The unfolding turmoil: lessons and responses of 2007-2008
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Road map

- Origins
- Puzzles
- Policy responses
- Capital market dysfunctionalities
- What to do now?

Origins

- Financial innovation – with exceptional opacity of new instruments
- Low real interest rates, search for yield
- ‘Ravenous’ risk appetites (incentives...)

The next one will come from somewhere else

- Now that we understand the origins, we have *danger of ‘fighting the last war’* – typically, policy-makers do that successfully
- Example: portfolio insurance 1987, derivatives disasters in 1990s, LTCM exceptionally high leverage in 1998 – those problems haven’t recurred
- Better regulation could have stopped some excesses – e.g., Bank of Spain didn’t permit abusive off-balance-sheet exposures, SIVs, etc., so despite bursting of Spanish real estate bubble, Spanish banks are in relatively good shape

What kind of ‘crisis’?

- Excellent summary: ‘credit risk event turned into a liquidity event...[the] combination...led to unique depth and duration of current crisis’
- Key is interaction between market liquidity and funding liquidity, with maturity mismatch
- Multiple liquidity spirals (Brunnermeier 2008)
- Puzzle: some *similar problems in autumn 1998* (even worse? a major sovereign default...), yet turmoil wasn’t as deep and didn’t last as long – although volatility spike was just as great

