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OPINION | COMMENTARY

Do More to Avert a Liquidity Crisis

Next steps for Congress, the Fed, the Treasury and the FDIC.

By Hal Scott

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The Federal Reserve, Treasury Department and banking regulators deserve congratulations for their bold, necessary actions to provide liquidity to the U.S. financial system amid the coronavirus crisis. But more remains to be done.

We thus recommend: (1) immediate congressional action to expand the Federal Deposit Insurance Corp.'s authority to guarantee bank liabilities and to authorize the Treasury to use the Exchange Stabilization Fund to guarantee prime money-market funds, (2) regulatory action to effect temporary reductions in bank capital and liquidity requirements, which will permit banks to expand their lending to consumers and businesses, and (3) additional Fed lending to banks and nonbanks. I am joined in these recommendations by Glenn Hubbard and John Thornton, both co-chairmen of the Committee on Capital Markets Regulation.

We support the Treasury Department's request and the Senate Phase 3 proposal to restore the Treasury's authority to use the Exchange Stabilization Fund to guarantee prime money-market funds temporarily.

An equally critical priority for Congress should be to restore the FDIC's authority to increase deposit-insurance limits, particularly on transaction accounts, as it did in the 2008 financial crisis. Limits on transaction accounts need to be increased on an unlimited basis to protect the payment system, also as in 2008. If prime money-market funds were fully guaranteed and bank transaction accounts were not, it would create an incentive for uninsured depositors to move their funds out of banks into prime money-market funds.

Further, Congress should pass a joint resolution, as current law permits, authorizing the FDIC to guarantee newly issued long-term debt by banks—again, as was done in 2008. In parallel, Congress should provide Treasury with the explicit authority to guarantee specified debt of nonbank financial institutions, which play a critical role in the financial system. Such pre-emptive actions can prevent a potential liquidity crisis.

Banking regulators recently announced that banks could use their capital and liquidity buffers to lend and respond to challenges presented by the effects of the coronavirus. Banks may hold voluntary capital buffers in excess of requirements or buffers that are required like the capital conservation buffer. We urge the Fed to include both buffers.

Regulators recently exempted banks, using the newly created Money Market Mutual Fund Liquidity Facility, from both risk-based and leverage capital requirements that would otherwise apply to assets purchased through this facility. That's a step in the right direction, but we recommend they do more.

First, they should temporarily suspend bank liquidity requirements, such as the Liquidity Coverage Ratio, and related supervisory requirements, such as the living will process. Second, they should exempt central bank deposits and government securities from the Tier 1 leverage ratio. Third, they should take no action at this time that would increase bank capital requirements through the regular annual stress test or the scheduled integration of the stress capital buffer. This approach would provide banks with the balance-sheet flexibility necessary to expand lending to each other, nonbanks, small businesses and individuals, while continuing to take deposits as people convert other assets into cash.

We commend the Fed for exercising its Section 13(3) authority as lender of last resort to establish a Commercial Paper Funding Facility, Money Market Mutual Fund Liquidity Facility and Primary Dealer Credit Facility. We support Treasury's use of the Exchange Stabilization

Fund to provide the CPFF and MMLF each with $10 billion in credit protection. The Fed and Treasury should continue to monitor these facilities to make sure limitations on their use square with the liquidity needs of the markets. The Fed should revise the eligibility of assets under the MMLF to include municipal securities without a restriction on their maturity.

We recommend that the Fed take further actions as lender of last resort. First, it should re-establish the Term Auction Facility, used in the 2008 crisis, allowing depository institutions to borrow against a broad range of collateral at an auction price, to avoid the stigma of borrowing at the discount window. Second, it should consider further exercising its Section 13(3) authority to provide additional liquidity to nonbanks, potentially including purchases of corporate debt (in addition to commercial paper) through a special-purpose vehicle. Third, we observe that banks are not fully using the Fed's new repo facility due to capital charges. The Fed should therefore allow the Fixed Income Clearing Corp., a AAA clearinghouse (which will not incur capital charges), to be a counterparty on Fed repos. FICC can then provide repo funding to its nonbank members. This has the additional benefit of freeing up bank capital for other lending.

Congress, the Fed and the FDIC should do whatever it takes to provide liquidity to the financial system in this crisis. Unlike 2008, this crisis was not the result of excessive risk taking by banks, and thus the provision of support won't create moral hazard. The steps we recommend are bold but necessary to prevent a potential liquidity crisis caused by the still-spreading coronavirus.

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