Financial Crises Management: Lessons from and for the US

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Preamble

- We are facing the most severe financial crisis since the Great Depression
- It will certainly be the topic of research for a generation of economists
- It is very audacious to try to summarize any lesson at this point.
  - Hindsight is 20/20
- Be aware that the next crisis will be different because the market learns from the previous mistakes (at least for a while).

Outline

1. Mistakes that lead to the crisis
   - Structural
   - Contingent
2. Problems in managing the crisis
   - Consistency
   - How vested interest can influence the agenda
   - Rule of law and breaching of contracts
   - Need for a resolution mechanism
   - Illiquidity vs. insolvency
   - Effects of mark-to-market
3. How to avoid a future crisis
   - New capital regulation

1a) Structural mistakes

1) The Rubin doctrine
   - From Mexico 94 to LTCM to post internet bubble, the continuous rescue lead to an excess complacency among lenders
2) The wrong monetary policy - inflation
   - Housing cost not properly accounted in measure of inflation
   - No risk of deflation in 02-04 with house prices raising in double digit
3) The wrong monetary policy – bubbles
   - Not all the bubbles equal. A bubble affecting the banking system much more dangerous
4) Lack of supervision on lending standards

1b) Contingent Mistakes

- Crisis moved in slow motion from February 07 to August 08.
- Lack of understanding of interconnections in the system
  - Exposure in the CDS market
  - Short term debt exposure
  - Liquidity dependent vehicles
    - Repo market
    - ABCP
    - SIV
    - Auction rate securities
- Lack of understanding of the dependence of the banking system from the market
  - Mark-to-market
  - Liquidity

What Could Have Been Done?

- Most of these problems should have been addressed before the crisis not during it.

1. Forcing a centralized clearing and transparency of the derivative liabilities
2. Introducing some of the liquidity enhancing facilities earlier
3. Decoupling regulation from mark-to-market accounting

