The End of An Illusion: The Global Credit Crunch and Liquidity Meltdown

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The Crisis: what do we know

- Over $1.6 trillion losses related to subprime (only in the USA)
- Trillions of dollars offered to the markets by the central banks
- Structural, cross-border banking collapses: Northern Rock, Fannie and Freddie, AIG, Lehman Brothers, Bradford and Bingley…
- People lose homes and jobs (6 million are expected to lose their home in the next 2 years in the USA)

The crisis is a result of:

North Atlantic credit boom (2002-2007)

Banks did not know what they were buying

US needed to finance its deficits and spending

Asian savings/liquidity glut

Crisis and the Illusion of Liquidity

- The Crisis is the outcome of a grand illusion of liquidity
- Deregulated credit
- Ponzi finance (subprime, securitisation)
- Private financial innovation and artificial liquidity (progressively illiquid financial system)

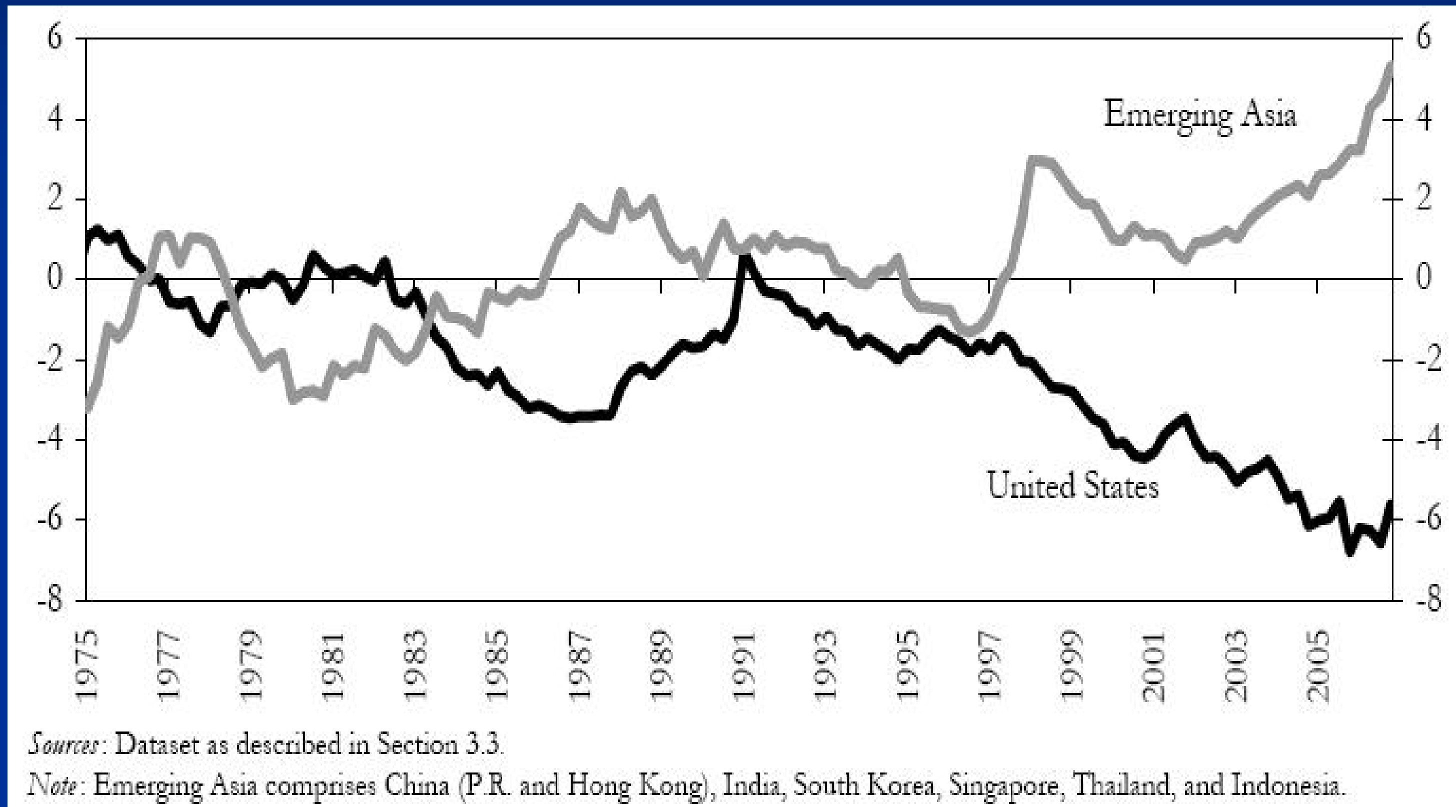
2002-2007

2005: Bernanke observes an anomaly:

"a remarkable reversal in the flows of credit to developing and emerging-market economies, a shift that has transformed those economies from borrowers on international capital markets to large net lenders."

"Statistical discrepancy" in CA imbalances: $137bn in 2006 ($41bn in 1996)

CA imbalances (% of GDP), 1975-2006



Sources: Dataset as described in Section 3.3.

Note: Emerging Asia comprises China (P.R. and Hong Kong), India, South Korea, Singapore, Thailand, and Indonesia.

Capital inflows support securitisation:

"The development of a broad-based secondary market for mortgage loans … greatly expanded consumer access to credit. By reducing the risk of making long-term, fixed-rate loans and ensuring liquidity for mortgage lenders, the secondary market helped stimulate widespread competition in the mortgage business"

(Greenspan, 2005).

