Balancing LOLR Assistance with Avoidance of Moral Hazard

By C.A.E. Goodhart
Financial Markets Group
London School of Economics

- If an agent is absolutely 100% sure to repay all debts as promised, it can always issue its own IOU.

- Specific paper money, the concept of liquidity, and the need for banks, all derive from the fact that default can never be ruled out completely.

- So a liquidity need almost always, absent physical problems, implies an underlying solvency concern.

- Solvency is a slippery concept. Based on what valuations? Not independent of the Central Bank's own actions.

- Problem coming with Bail-In.

- Bagehot rule on lending on good collateral compromised by stigma concerns.

- Lend to the market, not to the individual institution, (Dodd-Frank Act).

- An incorrect assessment of contagion.

But Moral Hazard

- Treat first worst.

- Involve other banks, (life-raft).

- Change the Incentive Structure
  - get rid of limited liability for insiders
  - pay bonuses in bail-inable debt

- Collective error much more responsible for crises than cyclical risk shifting.

- Even so, the imposition of penalties for failure will benefit the political context.