Discussion of

When is Less More? Bank Arrangements for Liquidity vs. Central Bank Support

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Historical Spike in Central Bank Liquidity Support

Figure 1: Central bank assets relative to GDP, 1611-2020

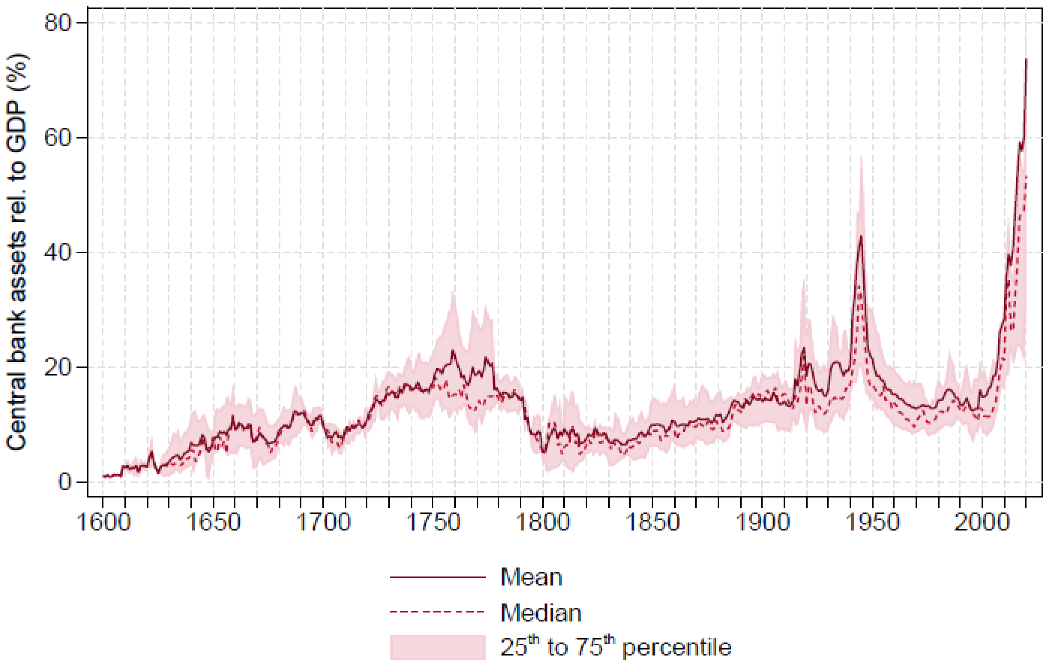
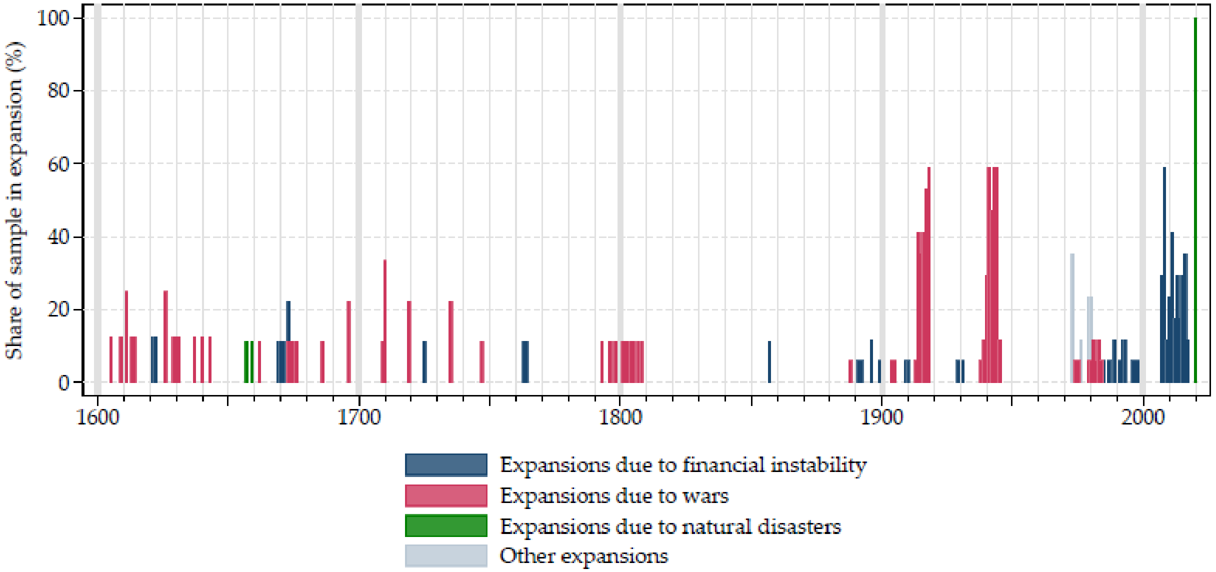