Good times and abundant liquidity

"conditions in the major financial markets remained calm and accommodative for much of 2005 and early 2006, reflecting the surprisingly strong performance of the world economy and still abundant liquidity"

(BIS, 2006 Annual Report: 98).

Meanwhile…

Inefficient financial systems in Asian economies

BIS: Hong Kong, India and South Korea: only 1% of housing loans are securitized, while in Japan and Malaysia, the ratio is between 5 and 6 % (USA = 68%).

“a liquidity glut is militating against Asia's capacity to generate an adequate supply of financial assets that will allow it to keep its savings at home” (Mukherejee 2007).

An explanation:

"benign financial market environment, low long-term interest rates, low risk aversion, the hunt for yield, and the perceived abundance of global liquidity, all of which prevailed at least until the turmoil episode that hit global financial markets during the summer of 2007"

(Bracke and Fidora, ECB 2008: 5).

?

How come global abundant liquidity turned into liquidity crunch overnight?

Why are banks reluctant to lend to each other?

Theories of excess liquidity ignore the systemic effects of financial innovation.

Crisis is the outcome of liquidity illusion.

Liquidity: the elephant in the dark room

Liquidity is a quality, a quantity, and probability

Liquidity during ‘good times’ is not the same as liquidity during stress

Liquidity for ‘one’ is not the same as liquidity for ‘the system’

Bid-Ask: ‘Liquidity is the turnover and confidence in the market’

Post-1971 Financial System

"…in almost all cases, additional liquidity is created through secondary markets in financial instruments. With derivatives markets being able to satisfy private liquidity demands even in the face of possible losses on cash positions, there is little incentive for capital to flow out of cash positions and into productive investments"

(Watson 1999: 67).

