The role of monetary policy in matters relating to financial stability: Monetary policy responses adopted during the most recent Financial Crisis

Ojo, Marianne

Oxford Brookes University, University of Heidelberg

24 November 2010

ABSTRACT

As well as providing an analysis of how financial stability could be sustained through the appropriate targeting of policy instruments at debt gearing, this paper aims to provide an overview of the respective roles which governments and shareholders could assume in deterring financial institutions from overly relying on certain policy measures (role of governments) and in reducing tax burdens on tax payers (role of shareholders). The duration of the recent Crisis has also witnessed the introduction of mechanisms aimed at bailing- in financial institutions – rather than merely bailing them out.

Even though monetary policy measures should ultimately be targeted at macro level, the respective roles assumed by governments and shareholders at micro level in facilitating the phasing out of certain monetary policy measures and assuming responsibility as the first resort during the impending collapse of a financial institution, are also of vital importance. This paper also aims to consider additional measures which could be implemented as a means of mitigating the number of financial instititions which could become overly dependent on monetary policy and liquidity sustenance measures provided during deteriorating financial conditions. Greater focus on strategies aimed at mitigating the number of financial institutions which could become overly dependent (bail-in strategies which could address bail outs) – rather than simply focussing on measures and exit strategies aimed at weaning such institutions after assistance has been granted to these financial institutions, could prove to be more effective.

A brief comparative analysis of the monetary policy response implemented in the Euro area during the recent Financial Crisis (against that which was implemented in the United States), will also be provided in this paper.

Key Words: monetary policy, central banks, financial crises, bail in, bail outs, liquidity, ECB, Federal Reserve, interest rates, regulation, stability, capital, Basel III

The Role of Monetary Policy in Matters Relating to Financial Stability: Monetary Policy Responses Adopted During the Most Recent Financial Crisis.

Marianne Ojo[1]

Introduction

Whilst central banks have assumed more prominent, extended and innovative roles since the onset of the recent Financial Crisis, the importance of the respective roles assumed by shareholders and governments in relation to the recapitalisation of financial institutions and the facilitation of exit strategies (particularly exit strategies from non standard policy measures), have also been brought to light.

According to Weber, the monetary policy response of the Eurozone, when compared to that of the United States, is principally attributed to the following factors:[2]

i) In contrast to the U.S financial system, banks play a dominant role in funding euro area non financial corporations – hence the explanation to why the Eurosystem's response to the Crisis has focussed on measures aimed at enabling liquidity-constrained banks to mitigate their short term funding gaps (eventually sustaining the ability of the banking sector to lend to the real economy) - „the enhanced credit support approach".[3]

ii) In comparison to the Federal Reserve or the Bank of England, outright asset purchases have played just a minor role in the European Central Bank (ECB) Governing Council's Strategy.

How can governments act to wean off financial institutions, who despite improved financial market conditions, continue to depend on the policy measures offered as a means of sustaining such institutions during deteriorating periods? Whilst the implementation of certain exit strategies – as well as additional measures which support these exit strategies have been advocated, mechanisms which are aimed at bailing in such institutions rather than simply bailing them out, appear to be a more effective means in mitigating the number of financial institutions which could become overly independent on support measures provided during periods of financial crises.

The first section of this paper (which ensues after the introductory section) will consider developments in the Eurozone which culminated in the the introduction of the full allotment policy which „allowed banks to accumulate substantial amounts of surplus liquidity". Section two, thereafter, will consider how governments could act to wean off financial institutions from the full

---

1 School of Social Sciences and Law, Oxford Brookes University and Visiting Scholar University of Heidelberg. marianneojo@brookes.ac.uk

2 Keynote speech by Axel A Weber, President of the Deutsche Bundesbank at the Shadow Open Market Committee (SOMC) Symposium, New York City, 12 October 2010 „Monetary Policy After the Crisis: A European Perspective" at page 2 <http://www.bis.org/review/r101018a.pdf>