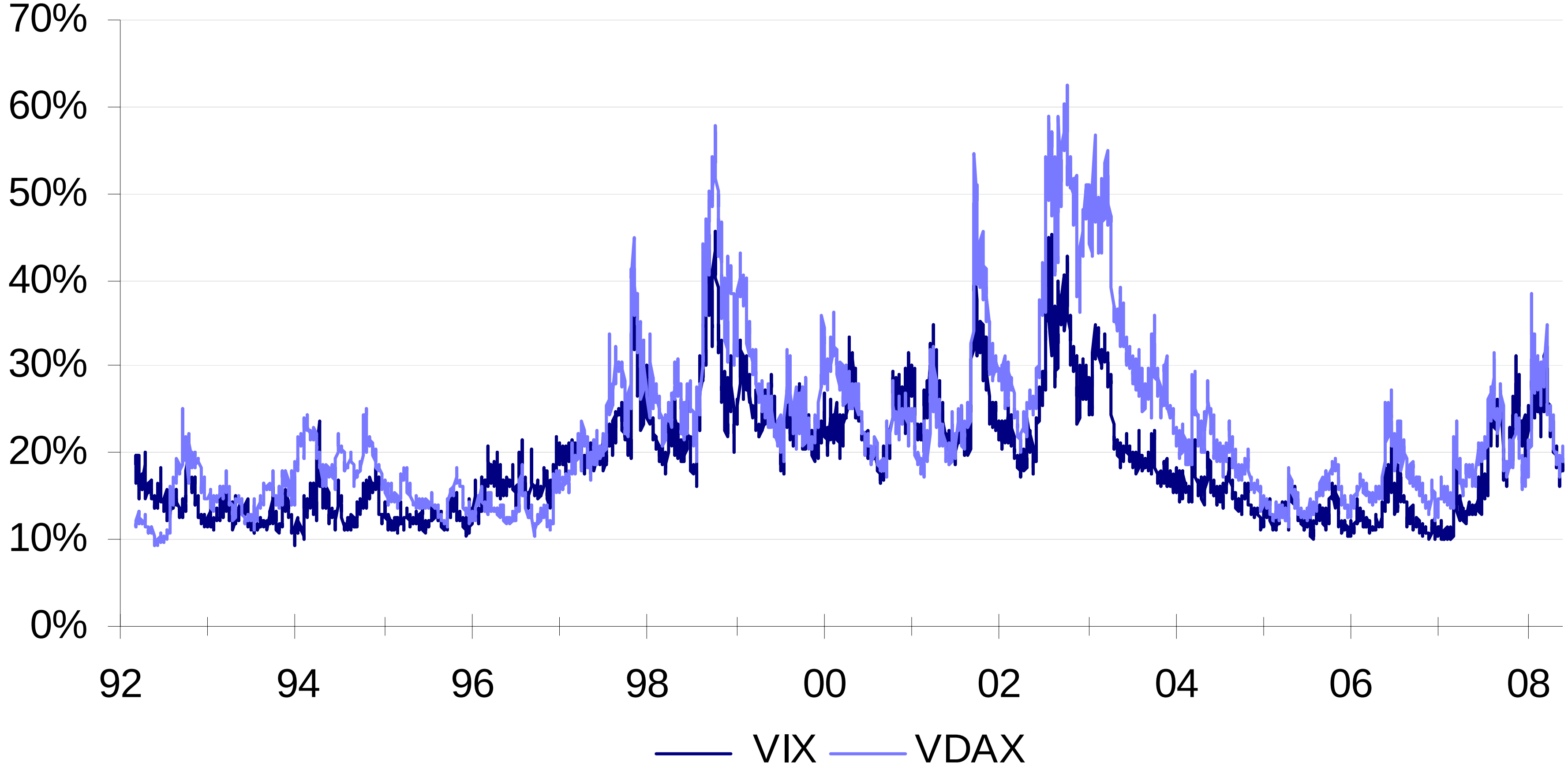
‘Crisis? What crisis?’ More puzzles…

- So far, ‘the biggest financial crisis since the Great Depression’ has had relatively little effect on non-financials and the aggregate real economy, even in the United States – could argue that commodity and food price inflation are much more important
- Despite bursts of deleveraging, overall the deleveraging so far has been much less than in previous episodes (Kashyap *et al*.)

…and more!

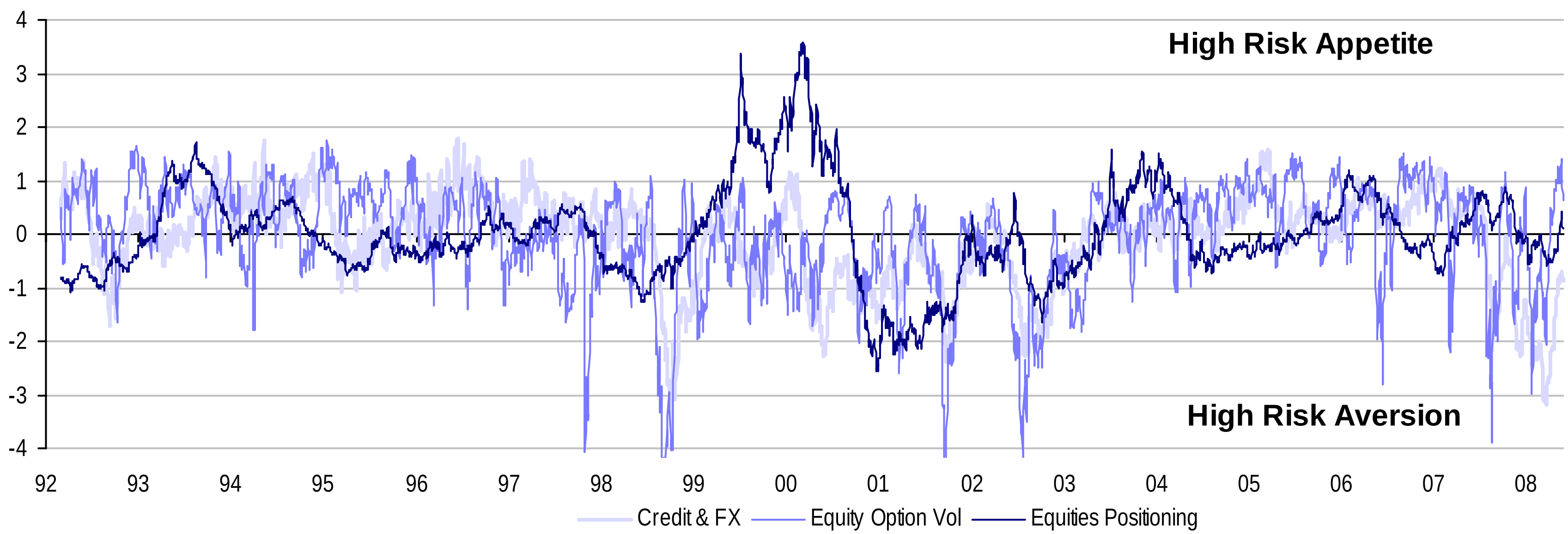
- Why do volatilities and indicators of risk aversion not appear unusual in historical perspective? Even the peak of CDS spreads in February-March isn't much higher than the 2002 peak (see following charts and BIS chart).
- Why are TED and LIBOR-OIS spreads still so high despite exceptional liquidity interventions (uptick since BIS charts)?
- Why have long rates not risen *pari passu* with inflation expectations?

Equity options volatility – what crisis?



Risk aversion: just another spike...

