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APPRAISING THE ROLE OF LENDER OF LAST RESORT: A COMPREHENSIVE STUDY OF FEDERAL RESERVES, BANK OF ENGLAND AND STATE BANK OF PAKISTAN

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ABSTRACT

This research enunciates the functions and the significance of the lender of last resort (LOLR) with reference to contemporary financial issues. Primarily, the research provides the conceptual underpinning of the doctrine of LOLR and divulges that the ambit of the role of LOLR was nothing more than liquidity; hence, it could not get attention by the policy makers until the recent global financial crisis of 2007-08. It further explores the progression in the responsibilities of the Central Banks (CBs) after the financial crisis of 2007-08. Equivocal financial challenges eroded the contentions and paved the way for the LOLR and made it an inevitable part of the functions of CBs. Qualitative study is applied to carry out this research. It appraises the operations of LOLR during the crisis and highlights the lacunas of current legislation regarding it. The present research explains the emergence of Federal Reserves as a CB for the United States and unfolds its rescue operations to strengthen the financial institutions during crises. It also evaluates the gaps of the Federal Reserve's Act, 1913 and extensively explains the significance of Dodd-Frank Act, 2010. Additionally, it studies the financial challenges of the United Kingdom and the operations of the Bank of England as LOLR. In the current hour, the financial system of Pakistan is enduring numerous financial challenges; nonetheless, there is not much scholarly work done in this context. This research highlights regulatory problems and suggests reform proposals, therefore, it will immensely contribute to the literature and benefit the concerned researchers of this area. The laws which legitimate the powers of CBs as LOLR are also studied. Finally, it provides a comprehensive discussion regarding the moral hazard problems which are inseparable in the presence of LOLR and argues that how effacing these problems could be for the system.

INTRODUCTION

This research critically evaluates the role of LOLR played by the Federal Reserves, The Bank of England and the State Bank of Pakistan. It is divided into six parts which appraises the role of domestic and international LOLR. First part enunciates the functions of LOLR and their significance in the modern economic system. Second part explains its nature before the financial crisis of 2007-2008. It further unfolds how it has been emerged after the financial crisis. Third part is further divided into three parts, its first part explains the operations of Federal Reserve's second part explains the role of Bank of England and the final part divulges the role of State Bank of Pakistan as LOLR. Fourth part unfolds the laws of the US, UK and Pakistan which legalize the functions of LOLR in their countries. Fifth Part provides the opinion of the scholars who have criticized this role and are against its presence in the financial systems. Final part of this chapter extensively evaluates the moral hazard problems pertaining to it.

FUNCTIONS AND SIGNIFICANCE OF LENDER OF LAST RESORT

In the modern economic system, it is a common fact that financial institutions can face liquidity shortage and it is only the CB of the state which is empowered to generate liquidity to fulfill

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its demand. There is no separate institution which is authorized to exercise the powers of LOLR. It is a vigorous part of the duties of CBs at domestic level and IMF which is a branch of World's bank performs the duties of international LOLR (Wallich, 1987). Usually, the understanding of LOLR is that the CBs intervene by lending liquidity to the financial institutions which need liquidity. The uncertain situation of the financial system and surging panic among investors invoke the operations of LOLR to enhance the resistance of the financial institutions against crisis (Giannini, 1999). However, impartation of the liquidity by private individuals or the institutions to the financial markets cannot attribute the role of LOLR to them because it is a part but not the entire function of this role. This role is not limited only to provide liquidity but has several functions. The stability of the financial system lies on trust of the depositors however; ups and downs are part of its activities (Fischer, 2016). In the modern financial systems, the institutions are working with each other hence they provide loans to the financial institutions which are facing problems. However, in some circumstance when they are unable to handle the issue and CB realizes that it could be detrimental for the system it operates as a LOLR (Humphrey, 2010).