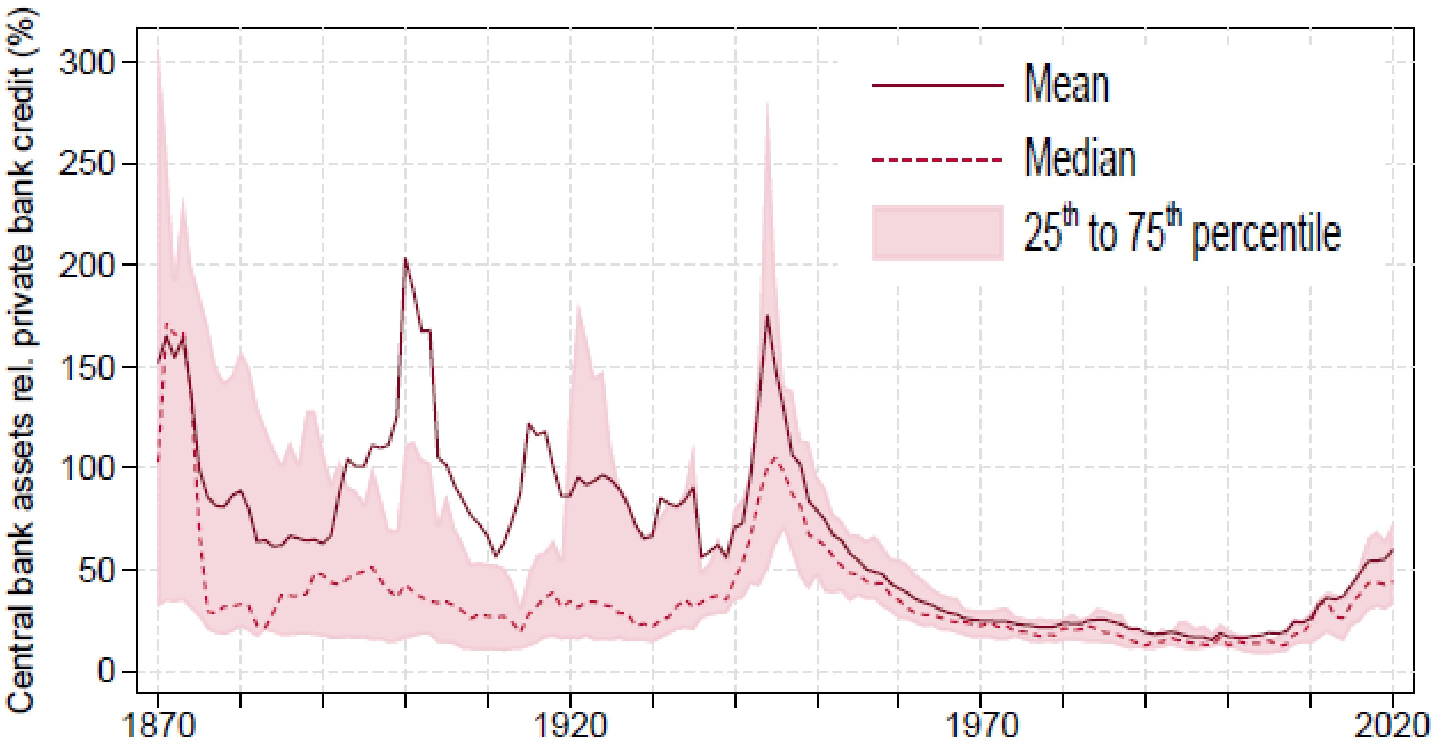
Figure 5: Major balance sheet expansion events, by type, 1600-2020



Source: Ferguson, Kornejew, Schmelzing, Schularick (2023) “The Safety Net: Central Bank Balance Sheets and Financial Crises, 1587-2020”.