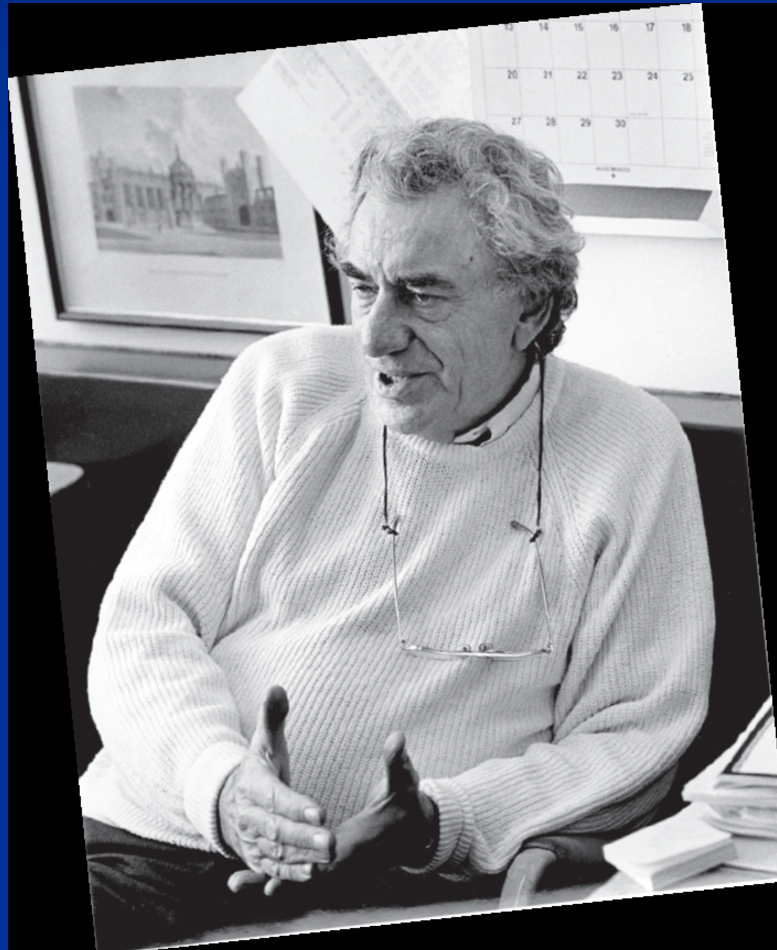
Schools of thought

- 1980s onwards: liquidity is the realm of private markets
- Mathematical studies of financial risk
- Control over liquidity has moved away from central banks in the UK and the USA
- Vanishing liquidity 2007-200?

Liquidity and Financial Fragility

- Keynes (1936) liquidity fetish, the paradox of liquidity
- Warburton (2000): debt delusion
- Borio (2000): artificial liquidity
- Persaud (e.g., 2007): liquidity black holes

Hyman Minsky (1919-1996)



Sustaining the liquidity illusion

- Ponzi finance (debt)
- The market's faith that innovation will be rewarded (liquidity as a state of mind)
- Structure of authority (CRA)

- Financial innovation and deregulated credit system

Ponzi finance and 'sub-Crime'

Subprime industry was a massive fraud

Originate and distribute model: selling the risks off, the bank has no incentive to analyse the credit risk

Loans to NINJAs were justified only by rising house values

The conditions of sub-prime mortgages made them a Ponzi pyramid:

'Teaser' rates lasted for 2 years and were re-set at 6% above the market rate, with no opportunity to get out

400 people have been charged with mortgage fraud

How come toxic waste was traded ?

'Creating' Liquidity

'Securitization disperses the risk and enhances liquidity'

'Liquidity' was supported by ever-growing demand for new assets (Europe, Asia)

Herd behaviour, collective confidence were key to sustaining the sense of liquidity:

"The possibility that liquidity could suddenly dry up was always a topic high on our list but we could only see more liquidity coming into the market – not going out of it" (*The Economist*, 9 August 2008: 68).

Making bad debts liquid:

Credit rating agencies =>

Financial Innovation (creative accounting)

Synthetic finance (layers securitisation structures)

From junk to AAA?

- Marketability of debt => isolate the credit risk of the assets from the credit risk of the entity that originated the assets.
- "True sale" (Northern Rock and Granite, Jersey-based SPV)
- Monthly payments from the homeowners would go to the SPV.
- The SPV would finance itself by selling bonds
- Once the assets have been isolated from the insolvency risk of the originator, there was no additional credit risk analysis required on the purchaser.

Risk analysis by the credit agency

- CRA: Not evaluating the subprime mortgages, but the *bonds issued* by the SPV.
- Layering the tranches of structured assets: super-senior; mezzanine and equity tranche.
- The highest-rated bonds would have priority on the cash received from mortgage holders until they were fully paid, then the next tier of bonds, then the next and so on.

How was the illusion sustained?