Sir Francis Baring (1797) argued that the Bank of England holds this power to lend liquidity when all other financial institutions failed to do so. Henry Thornton and Walter Bagehot has designed the characteristics of LOLR and explained the insight behind its operations (Fischer, 2016). The impartation of liquidity in the apprehension of a financial crisis is different from lending a loan. The CBs have responsibility to govern the system not to protect individual institutions. Therefore, the liquidity assistance in the operations of LOLR can only be granted to solvent institutions. The core function of the CBs as a LOLR is not to intervene during special circumstance but it is obligated to take all necessary steps to make an indomitable system. The dread of a crisis is more annihilating for the survival of the system than the shortage of liquidity. It is a vital part of the functions of the LOLR to ensure the trust of the stakeholder on the system. The reason behind establishing a CB is to have an institution which can regulate the financial system and have the powers to implement its policies (Bordo, 2014).

The functions of LOLR are enhanced and it is no more merely a facility of liquidity during crisis. It is regarded as a tool to govern the economic system. Thus, to give the monitoring and financial policy of the state is also an important part of this role. It must have an accurate check and balance of the system and diverge the insolvent financial institutions. The regulations regarding the functions of LOLR must be well clear that in which circumstance and on which grounds its assistance can be availed. It also ensures the trust of the domestic and foreign investors on the system by taking all necessary steps. According to the needs of the system, it provides opportunities to the financial systems to excel their businesses. Finally, if the financial institutions start facing liquidity shortage and are unable to overcome the problem by the normal loan facilities of the market. (Tucker, 2014). The CB extends its support of liquidity as a LOLR to abolish the problem of liquidity and curtail the panic of a crisis. The mandate of the role of LOLR is not limited to impart liquidity but it can also purchase the illiquid assets of the financial institutions which are in trouble (Tucker, 2014). Normally, to fulfill the demand of liquidity the financial institutions start selling their illiquid assets and a rapid sale always deteriorate the value of the assets and make the situation worse for the institutions to handle. Therefore, the functions of LOLR are not limited to certain operations, it can go to any limit for the survival of the system (Obstfeld, 2009).

The functions of an international LOLR are limited as compare to those of the domestic one. It is no more a contention if the modern global economic system requires an international LOLR or not. The failure of domestic system has effacing effects on the world's economy (Truman, 2010). Financial institutions seek help from the CBs when they face difficulties and the CBs in their difficult times ask the IMF to rescue them which is currently working as an ILOLR. (Landau, 2014). It can ask foreign investors to invest in the country which is facing liquidity problems or ensuring the existing investors that it will rescue the CB when it will be needed which eliminates the panic and allows the system to stabilize itself. The ILOLR can play a role of a consultant however; it cannot give the financial policy of the states. Like the domestic LOLR, the IMF cannot purchase the assets of the CB which requires its assistance. It can make its support conditional that the CB which needs its help must provide a viable financial policy that it will be able to return the money (Truman, 2010).

In the modern economic era, the significance of LOLR cannot be denied. Its salient functions and successful role in the recent financial crisis make it an inseparable part of the functions of the CBs at domestic and IMF at international level. Liquidity shortage and minor financial panics are common in the current financial systems which can be converted into a large financial crisis if there is no institution which can lend liquidity to address such problems. A trivial liquidity issue can escalate the apprehensions of crisis and make it difficult for even a solvent institution to survive. Large financial institutions in the absence of a LOLR will be mighty in the financial system and will make the conditions of loan facility unapproachable for small institutions. The rationale behind having a LOLR on domestic and international level is not merely to have an institution which will provide liquidity in difficult times but to make such an effective and efficient system where all institutions enjoy the same rights and can excel. However, to achieve this goal it requires a proper legislation to regulate this role according to the insights of having it. (Landau, 2014).