But the Size of the Safety Net is Smaller

Figure 2: CB assets as a share of total bank lending to the non-financial private sector



Source: Ferguson, Kornejew, Schmelzing, Schularick (2023) “The Safety Net: Central Bank Balance Sheets and Financial Crises, 1587-2020”.

And Less Time to Respond….

2008

WaMu

WACHOVIA

Run time: 16/19 days

Outflow: 4%/10% of deposits

2023

svb Silicon Valley Bank

SIGNATURE BANK®

Run time: 1-2 days

Outflow: 87%/29% of deposits*

Note: * Outflows in 2023 include those over first day of run plus outflows scheduled for the 2nd day but that did not occur as the banks were closed.

Source: Data on run time and deposit outflows from Rose (2023).

Paper Addresses Host of Related Issues

- **Very ambitious paper…**
  - How did we get to this situation?
  - Is this optimal? If not, why not?
  - How could the framework be improved (greater role of private sector)?
- **ALOT of pieces….**
  - Households, private investors and banks (with deposits, insurance & investment choice)
  - Bank runs and fire sales of assets
  - Central bank responses: liquidity infusions; bailouts vs loans at high rate vs pre-positioned liquidity
  - Private sector options & market for insurance (speculation, various forms insurance (older/CoCo, etc)
  - Interaction between central bank responses (pricing liquidity) and private sector options
  - Inefficiencies: banks overinvest, central bank support underpriced, speculation crowds out investment
  - Historical context: Scottish Free Banking Era, JP Morgan, Fed origin, Treasury cash-futures basis trade
- **Key Question: Do we need all the components?**

One Key Issue: Pricing Liquidity Support

- **Bagehot's rule:**
  - During a crisis, central bank should lend freely to solvent institutions (POG cover)
  - Against good collateral at a penalty rate
- **Acharya, Rajan, Shu model several options:**
  - "Bailout" central bank—focus on reducing fire sales through ex-post infusion of funds into distressed banks with no charge
    - Issue: Liquidity free, crowds out private insurance
  - Central bank pre-commits to lend conditional on stress at a premium
    - Issue: setting the premium (personal costs of intervention ≠ societal cost)
  - **Both scenarios: central bank does not adequately charge for liquidity support**

