Discussion of:

Who Borrows from the Lender of Last Resort?

by I. Drechsler, T. Drechsel, D. Marques-Ibanez, and P. Schnabl

Todd Keister
Rutgers University

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Overview

- Paper asks an interesting question
  - central banks have provided large amounts of credit since 2008
  - What types of banks borrowed?   Why?
- Uses a very nice data set from the Euro area
  - bank-level information about borrowing from the ECB *and* collateral
  - information on bank asset holdings from the European stress tests
- Interesting results
  - seem to indicate that a much of ECB's lending was put to "bad" uses
- My discussion: re-frame the issue a bit
  - look at results from a different point of view; ask what we learn

Traditional view of the LoLR

- Banks are susceptible to liquidity problems
  - result of (socially-desirable) maturity transformation
  - Diamond & Dybvig (1983); Champ, Smith & Williamson (1996)
- A central bank can create liquidity
  - that is, lend cash to banks against "good collateral"
  - doing so is costless to central bank (in principle)
  - and can significantly improve welfare
- Objective of this lending:
  - allow banks that are experiencing funding pressure
  - … to hold on to existing assets (*i.e.*, avoid fire sales)

- DDMS examine borrowing from the ECB with this view in mind
- Ask to what extent this borrowing seems to be driven by illiquidity
  - being done by banks experiencing funding pressure?
  - using their existing assets as collateral?
- … vs. driven by something else
  - perhaps used to purchase additional, risky assets
- Why this matters:

  "… if borrowing is driven by other motivations, such as risk seeking at the expense of the LOLR, or by political capture, then the benefits may be much smaller."

Another view of the LoLR

- Many central bank actions during the crisis did not fit the "traditional" mold
- Example from the U.S.: Commercial Paper Funding Facility (CPFF)
  - liquidity problems for Money Market Mutual Funds and others reduced supply of funds to commercial paper market
  - Federal Reserve lent to a specially-created LLC, which directly purchased commercial paper; operated Oct. 2008 – Feb. 2010
- This is still a lender-of-last-resort action
  - … but for a market (or asset type) rather than for banks
- Success requires the LLC to actively acquire the targeted assets
  - LLC borrowed from Fed, using the commercial paper as collateral

Borrowing from the ECB

- The ECB lends (solely?) to banks
  - reflects the more bank-centric financial system in Europe
  - as well as the design features of ECB
- But: that does not imply the sole objective was to help illiquid banks
- Perhaps one ECB objective was to support sovereign debt
  - aim to prevent self-fulfilling sovereign debt crises
  - Italian debt might be sustainable ("good collateral") if interest rates are low enough, but unsustainable if rates rise too high
  - Calvo (1988); Cole and Kehoe (2000)

Later on …

- Buiter & Rahbari (2012):

  We interpret the longer-term refinancing operations (LTROs) of December 2011 and February 2012 as being as much about acting, indirectly, as LoLR for the Spanish and Italian sovereigns by facilitating the purchase of their debt by domestic banks in the primary issue markets, as about dealing with a liquidity crunch for [Euro area] banks.

- Draghi (commenting on 3-year LTROs in 2011 interview with FT):

  Coming back to what banks are going to do with this money: we don't know exactly. … Banks will decide in total independence what they want to do, depending on what is the best risk / return combination for their businesses. One of the things that they may do is to buy sovereign bonds. But it is just one.

- For this objective, success of the policy requires:
  - banks to actively acquire distressed sovereign debt
  - use this debt as collateral with the ECB

Reinterpreting DDMS

- Suppose we want to measure the "take-up" on this indirect LoLR action
  - with the CPFF, this is easy: the amount borrowed from the facility
  - but for the ECB, all LoLR activity occurs through the same operations
- How much of banks' borrowing from the ECB was:
  - "traditional" activity related to illiquidity of existing assets?
  - "non-traditional" activity that directly supports distressed sovereign debt?
- Also, what types of banks were involved in each activity?
- Results in DDMS can help answer these questions

How much borrowing was non-traditional?

- Could just measure amount of distressed sovereign debt pledged as collateral to ECB
  - but much of this is likely bank's own holdings
- Instead:

$$\Delta \text{Holdings}_{it} = \alpha + \delta_t + \beta \Delta \text{Pledged}_{it} + \epsilon_{it}$$

When banks pledge more distressed sovereign bonds …

… is that associated with increased bond holdings?

- Result: For each additional euro of distressed debt pledged, ~45 cents was newly acquired

Who was doing this borrowing?

- Effect is stronger for banks with lower credit ratings in Aug. 2007
  - other results in paper corroborate this finding
- Worrisome – an adverse selection problem?
  - ECB aims to make it profitable for banks to borrow, buy distressed debt
  - … but this activity will be more attractive to some banks than others
    - banks that are more likely to fail
    - banks whose failure risk is more correlated with values of sovereign debt

Main comment

- Perhaps the paper frames the issue too narrowly
- A LoLR might have multiple objectives
  - helping illiquid banks avoid fire sales of assets
  - supporting particular assets/markets
- "Traditional" lending is known to face adverse selection
- The paper documents that "non-traditional" lending does as well
- Can these two adverse selection problems be compared?
  - are the mechanisms different? Or essentially the same?
  - can magnitudes be compared?

Other comments

- Alternative view also casts "political economy" issues in a different light
  - paper: perhaps some governments pressure local banks to buy their debt
  - alternative view: ECB creates a profitable opportunity, but feelings differ across national supervisors
    - a German bank that wants to load up on Italian debt ….
  - does this view have different implications?
- Would really like to see results for 2012
  - by this point, the "non-traditional" objective was nearly explicit
  - but may not be possible because there were no stress tests
  - is there any way around this?

Conclusion

- Interesting paper
- Authors have constructed a very useful data set
  - sorting out banks' motivation for borrowing from the LoLR is typically difficult/impossible
- Results are striking
  - banks entering the crisis with lower ratings borrow more from the LoLR, both for "traditional" and "non-traditional" reasons
- Drawing policy implications is tricky
  - "… if borrowing is driven by other motivations, such as risk seeking at the expense of the LOLR, or by political capture, then the benefits may be much smaller."
  - maybe, but … depends on the objective(s) of the LoLR