FEDERAL RESERVES AS LENDER OF LAST RESORT

Every financial system strives to maintain the stability of the system and back the financial institutions in tough economic conditions which requires a CB. The first CB for the United States was created in 1791 and it is known as the Bank of the United States. It was established to fulfill the traditional duties of a CB to assist the federal government in its financial matters. It was authorized to emit notes which were accepted by the federal government in making financial payments. Though, it was not well accepted unanimously by the inhabitants of the USA and particularly its private ownership allows it to work as an independent institution rather as a government institution. Hence, even after 20 years, it was unable to get approval from the congress to continue working as a CB. In 1836, President Andrew Jackson used his powers and rejected the bill of the extension of the second CB of the US (Powell, 2017). Absence of a CB was causing harm to the system and country had faced many financial crises in 1839, 1857, 1873, 1893 and in 1907. It was realized that the presence of an institution which can give monetary policy and help the financial institutions when they face liquidity problem the happening of these crises can be curbed. Minor financial institutions can create panic among the creditors and create a situation when the financial institutions will be unable to address it. The CBs are designed to help the financial institutions when the demand of liquidity rises and prevent the financial crisis. The CBs were collaterals hence, they were lending liquidity to the solvent institutions and allowed them to fulfill the demand of liquidity without selling of their assets. In the outset of 20th century, the US didn't have a CB hence; it had faced many crises one after another. Finally, the financial crisis of 1907 paved the way for the establishment of Federal Reserves though many economists were still opposing the idea of having a CB and were arguing that the powers should be granted to the regional bodies (Oganesyan, 2013).

The Federal Reserve Act (FRA) 1913 empowered the Federal Reserve to play the role of LOLR and lend liquidity to the financial institutions which were facing liquidity shortage. In the recent global crisis, the role of Federal Reserves is commendable as it took a radical approach to deter the crisis. It did not rely on the traditional lending policies and took unconventional step to prevent the financial institutions from collapsing which also played an important role to extend the conception of LOLR. Sections 10-B, 13 and 14 of FRA 1913 legalized the operations of Federal Reserve as LOLR. In the starting of 2007 the Federal Reserve lent liquidity to the financial markets to enable them to resist the crisis. Although Bagehot emphasized that high interest rate should be charged to curtail moral hazard problems, but it was reduced to encourage the banking sector to lend each other which worked well to stabilize the system (Herr, Rüdiger and Wu, 2016). Federal Reserve's completely ignored the principles of Bagehot and directly lent to the insolvent institutions. Basically, it lent freely to nationalize AIG company which worked well to stabilize it. The Federal Reserve also followed the parable of the Bank of England and purchased the illiquid assets of the financial institutions which were forced to sale them rapidly because of the liquidity demand. This step provided liquidity to the financial institutions and prevented the depreciation of their assets (Dobler, 2016).

The role of LOLR is regarded as a vital part of the modern economic system however; it was not warmly accepted by many economists because of the moral hazard problems. In the case of Lehman Brothers when the Federal Reserve refused to lend liquidity it was badly criticized by the economists. It was perhaps the biggest bankruptcy in the history of United States and left many lessons for the financial institution to be learnt. The presence of LOLR allows the financial institutions to ignore the consequences of risky investment because they believe that they will eventually be rescued if there will be a panic which creates moral hazard problems. To address the issue of moral hazard problems Federal Reserve has set an apt precedent in the case of Lehman brothers. Although, the Federal Reserve has played a very effective role to resist against the financial crisis, even then it was observed that there are many lacunas in the legislation and this significant role cannot be left on the discretion of Federal Reserve therefore; it needs to be legislated. (Tucker, 2014). The United States which was struggling to have a CB which can play a role of LOLR when the financial institutions need liquidity is now leading in expanding the doctrine of LOLR. After the recent financial crisis to address the loopholes of the existing laws and fixing the moral hazard problems United States has enforced Dodd-Frank Act 2010. It provides principles on which the financial institutions will be provided with liquidity (Judge, 2016).

BANK OF ENGLAND AS LENDER OF LAST RESORT

This part of the research explains how the Bank of England (BOE) adhered itself with the insights of Sir Francis Baring and played the role of LOLR for the financial institutions during crisis. It is important to appraise the operations of LOLR in previous crisis to get guidance. As Lord Mervyn King (2016) said, "During the crisis, I found that the study of earlier periods was more illuminating than any amount of econometric modelling" (p. 90). The evolution of the LOLR is extensively described that although the BOE had lent liquidity in Eighteenth century but lending liquidity to the financial institutions when they need it, is a duty of the CB which was established in the last quarter of Nineteenth century. It is important to evaluate if the BOE has altered its policies after accepting the role of LOLR or not. There is no evidence which can enunciate that there was an empirical change in the policies of BOE henceforth. It was criticized because of having the primary aims of profit maximization that there is a conflict of interest and it cannot hold the position of CB (Anson et al., 2017).