2) Problems in managing the crisis

a. Consistency

b. How vested interest can influence the agenda

c. Rule of law and breaching of contracts

d. Need of a resolution mechanism

e. Illiquidity vs. insolvency

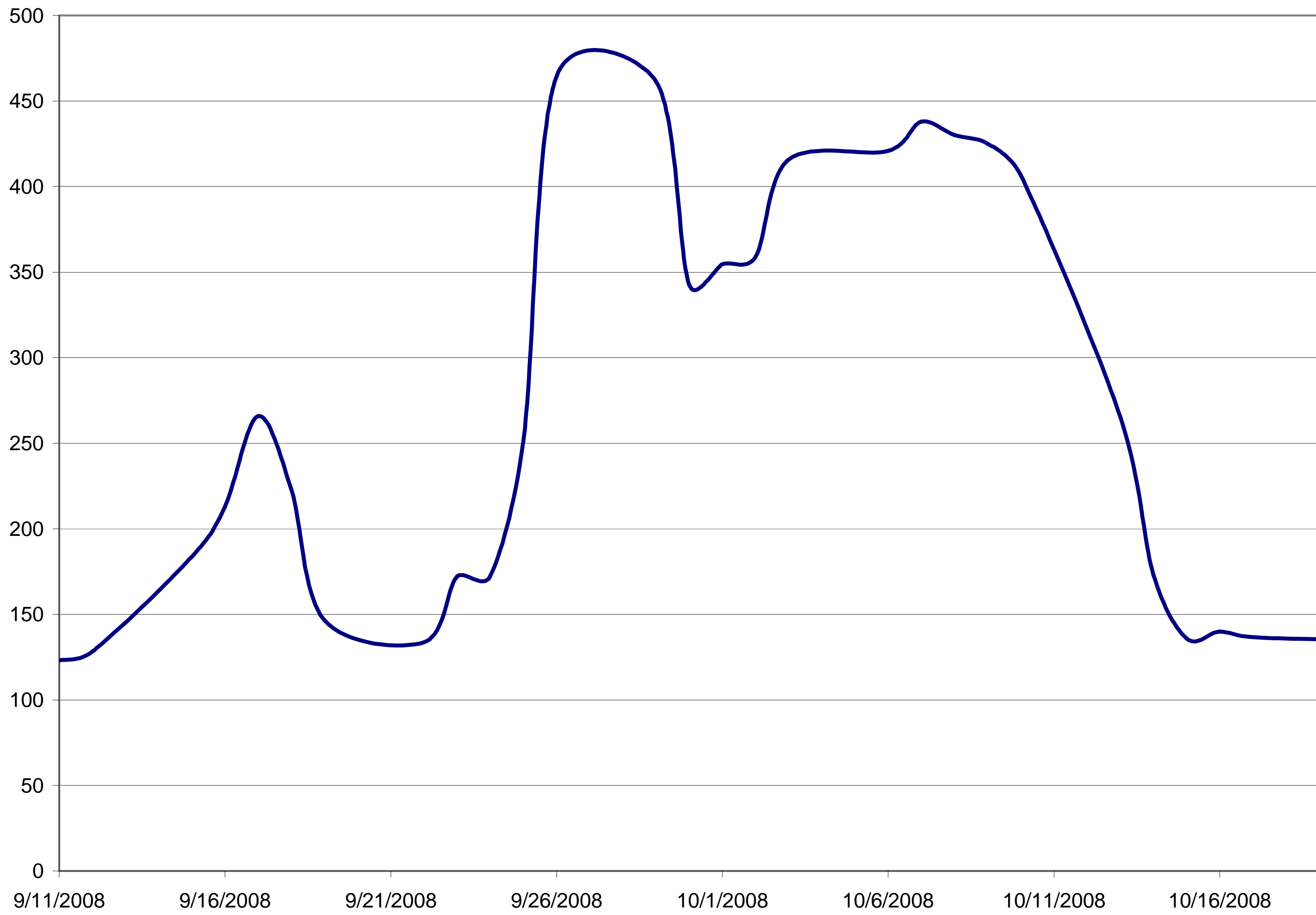
f. Effects of mark-to-markets

2a) Lack of consistency

- Save Bear Stearns, Fannie and Freddie
- Let Lehman and Wa Mu go under
- Save AIG, Citigroup, BoA.
- David Swensen:

"the government has done it with an *extreme* degree of inconsistency. You almost have to be trying to do things in an incoherent and inconsistent way to end up with the huge range of ways they have come up with to address these problems."