(comparable to end-’97, Sept-Nov ‘98, Sept ‘01, mid-’02)



UBS Global Risk Indicator, 27 May 2008

Policy responses – note some differences in euro area

- Cuts in policy rates (not by ECB – but they would otherwise have raised in August 2007)
- Widening of collateral accepted (not in € area)
- New facilities (not in € area)
- Swap agreements (why was so much $ liquidity needed in € area?)
- Efforts to repair bank balance sheets

Comment: There has been a *lamentable lack of policy coordination among the major central banks*, sometimes even vocal discord

Writedowns and recapitalization

- Why didn’t banks *cut dividends* quickly and a lot? Any pressure from regulators to do so?
- Piecemeal and repeated writedowns perceived as lack of transparency →
- Continuous fall in bank share prices →
- Investors have been burnt →
- Current reluctance to invest more in bank recapitalization

All this has been partly caused, partly exacerbated by mark-to-market accounting

Capital market dysfunctionalities

- CDS markets
- Mark-to-market (‘fair value’) accounting
- Credit rating agencies

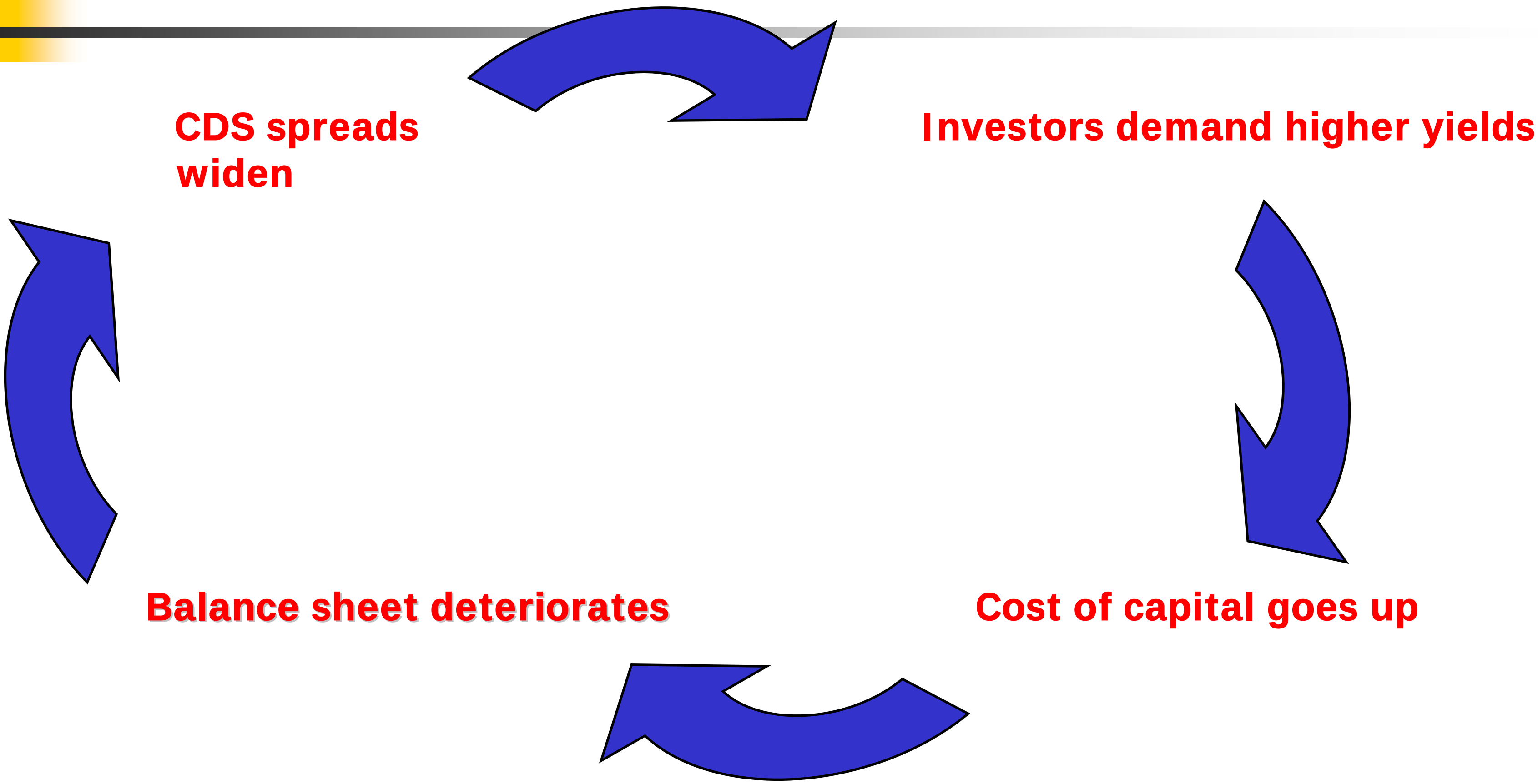
CDS spreads: what do they mean?