The BOE has played the role of LOLR in the crisis of 1847, 1857 and 1866. Bagehot (1873) described the rules for LOLR which were followed by the CBs around the world. Bagehot's doctrine has three main principles of lending i) the CB must lend freely ii) it must lend at a high interest rate iii) its lending must be against worthy collaterals. Although, it can be evinced by the operations of the BOE as LOLR that it has freely lent liquidity, but it was lent only to few institutions. Like the other CBs there were no regulations regarding LOLR. Thus, BOE has also used its discretionary powers and lent three-fourth of the total amount of liquidity to the top five borrowers. The principle of charging high interest rate was strictly followed in the crisis of 1857 and 1866. The interest rate was more than the commonly practiced rate. Nonetheless, in the crisis of 1847 the interest rate on the lending of BOE was even below than the normal market rates. Therefore, it can be argued that there was no absolute condition for the lending of liquidity in the operations of LOLR that it cannot be lent on the interest rate less than the normal rate. Finally, the principle of lending against worthy collaterals was also practiced but the BOE has again used its discretionary powers to evaluation the collaterals and did not follow the same rules for all enterprises (Anson et al., 2017).

The principle behind the operations of LOLR is that it will only intervene and lend liquidity to the financial institutions which are experiencing liquidity problems but are not insolvent. In the cases of Barings and Yorkshire Penny Bank (YPB) when both were unable to fulfill the demand of liquidity sought assistance from the BOE were recused because they were illiquid not insolvent. However, in 1878 the City of Glasgow Bank (CGB) were refused to get liquidity support because the collaterals which were produced by the CGB were not accepted as a good security. It is however, an unaddressed issue that how the CB will determine if the financial institution is illiquid or insolvent (Anson et al., 2017). Baring was rescued and had established an argument that it was merely illiquid, but it took four years to settle its liabilities. Many institutions were declared insolvent and could not get the support of LOLR would be able to settle their liabilities if were granted several years like other institutions. In the case of Northern Rocks, the BOE has used an entirely different approach and instead of lending liquidity the BOE decided to nationalize it because it was not befitting for the system to let it fall on the grounds of not having good securities.

Tucker (2014) expressed his views that it was a tragedy that the role of LOLR was neglected in the major policy debates of central banking and no effects have been made to legislate on it. Albeit, the significance of the LOLR in modern financial system cannot be denied but leaving its functions on the discretion of CB will be fatal. The role of BOE as a LOLR during the financial crisis was well regarded by many economists however; it is also emphasized by all the policy-makers that like the issue of moral hazard problem it is also important to frame a regulatory frame-work for the functions of LOLR. The absence of an effective regulation will continue to allow the BOE to use its discretionary powers to judge if the financial institution is insolvent or merely illiquid. Hence, this role will remain controversial and it will not be possible to achieve the desired goals (Tomasic, 2009).

STATE BANK OF PAKISTAN AS LENDER OF LAST RESORT

Pakistan is among the developing countries and its banking sector is still evolving. State Bank of Pakistan (SBP) holds the gold resources of the country and has power to emit notes. It is the only institution which can lend liquidity to the financial institutions when no other institution is capable of lending (Raja, 2009). The SBP plays the role of LOLR to strengthen the financial institutions against crisis. However, its functions as being a LOLR are equivocal and still emerging. The State Bank of Pakistan Act 1956 legalize the LOLR operations of SBP. Due to unprogressive financial policies and unproficiency in the operations of LOLR, Pakistan has faced sever financial crisis. In this modern era the role of LOLR is not merely to lend liquidity in crisis, it has several functions to protect the system from recession as it was described. (Altaf, 2016). The panic among the creditors is the most annihilating factor for the financial system which the CB should eliminate while performing the role of LOLR. The SBP lent liquidity to many financial institutions to stabilize the system and issued many new notes to fulfill the demand. However, the emittance of new notes rapidly deteriorated value of the currency and caused inflation. Therefore, Pakistan sought the assistance from IMF which is playing the role of international LOLR.