3 Under this „enhanced credit support approach", the Governing Council of the European Central Bank not only lowered its key interest rates to historical all time lows, but also decided to temporarily extend its liquidity operations (in terms of frequency and maturity – as well as expanding the list of eligible collateral). See ibid at page 2

allotment policy (mechanisms aimed at addressing bail outs) as well as policies and mechanisms which could be implemented by governments to mitigate situations whereby financial institutions, who despite improved financial market conditions, continue to depend on the full allotment policy (the bail-in strategic aspect). This aspect will also incorporate the role of shareholders as the first resort during the impending collapse of a financial institution. The third section will then provide a brief analysis of the policy response measures adopted in the U.S during the recent Financial Crisis before a conclusion is drawn.

A. The Eurozone: From the Variable Rate Tender to Full Allotment.

The liquidity needs of the banking system in the Euro area, it is stated[4], are principally attributable to non banks' demands for bank notes and substantial remunerated reserve requirements.

Factors which culminated in the introduction of the **full allotment policy** which „allowed banks to accumulate substantial amounts of surplus liquidity – which could be lent to other banks or placed in the Eurosystem's deposit facility (an overnight facility used to deposit excess reserves)" are as follows:[5]

- Prior to October 2008, refinancing operations were conducted as variable rate tenders, with allotment amounts closely aligned with the aggregate liquidity needs of the banking system.
- In October 2008, however, the variable rate tender procedure with benchmark allotment was replaced with a fixed rate full allotment procedure – as a means of facilitating and sustaining banks' liquidity operations (despite the restrictions in flow of liquidity – resulting from the aftermath of Lehman's collapse).

B. How Can Governments Wean Off Financial Institutions from Overly Depending on the Full Allotment Policy (post grant of support measures)? Further How Could Governments also Act to Mitigate Situations whereby Financial Institutions, Who Despite Improved Financial Market Conditions, Continue to Depend on the Full Allotment Policy (pre grant of support measures)?

The most obvious solution relating to the weaning off of financial institutions would appear to be the introduction of exit strategies which would compel overly reliant financial institutions to withdraw from such allotment policies. Incentives which could serve in encouraging such financial institutions to withdraw from such policies, could accompany such exit strategies in the form of lower interest rate deals and packages to be offered to financial institutions – the level of such interest rates being dependent on the length of period during which such financial institutions applied for such liquidity assistance (that is, the degree to which interests rates are reduced for such institutions will increase proportionately to how quickly such institutions withdraw from continued dependence on liquidity assistance and other policies implemented to assist them during periods of financial difficulties).

The Recapitalisation Communication also states that „in facilitating exit strategies, member States may also consider using a restrictive dividend policy to ensure the temporary character of State intervention."[6]

[4] „In the Euro area, the bulk of liquidity is provided via the collateralized lending of different maturities – the main refinancing operation, the one week operation, being the most important." See ibid at page 3

[5] See ibid

[6] See paragraph 32 of the Recapitalisation Communication (Communication from the Commission — The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and

In relation to the mitigation of situations whereby financial institutions - who despite improved financial market conditions, continue to depend on the full allotment policy, the satisfaction of stipulated criteria and requirements relating to the level and quality of capital (for purposes aimed at ensuring loss absorbency) should serve as a pre requisite before such full allotment policies are granted to financial institutions who apply for these. The loss absorbency of capital will be approached under the headings below:

"Conversion/Write offs"

Whereby debt instruments are transferred into "higher quality and common equity capital with better loss absorption characteristics – with the result that the institution's ability to withstand further losses is consolidated."[7]

- Debt regarded as bank capital should be converted to stock or written off in a crisis – hence compelling bond investors to bear some of the cost of future bail outs.[8]
- All regulatory capital instruments sold by banks should be capable of absorbing losses if the company is unable to fund itself – before taxpayers' cash is plundered into rescuing a lender, so-called contingent capital should be converted into equity or written off.[9]

Benefits of the Basel Committee's Proposals which are aimed at "ensuring the loss absorbency of regulatory capital at the point of non viability" include

- The discouragement excessive risk taking (since investors will not be encouraged to buy securities under the assumption that they will avoid losses in the event of a bank failure).
- The reduction of the need for government bailouts owing to the requirement that contingent capital be converted (to equity or written off) to fund rescues rather than taxpayers solely bearing the cost. Hence bond investors of a bank will serve as the first resort during the impending collapse of a bank.

