Optimal Seniority of Last Resort Loans

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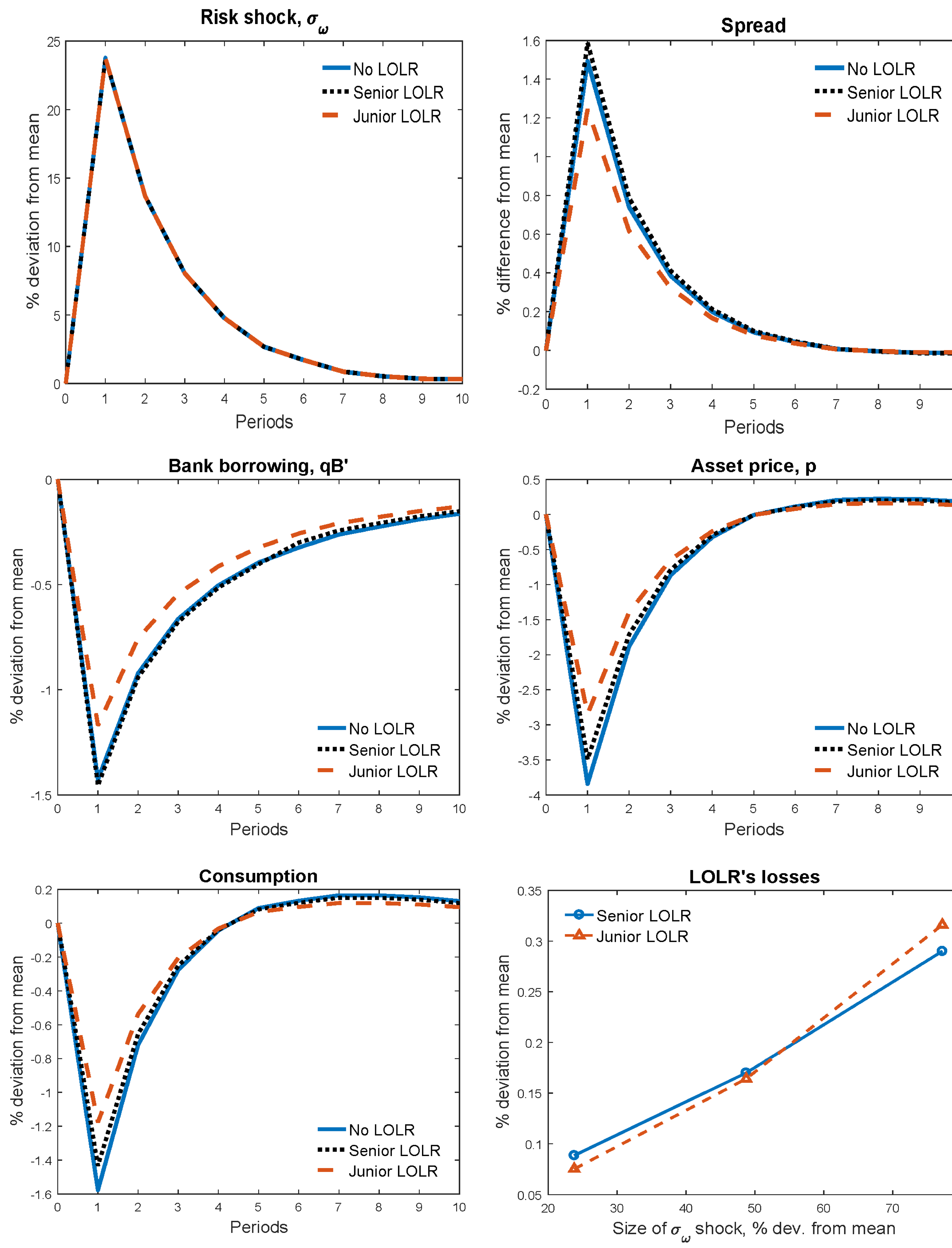
Introduction

- Lenders of last resort (LOLR) usually insist that their loans enjoy preferred creditor status (LOLR loans are senior).
- For example, both the European Stability Mechanism or the new European Monetary Fund's foundational charter includes this mandate of seniority.
- The objective of the LOLR seniority status is two-fold:

  1) to provide financial support at times when regular access to market financing is impaired or at risk of being impaired.

  2) to minimize credit risk for the LOLR.
- In this paper we show that, under certain conditions, to achieve the previous goals, the optimal seniority for LOLR loans is to be junior, not senior. That is, private sector loans should be senior.
- Our results are due to a positive "collateral channel".
- Junior LOLR encourages the private sector to lend more and at lower rates because the junior LOLR loan serves as implicit collateral.
- Our results rationalize the puzzle that during the last crisis, borrowing costs for Ireland and Greece increased once those countries received LOLR help (Steinkamp and Westermann 2014, Steinkamp and Westermann 2017, Acharya et al. 2016).



IRFs to a financial (risk) shock

Model

- Small open economy with banks, households, government and international LOLR.
- Banks borrow from international markets at endogenous spread due to costly-state-verification frictions and endogenous default.
- A banking crisis is a period in which risk shocks increase borrowing costs for the banks. A negative financial accelerator follows with negative real effects.
- In a financial crisis, negative externalities make it worthwhile for the country to borrow from the international LOLR to then lend to its banks.
- We compare senior and junior LOLR loans for a model that matches recent financial crises experiences.

Conclusions

- Making international LOLR loans senior prevents a collateral channel for private lenders.
- Senior loans from LOLR cause a run by the private sector.
- Seniority of LOLR loans may backfire: LOLR ends lending more and taking more risk than with junior loans.
- Need to rethink the current design of the European Stability Mechanism and the new European Monetary Fund.

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