EVOLVING LEGAL FRAMEWORKS FOR CENTRAL BANK LIQUIDITY STABILIZATION: THE FED AS A CASE STUDY

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1. **Minsky**: Provided early theoretical support for **expansive liquidity stabilization** by CB as a **market maker of last resort**.

2. **Fed legalism**: Give a **market-infused reading** of Fed’s authority to trade for its own account.

3. **Fed rescues**: Expanded its **liquidity support for shadow banks and structured finance** consistent with its **generative authority** to trade for its own account.

4. **Title XI, Dodd-Frank**: Limited the Fed's **discretion over liquidity stabilization** and may limit the Fed's ability to respond to future liquidity crisis.

5. **Tentative response** to Levy Ford report on LLR.
LIQUIDITY STABILIZATION AS LENDER OF LAST RESORT

Bagehot, LOMBARD STREET (1873): Lend freely against good collateral and at a penalty interest rate.

Knickerbocker Trust Company (1907): J.P. Morgan acts as private lender of last resort; provides public relations basis to rebut objections to establishment of central bank.

Federal Reserve Act (1913): Intended to be a ‘banker’s bank’; rediscounting commercial paper central to mission; goal is to facilitate bank funding.
MARKET MAKING DEFINED: Using proprietary capital to provide asset liquidity and smooth out price changes by buying in a bear market and selling in a bull market.

FUNDING MARKET SHIFT: Rise of a securitized credit market with shadow banks and more inter-bank exposures; more links between asset market and firm funding liquidity.

‘WHAT IS TO BE DONE?’

CONFERENCE: Governor Rosengren’s comments re broker-dealers and shadow banks and exchange about MMLR
BUITER, FINANCIAL TIMES: 2007-2008 editorials calls for CB to provide last resort funding beyond its traditional liquidity clients (MMLR).


A flexible central bank that stands ready to acquire any type of asset it feels is necessary to avoid instability is a major requirement for the successful operation of a complex financial system. The central bank must follow, and in crisis ratify, what has taken place in the market. Only in times of stagnation or tranquility can the economy afford a central bank that stands on principle. (emphasis added)

Historically, central banks have not been adventurous in expanding the scope of their operations, and the Federal Reserve System is bound by a legislative mandate. (emphasis added)

1932  Broadening borrower base (‘unusual and exigent’)

1935  Relaxing of collateral requirements for § 13(3)

1966  Authority to trade government agency obligations

1980  Authority to trade foreign public debt

1991  Broadening collateral eligibility for § 13(3)

2002  Relaxes quorum requirement for § 13(3)
RELATIONSHIP TO MARKET

• Regulates market by trading in it, i.e., buying at a premium and selling at a discount
• Generative authority
• Entitled to great deference

INSTITUTIONAL ANALOGIES

• Federal judicial review, e.g., Marbury v. Madison
• Executive primacy in foreign affairs: intrinsic authority?
<table>
<thead>
<tr>
<th>Year</th>
<th>Type</th>
<th>Description</th>
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<tbody>
<tr>
<td>1923</td>
<td>Policy Decision</td>
<td>Benjamin Strong’s insight about open market trading of government securities</td>
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<tr>
<td>1953</td>
<td>Policy Decision</td>
<td>Bills-only doctrine for SOMA</td>
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<td>1961</td>
<td>Policy Decision</td>
<td>Operation Twist</td>
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<td>1962</td>
<td>Interpretive</td>
<td>Authority for foreign exchange transactions</td>
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<td>1966</td>
<td>Interpretive</td>
<td>Reverse repurchase agreements</td>
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<td>2008</td>
<td>Policy Decision</td>
<td>Liquidity stabilization through ‘financial hospitals’</td>
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INPATIENT
• Maiden Lane (Bear – repurchase markets)
• Maiden Lane II (AIG – securities lending)
• Maiden Lane III (AIG – credit default swaps)

LOSS/RISK/RETURN STRUCTURE
• Fed - senior, liquidated credit interest
• First loss position (Bear $1b; AIG $1b and $5b)
• Participating upside residual (shared by Fed and Bear/AIG)
FINANCIAL HOSPITALS
Interbank liquidity stabilization 2007-2008

OUTPATIENT

• Primary Dealer Credit Facility
• Commercial Paper Funding Facility
• Money Market Investors Funding Facility
• Asset-Backed Money Market Fund Liquidity Facility
• Term Asset-Backed Securities Loan Facility
IT WORKED IN PRACTICE: CAN WE MAKE IT WORK IN THEORY?

TERM: Willingness to hold to maturity helped to create synthetic hedged assets

ASSET MARKET LIQUIDITY: Reanimated secondary and collateral markets for structured finance

FIRM FUNDING LIQUIDITY: Providing credit and letting firms liquefy assets kept firms liquid.

PRICE DISCOVERY: Followed fair value accounting

LOSS-SHIFTING?: Fed shielded private investors from financial loss but it did not shift or bear loss – it disappeared the loss.
Any attempt to settle *finally* upon a mode of operation and a domain of responsibility of the central bank runs the risk that actual change will make the agreed-upon rules *obsolete*.

(emphasis added)

NEW STATUTORY RESTRICTIONS
• Treasury approval for liquidity stabilization
• Information disclosure about stabilization programs
• Prohibition on single-entity bailout
• Collateral valuation policies
• Regulations

MARKET-MAKING DOWNSIDES
• Limits market agility when time is of the essence
• Increases inter-branch politicization
• Rules out liquidity support for single entity
• Compelling public disclosure of expected values may limit ability to get best price when laying off positions
REPORT PREMISES AND CONCLUSIONS

• Accountability deficit because of secrecy and lack of democratic oversight
• Fed departed from a classical understanding of LLR
• Fed still retains discretion to conduct liquidity stabilization through 13(3)

TENTATIVE CONCLUSIONS

• Fed’s anti-majoritarian mandate justifies part of accountability deficit
• Fed’s structure already includes political checks and balances
• What about the next AIG, e.g., systemically crucial single entity?
THANK YOU