The role of LOLR has been emerged swiftly after the recent financial crisis in developed countries especially in UK and USA. Nonetheless, it is still not the part of major financial debates of the financial and economic forums of Pakistan. The Islamic Banking is an emerging sector in Pakistan however; there is no legislation and clear policy of the SBP that in case if this sector faces the liquidity crisis who will play the role of LOLR (Umer, 2015). There are no set principles for providing liquidity support and it will not be befitting to adopt the principles of the UK or USA because each system has different needs and dimensions (Altaf, 2016). The banking sector is not the only one getting liquidity support from the SBP but it also lends to the government institutions like Pakistan International Airlines (PIA), Pakistan Steel Mill and Pakistan Railways etc. Most of the financial and governmental institutions are unable to return the money to the SBP. Absence of a strong regulation to curtail moral hazard problems is hauling the system towards crisis. Public money is going in vain and due to moral hazard problems the LOLR itself is becoming the cause of recession. Thus, the SBP had no other option but to seek assistance from IMF. Notwithstanding, it is a dilemma that Pakistan’s economy is standing at the verge of destruction and miserably depending on the aid of IMF but still there are no financial regulations which can address these issues. Although, IMF is working as an ILOLR, but it is alleged that it is influencing the economic systems of the countries and its stipulations are fair with the developing countries. This research aims to propose a regulatory frame work for the functions of LOLR in Pakistan.

LAWS RELATING TO LOLR IN US, UK AND PAK

The benefits of the role of LOLR in the recent financial has emerged it conception swiftly. There are no more contentions whether the modern financial systems at domestic and international need a LOLR or not. In the recent financial crisis, the CBs took unconventional measures to protect the system which worked well for the extension of the functions of LOLR. Federal Reserves unfolded all possible measures to address the crisis which is extensively discussed in this research. However, the role of LOLR in the crisis highlighted the moral hazard problems and lacunas of the current regulations regarding LOLR. The Federal Reserve Act 1913 legalizes its operations as LOLR, section 10, 13 and 14 of the Federal Reserve Act 1913 empowers it to play the role of LOLR. Nonetheless, it does not regulate its functions of LOLR. There are several principles to perform this role but still the Federal Reserve has many discretionary powers in this regard. The United States is the first one to regulate the functions of LOLR immediately after the financial crisis. Dodd-Frank Act 2010 describes all the functions of Federal Reserves as LOLR and provides the stipulations on which it can refuse to rescue a financial institution.

The Bank of England Act 1988 has legalized the operations of BOE as LOLR. It has played an important role to strengthen the financial institutions against crisis. It can be observed in the operations of BOE as LOLR that it followed the principles of Bagehot for operating as LOLR. The principles of Bagehot regarding the LOLR are extensively described. However, it can also be observed that these principles were not followed by the BOE as a hard and fast rule while acting as LOLR. There are several cases where the BOE has used its discretionary powers which was castigated by many economists. It was argued that to avoid this role from being politicized, it must be regulated.

In Pakistan, the State Bank of Pakistan (SBP) is empowered to play the role of LOLR for the domestic financial system. Section 17, 18 and 19 of the State Bank of Pakistan Act 1956 legalize the operations of SBP as LOLR. There is no regulation regarding the functions of LOLR and it is badly politicized. The domestic system enjoys the liquidity support of LOLR but does not return the loans, which is a big threat to the financial stability of Pakistan. Although, many developed countries have no regulations of LOLR but still they are following certain principles to carry out these operations and the current financial situation of Pakistan cannot sustain against a financial crisis without the help of IMF. Thus, it must regulate the functions of LOLR otherwise it cannot attain any benefit from this role.

CONCLUSION

This research has provided a critical evaluation of the role of LOLR. It has discussed the functions of LOLR and explained that if there will be no institution which will play the role of LOLR for the financial system in this modern system, the entire system can collapse because of a minor liquidity problem. The LOLR can address the liquidity problem and eliminate pain among the investors. It had discussed the role of Federal Reserve, the Bank of England and the State Bank of Pakistan as LOLR. It had also explained the laws of all three countries relating to the role of LOLR. Finally, it has explained the moral hazard problems and criticism on this role.

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