- If current level of CDS spreads accurately estimated P(default), then many banks would be pronounced dead
- But *CDS market is highly distorted*
  - Started as credit protection, but then became also a vehicle for speculation (not just 'hedging') - volume is an order of magnitude greater than the underlying
  - now everyone wants to hedge the banks, but who wants to write protection? – with limited supply and rumours fuelling demand, prices go way up, trading is thin and volatile
- Irrationalities: cost of protection against Lehman Bros default rose 15% the day after the Bear Stearns bailout!
- *This is a highly speculative market, with some market manipulation*

The abnormally high CDS spreads are a major problem for the banks...

- ...because new issues have been priced by reference to (hence above) CDS spreads
- At such prices, the markets are effectively closed
- Hedge funds (HFs) ‘playing rough’ – if you buy CDS at 200 bp (say), you would want to make things look worse and drive spreads up further
- Even more opportunities: short the banks while you are driving up CDS spreads

CDS vicious circle



Exacerbated when ratings agencies follow CDS spreads – and CDS spreads follow ratings

CDS markets: policy

- Yes, centralised clearing will significantly help in lowering counterparty risk (but how many ‘central’ clearers will there be?)
- Still, that falls far short of the transparency and normalisation of the markets that would come from requiring that they go onto *organised exchanges*
- If specificity of these instruments precludes exchange-trading, then make them more uniform
- But *investment banks will lobby very heavily against* this: both specificity and opacity generate big profits

Marking to market (‘fair value’)

- There may be no market!
- Valuing assets at ‘market value’ in period of financial distress amplifies the balance sheet problems
- And marking to market inhibits re-liquefying of markets, because asset holders will not want to sell at distressed prices if they then have to mark down their entire portfolios to those prices

So another vicious circle

- Banks don't want to sell in illiquid markets (fear having to mark down their entire portfolios), so markets remain illiquid
- HFs sell at distressed prices, banks must mark books lower, tighten credit, so HFs must sell more
- Long-term investors don't buy because they believe prices will fall still further
- Many assets valued w.r.t. credit derivative prices (*e.g.*, ABX index), which are highly volatile and appear to overestimate probabilities of default (*e.g.*, CDS spreads)

The 1982 debt crisis marked to market

- The 9 New York money center banks had aggregate exposure to LA sovereign debt of around 250% of their equity capital
- If the banks had 'marked to market' those assets when Brazil, Mexico *et al.* stopped paying, they would have been 'under water' (assuming that a market valuation would not have exceeded 60 cents/$)

Marking to market: policy

- First, note that ‘fair-value accounting’ was introduced only recently by SEC (mid-1990s)
- ‘It is clear that suspending fair-value accounting...would do more to reduce confidence...than any short-term relief it might bring...But there are legitimate issues...regarding how to value assets when markets are illiquid...IASB has established an expert panel...’ (Remolona)
- ...which will report in due course. Meanwhile... – at least limit it to assets on trading book, exclude buy-and-hold assets

The third dysfunctionality: the (dis)credit(ed) ratings agencies

- Natural monopoly characteristics are enhanced by dependence of regulators on ratings – ‘regulatory license’
- Conflicts of interest
- Models are suspect
- Ratings are lagging indicators
- CRAs may not add value (Levich et al. 2002)

CRAs: policy

- ‘Regulators have ***begun to investigate*** [RP] the ways in which ratings are sometimes “hard-wired” into regulatory and supervisory frameworks.’ (Remolona)
- We need better management of conflicts of interest ‘in line with IOSCO Code of Conduct.’ (Remolona)
- But the 2005 version was fully implemented (see AMF report January 2007) – with zero effect
- Self-regulation will accomplish nothing

So how to deal with the CRAs?

- Incentive issues – a classic mechanism design problem
- Normally public goods should have public funding – but not here
- Revive subscription (pre-1975) – perhaps a levy on users
- Require agencies to provide more information or judgment – assess liquidity characteristics of instrument, likely volatility of market price, provide a range rather than a point estimate
- Separate rating from advisory/consultative
- *Eliminate 'regulatory license'*

Conclusions

- ‘All crises are the same…All crises are different.’

  R. Portes, ‘An Analysis of Financial Crisis: Lessons for the International Financial System’, pp. 471-478 of W. C. Hunter, *et al.*, eds., *The Asian Financial Crisis: Origins, Implications, and Solutions*, 1999)

- It’s Bastille Day…