Two mechanisms which are considered to be instrumental in the achievement of the goal of managing failing financial institutions – as well as the re capitalisation of institutions (without the need for capital support from governments and tax payers have been proposed:[10]

- 1) The Bail In Mechanism : Whose implementation commences when a firm reaches a pre-defined trigger – which would re-capitalise a firm as a going concern (through the conversion of selected levels of unsecured debt to common equity). Since no shareholder or creditor consultation is considered to be necessary, a swift implementation of its operation is expected.

- 2) Contingent Capital: Whose implementation has been undertaken historically by the insurance sector and which serves as a provision for one-time losses. It is issued in the form of notes which are convertible into equity as soon as a pre-defined trigger is attained by the issuer. Since it requires no regulatory involvement, transparency is enhanced – such

safeguards against undue distortions of competition)

7 See Basel Committee on Banking Supervision, Consultative Document "Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non Viability" August 2010 at page 13 (page 19 of 20) < http://www.bis.org/publ/bcbs174.pdf?noframes=1>

8 "Basel Committee Says Bank Bond Investors Should Help Fund Future Bailouts" <http://www.bloomberg.com/news/2010-08-19/basel-committee-says-bank-bond-investors-should-help-bear-cost-of-bailouts.html>

9 ibid

10 See Association for Financial Markets in Europe, "AFME Outlines Ways To Rescue Failing Banks Without Tax Payer Financing" http://www.afme.eu/AFME/Home/sifi%20pr.pdf at page 1 of 2

transparency serving as a potential means in helping to prevent localised problems from triggering into a full blown systemic crisis."

„Because hedge funds have so much lower gearing, or leverage than banks, they have been able to absorb much bigger falls in asset values.“[11]

According to Miles,[12] the short term nominal interest rate is a very blunt instrument to implement in attempting to limit the gearing of financial institutions. Furthermore, he argues that capital requirments, and explicit limits on gearing constitute more direct means of controlling leverage.[13]

Financial stability, in his opinion, could be preserved by directing policy instruments at debt gearing (or leverage) – and that with banks, „this could be achieved through a prevention in the initial (limited) fall in the value of assets and by ensuring that banks are able to withstand falls in asset values through sufficient loss absorbing capital – rather than expecting monetary policy (changes in interest rates) to substantially reduce asset price variability. He thereby, not only justifies his support for Basel III, but also thinks that time varying limits on gearing of financial firms (limits which could vary with asset prices and with the economic cycle) will contribute towards helping to maintain financial stability.[14] The Basel Committee also proposes the introduction of non risk based leverage ratios as supplementary measures to the Basel risk based framework.[15]

C. Monetary Policy Measures Implemented in the United States

Measures which have been taken by the Federal Reserve since the most recent Financial Crisis made its debut, include the following :[16]

- The terms on which lending was provided to depository institutions (traditional borrowers) were eased quite dramatically.

- This was followed by the lowering of interest rate on discount window loans, an increase in their maturity, and, auctioned credit (aimed at reducing the stigma of borrowing from the window).
- Cooperative measures with foreign central banks through currency swaps (to make dollar funding available to banks operating abroad) also took place.

---

11 See D Miles, „Leverage and Monetary Policy“, Speech by David Miles, Member of the Monetary Policy Committee of the Bank of England at the Economic and Social Research Institute Foundation for Fiscal Studies, 12 October 2010 at page 9 <http://www.bis.org/review/r101018e.pdf>

12 ibid

13 He however concedes that "simply because they are a more direct means to control leverage does not prove that capital requirements or limits to gearing are a far more effective tool to preserve financial stability than changing interest rates." He also provides at least two situations where the use of capital controls and limits on gearing might not be a very effective means of maintaining financial stability; ibid.

