<u>SESSION IV</u>

Is New Regulation or New Legislation Needed to Extend the Temporary Facilities?

(2:00–2:50pm)

Chair: Kenneth Scott, Stanford Law School

Presenter: Rodgin Cohen, Sullivan and Cromwell

This session will address a number of key legal questions. What was the legal basis for the PDCF and other recent Fed interventions? Is new legislation needed to extend or make permanent such facilities or authorities? Is the Fed or another institution best suited legally to implement them? What types of new legislation would provide the best solution for dealing with future financial crises?

Coffee Break (2:50-3:05)

<u>SESSION V</u>

Clarifying the Criteria for Federal Reserve Intervention

(3:05–4:15 pm)

Chair: George Shultz

Presenters: Joe Grundfest, Stanford Law School

John Taylor, Hoover Institution, Stanford University

This final session on policy issues will start off with two presentations that will raise questions from different policy perspectives. What should be done to clarify the specific circumstances under which the Fed would take actions to prevent a collapse of a financial institution? What are the costs of not being specific? What should be the financial impact on creditors and owners? Can limits or actions be legally defined? Is it realistic to assume they will be adhered to? Can we define “too big to fail” or “too interconnected to fail”?

Wrap-Up and Summary of Preliminary Conclusions (4:15-4:30pm)

John D. Ciorciari, Hoover Institution, Stanford University