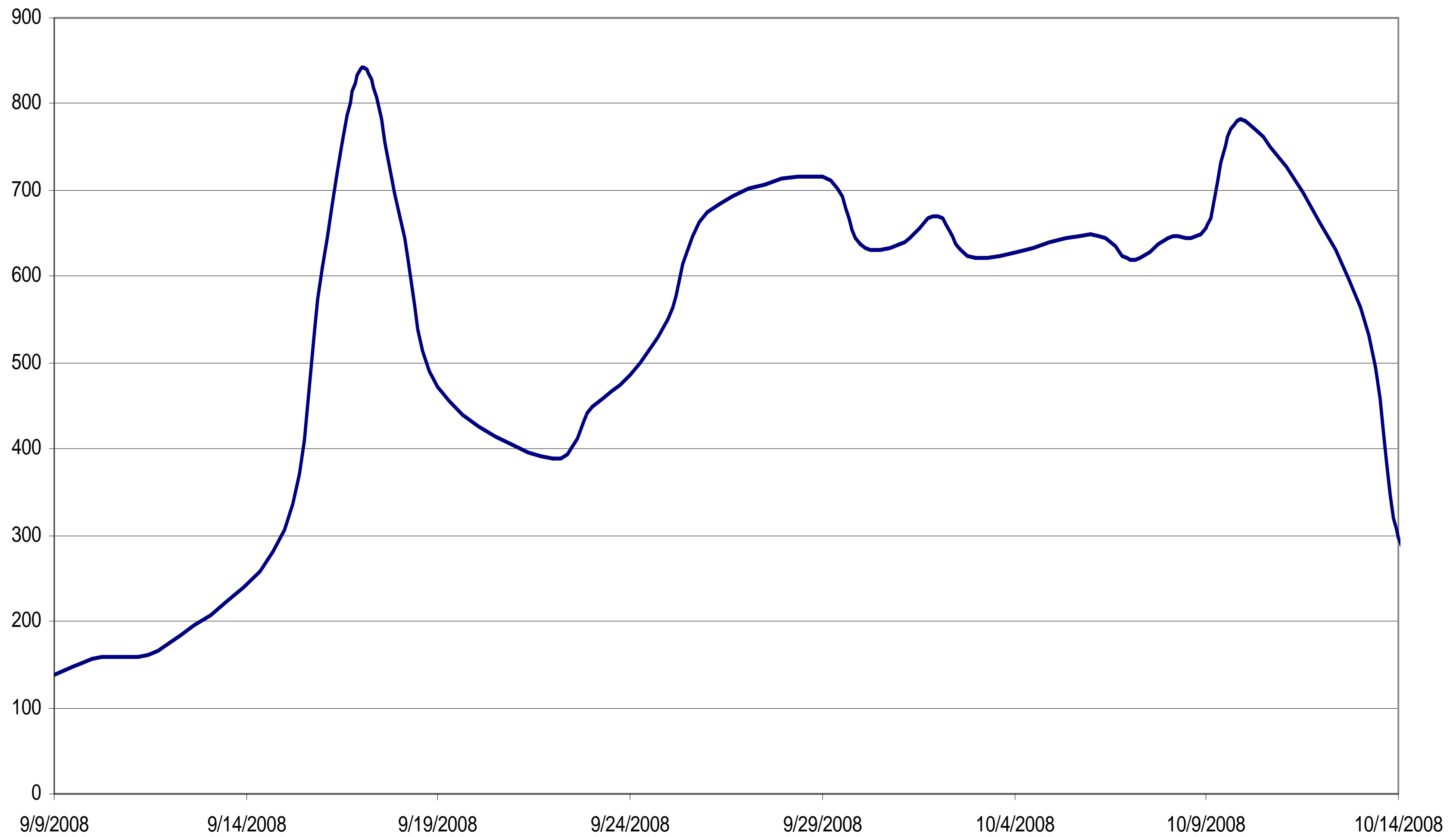
Citi CDS in Sept.09



2b) Vested Interest

- Majority of Americans favors housing reliefs but against bank reliefs
  – Why we got the second but not the first?
- Asset purchased was favored by the industry
  – Swagel declarations
- Nuclear option pulled when Goldman Sachs became at risk
  – Appearance of a conflict of interest is as bad as the conflict of interest itself

Goldman CDS in Sept.09



Need for a Principled Based Approach

- Without a theoretical framework of reference -> lobbying pressure irresistible

=> Need for a principled-based approach

- What are these principles?

1) Identify market failure
2) Minimize intervention to fix failures
3) Minimize taxpayers' cost

2c) Rule of law and breaching of contracts

- Important to preserve rule of law but
  - Why does it apply to executives but not to union contracts?
  - Why does it apply to the bondholders of Citigroup but not to those of GM?
- Reason why you want to respect contracts is because you do not want to adversely affect expectations
  - What about CDS contracts?

