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News release

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The Repertoire of Official Sector Interventions in the Financial System: Last Resort Lending, Market-Making, and Capital - Speech by Paul Tucker

In a speech given today at the Bank of Japan's 2009 International Conference in Tokyo, Paul Tucker - Deputy Governor for Financial Stability and a member of the Monetary Policy Committee - discusses the role the authorities can and might play in the provision of liquidity and capital support to the financial system. He sets out the principles underpinning the Bank's provision of liquidity insurance to banks; and some initial thoughts on principles for other support operations.

In the area of liquidity insurance for banks, he notes central banks can call on more than a century of experience. But the financial crisis has exposed a gap in thinking about what principles should guide any Market Maker of Last Resort or Capital of Last Resort interventions by the authorities. Paul Tucker stresses the links between liquidity and solvency. He says, ".the 'liquidity' and 'solvency' explanations of the current crisis are inseparable. Especially in a world in which banks' trading portfolios are marked to market, a drying up of liquidity in markets brings about a fall in asset prices, and so a depletion of banks' net worth. .If anyone doubted it, this crisis underlines how problems of funding liquidity, asset-market liquidity, and solvency are intertwined. And those dimensions of a systemic crisis map into the authorities' capability, in principle, to be a Lender of Last Resort; a Market Maker of Last Resort; and a provider of Capital of Last Resort."

In relation to central bank liquidity insurance to banks, he highlights that the Bank of England now offers six permanent facilities through which liquidity can pass between it and the banking system. In designing those facilities the Bank has clear principles. It aims to reduce the cost of disruptions to the liquidity and payments services supplied by commercial banks by balancing the provision of liquidity insurance against the costs of creating incentives for banks to take greater risks, and subject to the need to avoid taking risk onto its balance sheet. Paul Tucker stresses the need for the authorities to set the right incentives for financial institutions to manage their own liquidity risk prudently. He identifies the need for 'peacetime' behaviour to be consistent with 'wartime' behaviour and for liquidity facilities not to impair the implementation of monetary policy in any way. These principles influence the type of collateral a central bank accepts, and the prices and margins it sets. They are also relevant to the international debate about how to improve the regulation of liquidity. Paul Tucker supports proposals that ".regulators should define the 'liquidity buffer' to comprise highquality securities that can reliably be traded or exchanged in liquid markets, including in stressed circumstances. In practice, that would mean focusing on government bonds in many economies."

In relation to the role of Market Marker of Last Resort, Paul Tucker cautions that ".entering a market as a buyer does not automatically enhance the liquidity of that market. [And] whereas central banks can protect themselves against the risk in secured loans by requiring more collateral if conditions deteriorate, an outright purchase is a one-off transaction; if we pay too much given the true risk, that's that." He outlines for debate six propositions that could guide any MMLR operations, stressing the need for a central bank to perform a catalytic role, ".helping ideally to kick-start the market rather than replace it." That is consistent with the design and operation of the Bank of England's existing commercial paper and corporate bond schemes within its Asset Purchase Facility.

Turning to capital, if very rarely the banking system requires the authorities to provide capital support in some way, Paul Tucker says there is a need for ".principles and policies for what might be called 'Capital of Last Resort', to sit alongside the Lender of Last Resort principles." He suggests for debate that one possible approach would in future be to build on deposit protection insurance in order to put more of the cost of banking system failures on shareholders in the banking system generally rather than the taxpayer. And he comments on some ideas for increasing private sector capital insurance, such as banks being required to issue debt that could be converted into equity during a systemic crisis.

This is a contribution to debates on new 'rules of the game' to ensure a more resilient global financial system in the future.

http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech390.pdf