Discussion of:

Overcoming Borrowing Stigma: The Design of Lending-of-Last-Resort Policies

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Background

- **Wholesale Funding Runs in Summer 2007**
  - Two Bear Stearns hedge funds declared bankruptcy
  - BNP Paribas stopped allowing withdrawals
  - → Other institutions experience short-term wholesale funding runs (repo and ABCP)
  - → **LOLR needed**

- **Discount Window**
  - Commercial banks can borrow from the Federal Reserve
  - Short-term collateralized loans
  - Penalty rate as prescribed by Bagehot

- **Stigma**
  - By using the DW, banks reveal that they lost access to the private markets
  - Bank level borrowing is confidential, but market participants might figure out
  - In Aug07, penalty rate lowered from 100 to 50 bps and maturity extended from o/n to 30 days

    ... but banks do not borrow; stigma is still there

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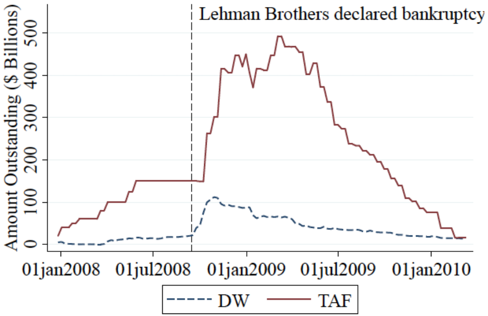
(a) **Borrowing Amount**



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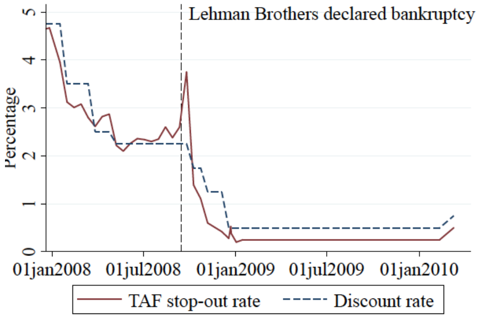
- **Outstanding balance:** TAF$\gg$DW
- **Borrowing rate:** DW$<$TAF at times (especially right after Lehman)

(b) **Borrowing Rates**



Why could TAF overcome the stigma and generate more borrowing than DW?

The Authors' Answer

- **Setup**
  - Banks have private information about their financial condition
  - Some (weaker) banks have more urgent need for liquidity
  - TAF delays its release of liquidity compared with DW
  - Stigma depends on financial conditions of participating banks
- **Banks self-select in DW and TAF**
  - Weakest banks cannot wait for liquidity and therefore borrow from DW
  - Stronger banks participate in TAF as they hope to get a good rate
- **More liquidity provision with TAF + DW Vs. DW only**
  - Stronger banks that would have gone to DW bid at TAF
  - Stronger banks that would have not gone to DW bid at TAF

  $\rightarrow$ Stigma at TAF is lower, increasing the supply of short-term debt in the economy

Stigma is Unavoidable in the LOLR Framework

- **Low-quality banks borrow from the LOLR**
  - Coordination failure, *all* banks suffer a run
  - Banks differ in their balance sheet strength
  - Worse banks need to tap the LOLR
  - Loans engineered in a way to have only bad banks tap the LOLR (penalty rate)
- **Market participants figure out who borrows**
  - The Board publishes weekly the DW lending by each of the Federal Reserve District Bank
  - A BBC leak about Northern Rock tapping BoE liquidity triggered a run
  - This risk seems unavoidable
- **Need to pool good and bad banks together**
  - *"Stronger banks, in contrast, are lured to participate in the auction because the potential of borrowing cheap renders the auction more attractive than DW."*
  - What about Bagehot's prescription about the "penalty rate"?

One Extreme Example: ECB 2011-12 LTROs

- **ECB offered a *subsidy* to good banks to borrow**
  - Run by US MMFs in 2011H2
  - Some eurozone banks were struggling (mostly in the periphery)
  - ECB offers a 1% 3-year loan against almost any type of collateral
- **No stigma whatsoever**
  - All banks borrowed in Italy and Spain
  - ! CEO/CFOs self-reported their uptake of ECB liquidity (available on Bloomberg terminal)
- **Is there an unavoidable trade-off?**
  - On the one hand, prevent good banks from borrowing to preserve market discipline
  - On the other hand, induce good banks to borrow to reduce stigma
  - $\Rightarrow$ The policy goal cannot be to simply "increase liquidity provision" and induce a pooling eqm

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