14 ibid

15 See G Tumpel-Gugerell, „The Interplay of Banking, Financial Intermediation and Regulation.“at the 13th Conference of the European Central Bank–Center for Financial Studies (ECB–CFS) Research Network on "Macro-prudential Regulation as an Approach to Contain Systemic Risk: Economic Foundations, Diagnostic Tools and Policy Instruments", Frankfurt am Main, 27 September 2010 at page 3 <http://www.bis.org/review/r100929e.pdf>

16 See D Kohn, „Monetary Policy in the Financial Crisis“ Federal Reserve Board Publications April 2009 <http://www.federalreserve.gov/newsevents/speech/kohn20090418a.htm>

The provision of extraordinary measures was also illustrated by the fact that for the first time since the 1930s, credit was extended to non depository institutions – as well as the grant of discount window access to primary dealers when it became evident that constraints on their access to liquidity threatened broader financial stability and economic activity.[17]

D. Conclusion

The improvement of the quality and quantity of capital – both on a going and gone concern basis, as a means of improving loss absorbing characteristics, would not only reduce the potential for financial institutions to take excessive risks, reduce tax burdens on tax payers, it would also serve as an effective complement to monetary policy inititatives in preventing the fall in the value of assets.

Incentives which could serve in encouraging such financial institutions to withdraw from such policies, could accompany such exit strategies in the form of lower interest rate deals and packages to be offered to financial institutions – the level of such interest rates being dependent on the length of period during which such financial institutions applied for such liquidity assistance.

As the recent Crisis has demonstrated, systemic risks are closly linked to liquidity risks – hence maturity transformations and liquidity funding constitute important factors in determining the resilience of the financial system.

[17] An illustration in relation to last Autumn, is also provided by Kohn - when „a run on money market mutual funds was severely constricting their purchases of commercial paper, an important source of credit to many businesses.“ In this respect he adds that „the funds, their customers, and their borrowers were supported by making credit available – credit which allowed funds to meet heavy redemption requests and which also provided credit directly to borrowers in the commercial paper market.“

REFERENCES

Association for Financial Markets in Europe, "AFME Outlines Ways To Rescue Failing Banks Without Tax Payer Financing" http://www.afme.eu/AFME/Home/sifi%20pr.pdf

Basel Committee on Banking Supervision, Consultative Document "Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non Viability" August 2010 < http://www.bis.org/publ/bcbs174.pdf?noframes=1>

"Basel Committee Says Bank Bond Investors Should Help Fund Future Bailouts" <http://www.bloomberg.com/news/2010-08-19/basel-committee-says-bank-bond-investors-should-help-bear-cost-of-bailouts.html>

Kohn D, „Monetary Policy in the Financial Crisis" Federal Reserve Board Publications April 2009 <http://www.federalreserve.gov/newsevents/speech/kohn20090418a.htm>

Miles D, „Leverage and Monetary Policy", Speech given at the Economic and Social Research Institute Foundation for Fiscal Studies, 12 October 2010 <http://www.bis.org/review/r101018e.pdf>

The Recapitalisation Communication (Communication from the Commission — The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition)

Tumpel-Gugerell G, „The Interplay of Banking, Financial Intermediation and Regulation."at the 13th Conference of the European Central Bank–Center for Financial Studies (ECB–CFS) Research Network on "Macro-prudential Regulation as an Approach to Contain Systemic Risk: Economic Foundations, Diagnostic Tools and Policy Instruments", Frankfurt am Main, 27 September 2010 at page 3 <http://www.bis.org/review/r100929e.pdf>

Weber A, Keynote Speech at the Shadow Open Market Committee (SOMC) Symposium, New York City, 12 October 2010 „Monetary Policy After the Crisis: A European Perspective" <http://www.bis.org/review/r101018a.pdf>