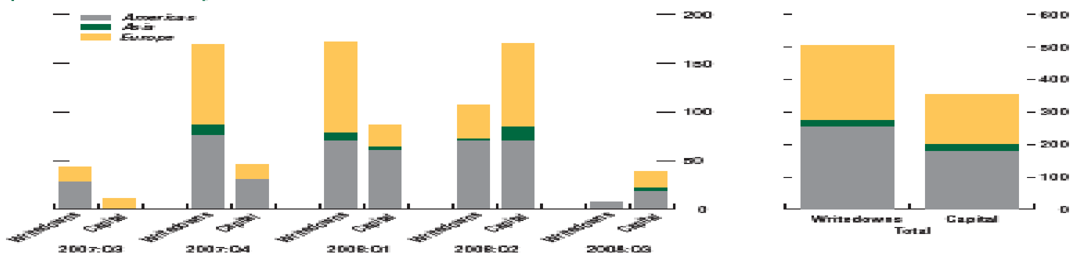
- Incompetence (not specific to the 21st century)
  - Anglo-Saxon banks turn out to be particular greedy, while Spanish or Japanese are somewhat less so.
- Political gains from the housing boom and financialisation
- Whistleblowers were dismissed
- "Financial innovation promotes efficiency and enhances liquidity"

Time to Pay Up

June 2008: of the $387bn in credit losses that global banks have reported since the start of 2007, $200bn was suffered by European banking groups and 'only' $166bn by US banks (Tett 2008).

Banks got the worst share of the deal

Global Bank Writedowns and Capital Raised
(In billions of U.S. dollars)



Source: Bloomberg L.P.

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Emerging orthodoxy on the crisis:

- US-centred phenomenon externalised to Europe and the world (Gordon Brown)
- Subprime industry ('managerial failure of control')
- Securitisation (mis-pricing of risks, lack of oversight)
- Failure of soft-touch financial regulation (Europe)
- Fault of Asian savers and their liquidity supplies to Western economies (Martin Wolf 2008; the Fed)

Restoring Liquidity: an Atlantic divide?

2008: Europeans subsidised US deficits to bear higher costs

Will Europe learn a lesson?

Two phases in crisis management

9 August 2007-9 October 2008: *ad hoc* approach to market turmoil; some coordination attempts between the Atlantic regulators (swaps, interest rates cuts). Some noises about better regulation. Overall: belief that the crisis is the 'correction' of the market.

9 October 2008: nationalisation of the banking systems; re-installing the presence of the state in private finance; enhancing capital bases of the banks.

March 2008

- US Treasury Blueprint for a new financial regulation.
- New, better informed institution to manage the market.
- "The methods of the market were correct, assumptions were wrong."
- Managerial and operational failure, not systemic, structural or ideological.
- Problems centred (and were confined) in the mortgage market.
- The FSA model as an example.

March 2008: Charlie McGreevy, European Roadmap

- Leverage
- Incompetence and ineptness of supervisors
- Fiasco of credit ratings agencies
- Overhaul of the system
- Transparency, incentives and better knowledge (higher pay)
- Clearing platforms for OTC derivatives
- Licence and regulate the CRAs
- EU to take the lead in international architecture

October 2008: Brown-Darling plan

Cash support in exchange for equity stake in banks

Governmental guarantees on privately issued paper

Make banks lend to each other and the rest of the economy

Restore lending to the 2007 level (peak of the bubble)

Recapitalisation (restoring the quality of credit and capital, de-leveraging (getting out of debt).

Lessons: greed and exuberance of the bankers.

15 November 2008: Bretton Woods 2?

Merkel and Sarkozy: "genuine, all-encompassing reform of the international financial system".

European Council: as "take early decisions on transparency, global standards of regulation, cross-border supervision and crisis management, to avoid conflicts of interest and to create an early warning system, so as to engender confidence among savers and investors in every country."

Bush: "leaders will review progress being made to address the current financial crisis, advance a common understanding of its causes, and, in order to avoid a repetition, agree on a common set of principles for reform of the regulatory and institutional regimes for the world's financial sector".

