SECTION V

THE ROLE OF THE FED

Overview

The current financial crisis has been a watershed moment not just for markets and institutions but also for the U.S. Federal Reserve and for central banks around the world. The Federal Reserve has been forced to innovate in the past year with a multitude of lender-of-last-resort facilities to a range of financial institutions and against a variety of collateral. This has been a response to the fact that the financial system faced and continues to face a severe liquidity crisis and because the institutions at risk posed severe systemic risks, endangering many other parts of the system by their fragility. How should the Fed and other central banks deal with these risks – reducing them in the first place and fighting them once they materialize? This section proposes methods for assessing and dealing with systemic risk to the financial system and to propose some design principles for lending facilities to deal with financial crises:

- Chapter 13, "Regulating Systemic Risk," addresses the question of how best to regulate systemic risk. Current financial regulations seek to limit the risk of individual institutions in isolation but do nothing to address the risk more broadly. The novel idea in this chapter is to tax firms based on their contribution to systemic risk in order to incentivize them to internalize the cost of their systemic risk and hopefully induce them to create less of it.
- The essence of the proposal in Chapter 14, "Private Lessons for Public Banking: The Case for Conditionality in LOLR Facilities", is that central banks should not view systemic crises as simply being due to liquidity problems but should look out for underlying solvency concerns. In particular, it proposes how central banks could address the adverse incentive effects of the lender of last resort (LOLR) facility – that insolvent institutions may borrow against poor collateral – and induce more prudent behavior by firms.