  → more speculative investment funded by banks

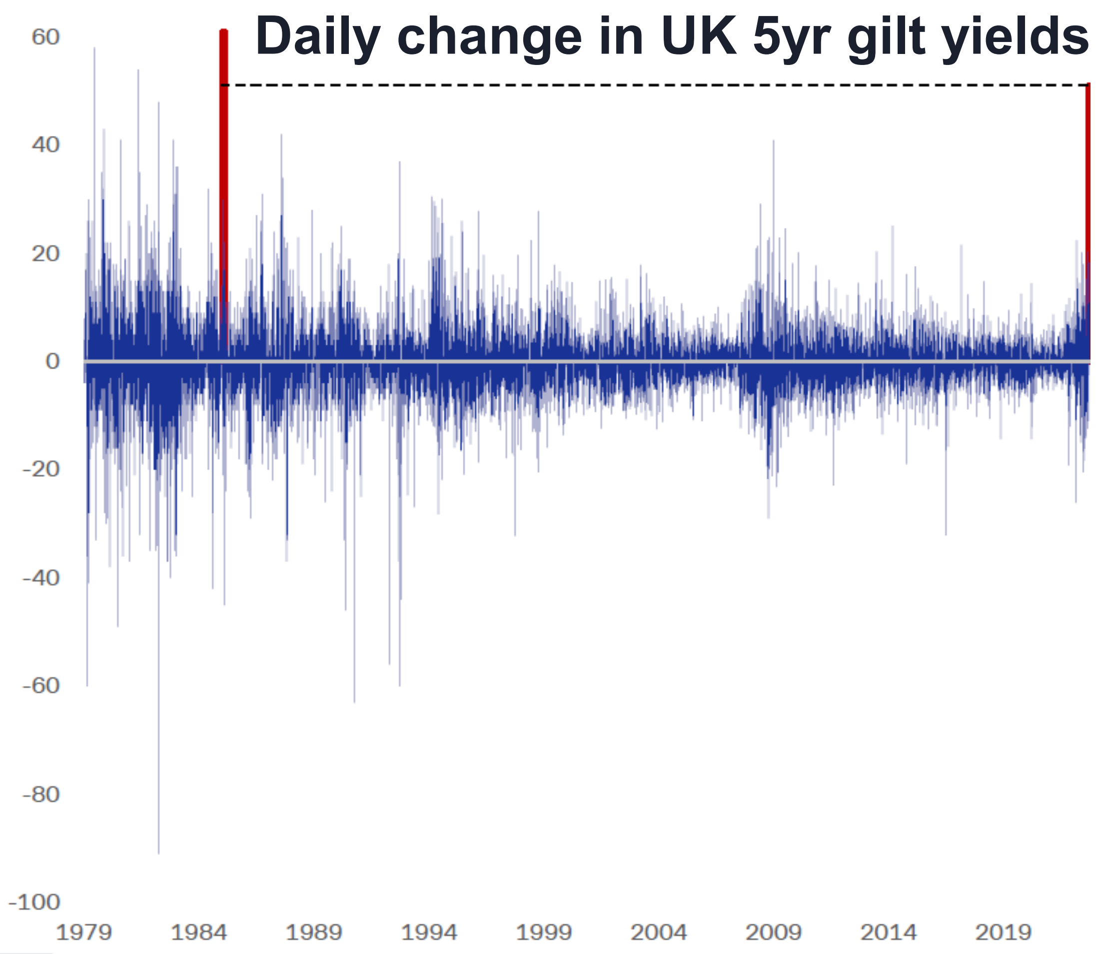
  → crowds out private sector alternatives

  → increases incidence of banking stress

Application to Recent Events

- **Two examples: illiquidity feeds fire sales, broader systemic financial stress**
  1) **SVB/Regional Banks in US 2023**
     → Bank Term Funding Program (BTBF): loans for depository institutions against collateral **valued at par**
  2) **LDI crisis in UK in 2022**
     → BoE gilts purchases over 13 business days using **backstop pricing aimed at removing liquidity premium**
- **Both stabilized risks around fire sales (and runs), but key differences**
  — Penalty for bad investment decisions? LDI (not BTBF)
  — Profit for central bank? LDI (not BTBF)
  — Introduced moral hazard and crowd out private sector alternative? BTBF (less for LDI)
- **What explains the difference in applying Bagehot's penalty rate?**
  — Planning in advance? Preparedness? Ability to respond quickly?
  — Willingness of central bank (governor) to risk failure?

Challenge: How to Price Extreme Events?



Extreme market moves hard to price

- Largest daily increase in UK 5yr gilt yields since 1985
- Worst rolling 5-day move in 10yr gilts since records began
- In <3 days, 30yr gilt yields ↑ 1.6pp, 3x larger than any other historical 3-day move

No more bailouts….not credible

- After series of bailouts…back to late-1800s…
- Can't avoid the repeated game
- How to shift to new equilibrium?

Source: Deutsche Bank, UK Market Crisis 101

Final Thoughts

- Paper addresses critically important questions
- Ambitious model with many useful insights
  - Paper just scratches surface of what can learn from framework
- **Very supportive of ideas for alternative forms of liquidity support through private sector**
  - But imposing challenges…pricing, recent actions