Brown: Transparency (internationally agreed accounting standards, credit insurance market standards), integrity (credit agencies, executive pay), responsibility (board member competency and expertise), sound banking practice (protecting against speculative bubbles).

New Bretton Woods: an effective global early warning system for risk prevention, globally accepted standards to supervise cross-border capital flows and the activities of global firms, plus stronger institutions for cooperative action in crises.

Problems with the approach

Recreating the conditions of the bubble.

Understanding 'liquidity' as confidence.

Lesson: bankers' greed and lack of oversight.

Not political environment or regulatory regime or the finance/real disjuncture.

International coordination (national priorities, inter-agency conflicts and many unknowns).

A New Financial Architecture?

Unique window
Basle process (liquidity risks and capital requirements)
Clearing platforms for OTC products
Critique of securitization and CRAs

BUT

International coordination (global problem, national solution).
Coordination within the EU (no crisis manager).
Reliance on cash from BRICS.
Commodity bubbles.
Finance is a cycle, it did happen before.
Aiming to restore ‘normal’ times?

As we speak…

Isle of Man Icelandic bank is demanding cash from the UK government.

No regulator or supervisor has resigned.

Markets still believe in securitization (shorters have been key to putting the prices to a new equilibrium)

Economics is still busy modelling markets and equilibriums

Very few recognise that 2003-2007 was one grand illusion of wealth and liquidity

Banks are reluctant to accept national bailouts

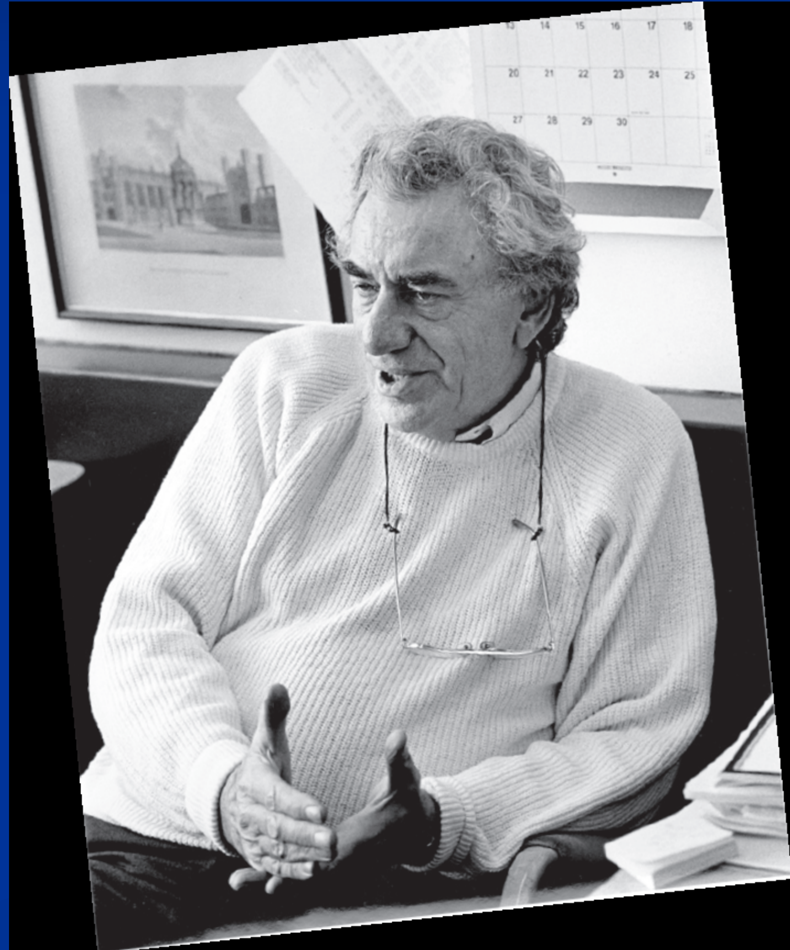
Few are questioning the nature of the preceding boom (debt; liquidity, private sector approach)

Divergence between the EU and the Fed

It takes a hedge fund manager two hours to design a product that circumvents any new regulation.

Can IT happen again?

Yes.



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