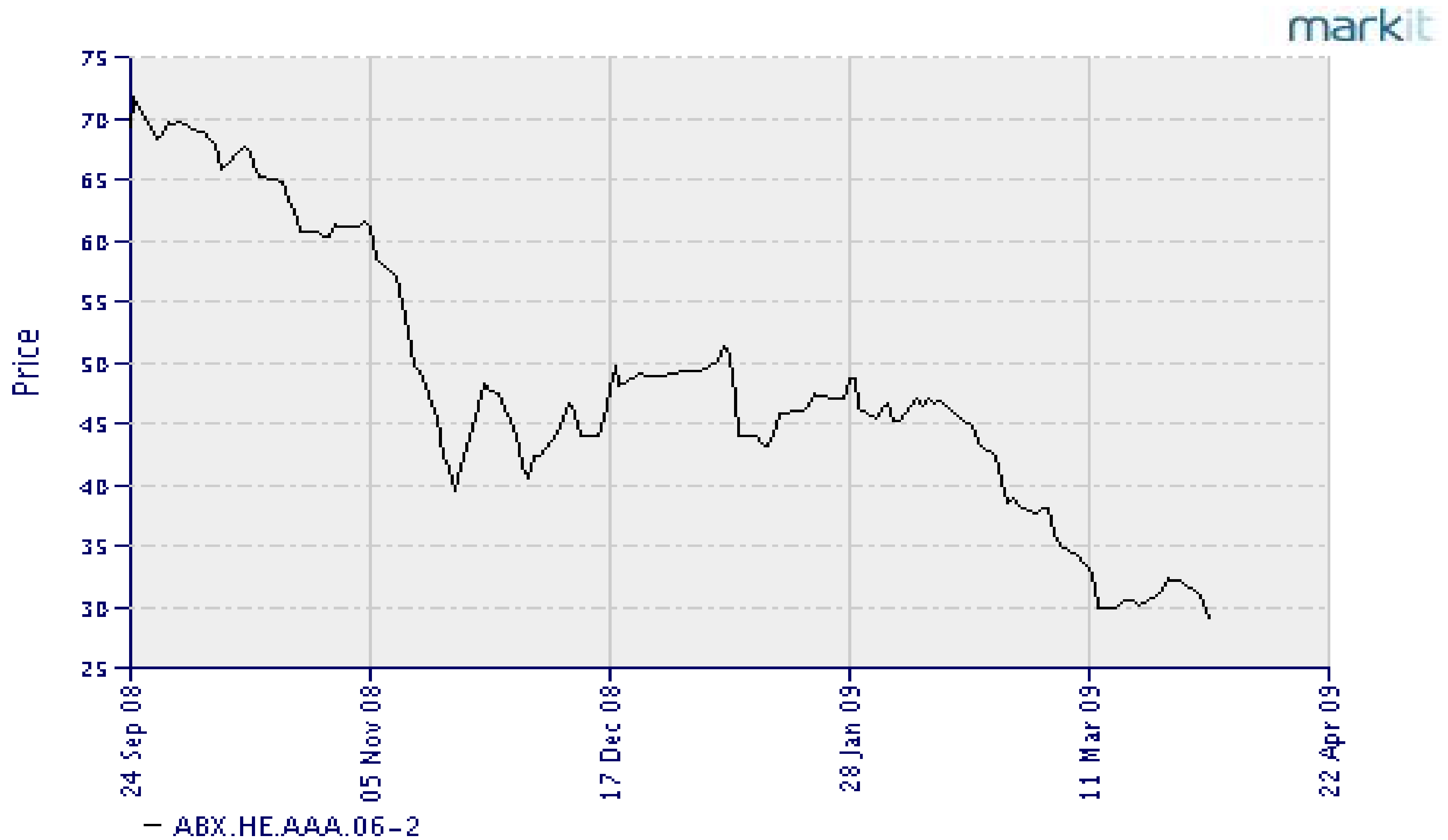
2d) Need for a resolution mechanism

- Lobby to save every institution strengthened by the lack of a credible way to take over these institutions and manage the process
- Chapter 11 invented to minimize the disruption of bankruptcy for industrial companies
- We need a similar process for financial companies

2e) Illiquidity vs. insolvency

- No borrowers have ever admitted to be insolvent, they are all facing a temporary liquidity crisis.
- Need for some ways to separate the two
  - Term structure of CDS can help
  - Develop a timely stress-test mechanism
- How much TARP would have cost us?

ABX Index decline



2f) Effects of Mark-to-Market

- Inconsistency in application
  - Models different across companies and not disclosed
  - Commercial banks have a majority held to maturity
- Regulation tied to accounting -> pressure to hide losses
- Rating tied to accounting

3.How to avoid a future crisis

- If large financial institutions (LFIs) are too big to fail, we need a mechanism that performs the same functions as bankruptcy but without the systemic drawbacks.
- Bankruptcy
  - facilitates the efficient choice to be made between reorganization and liquidation;
  - penalizes incumbent management and shareholders;
  - resolves conflicting claims.
- Hart and Zingales (2009) designs such mechanism

Intuition

- It mimics the way margin calls function.
- LFIs will post enough collateral (equity) to ensure that the debt is paid w. p. 1.
- When the fluctuation in the value of the underlying assets puts debt at risk, LFI equityholders are faced with a margin call
  - they must either inject new capital
  - or lose their equity in the bank.

Intuition -2

- 2 differences with the margin calls:

1) Trigger mechanism: based on the CDS price
2) Resolution mechanism: If equity is not issued, regulator verifies the value of the firm and
   - If debt is not at risk, he infuse some funds in the form of pari passu debt
   - If debt is at risk, he fires the manager and appoint a receiver who imposes a haircut on creditors

Resolution Mechanism

- We assumed that the receiver
  - wipes out the initial equity and debt;
  - puts in place a new value-maximizing capital structure that avoids future bankruptcy;
  - sells the LFI expeditiously;
  - distributes the proceeds to former creditors, ensuring that <u>creditors are not fully repaid.</u>
- An alternative would be to have the receiver force a debt for equity swap.
- But more difficult to impose a haircut on creditors.

Does It Help to Avoid Systemic Crisis?

- 3 reasons why an LFI failure has systemic effects:

1) Losses on the credit extended to the insolvent LFI can make other LFIs insolvent.
   - Our mechanism eliminates this problem
2) The failure of an LFI can force assets liquidation leading to downward spiral in assets prices
   - Our mechanism does not force any asset liquidation, thus avoiding a downward spiral in assets prices.
3) LFI failure reduces financial and human resources dedicated to trading certain assets classes.
   - Our mechanism increases the amount of capital invested in the sector, alleviating the shortage which is at the root of many crises.

Conclusions

- Albeit the new crisis will be different, it is important to try to draw lessons from the current one.

1) Need for a theoretical framework to ensure consistency and resistance to lobbying
2) Need for a resolution mechanism to reduce threat power
3) Need for a new capital requirement to prevent a repeat