SOME UNCOMFORTABLE PUZZLES OF THE CREDIT CRUNCH:

Understanding Liquidity Illusion

Anastasia Nesvetailova (City University, London)

DISMISSED: THE WARNING SINGS AND THE WHISTLE-BLOWERS

RBS: chief compliance manager warned about the risks of aggressive strategy in 2005.

The officer was dismissed from his job by Sir Fred Goodwin, then chief executive

Until 28 January 2009 Goodwin served on the Treasury advisory committee with a remit to examine ‘proposals to reduce administrative burdens of regulation.’

British Banks

UK authorities had been informed about a potential crisis back in 2004.

'War games' organised by BoE, the FSA and the Treasury revealed Northern Rock and HBOS as threats to systemic risk.

Regulators chose not to force harsh decisions upon profitable institutions.

USA

Bernie Madoff: In late 2006, Aksia advisory firm warned their clients not to invest with Madoff as Ponzi scheme was suspected

Stanford – suspicious returns and strange accounting firms

Academia/Market

Avinash Persaud, 2002, letter to FT:

"Large banks may [loose considerable amounts] on their syndication of collateralised debt obligations – the next bubble to burst."

Warnings by the BIS and even the IMF.

The work of Minskyans

A thin line between fraud and financial innovation

- Crisis of ‘Ponzi finance,’ ‘casino capitalism’ or ‘fictitious capital’
- Subprime market as a Ponzi scheme
- Individual crooks
- Securitisation as a vehicle to conceal illicit deals and frauds (Goldman Sachs)

So how come it all flourished?

An axiom of financial innovation

By innovating in credit instruments, financial markets not only optimise risk, but enhance liquidity and welfare of the economic system

Manifestation => an illusion of liquidity

Liquidity Illusion

BIS: Liquidity illusion is a state of the market when risks, and particularly liquidity risks, are severely underestimated.

Liquidity illusion is a complex process embedded in the political economy of finance

- Ideas and theories, behaviour, institutional organisation of financial regulation

LIQUIDITY AND THE PARADIGM OF SELF-REGULATING CREDIT

Liquidity has become a functional form of the paradigm self -regulating, efficient finance

Market completion theory: financial innovation is driven by the search of greater liquidity

CREATING LIQUIDITY?

Market completion: by pooling, pricing and transferring a variety of assets into a financial turnover, financial engineers have increased market turnover and in popular visions, liquidity.

By creating securities out of illiquid assets, securitisation enhances liquidity across the financial system as a whole.

But new instruments, while adding to a sense of greater market liquidity, rely on the liquidity of underlying assets .

Keynes' paradox of liquidity: liquidity for one institution does not mean liquidity for the system as a whole.

Minsky:

‘to the extent that either the most liquid assets leave the banking system for the portfolios of other financial institutions or the debts of the newly grown and developed financial institutions enter the portfolios of banks, the liquidity of the banking system declines’ (Minsky 1984: 174).

Private financial innovation in a debt-driven unregulated system makes the economy progressively illiquid

Causes: regulation and innovation

Securitisation was the banking industry's reaction to new regulations (Basel II).

The accord made it unprofitable for banks to hold safe and liquid assets on balance sheets.

Banks responded by originating more debt on the basis of the capacity to shift assets off the balance sheet into the unregulated financial system.

Securitisation is a product of the internal transformation of the financial industry itself (shadow banking and offshore finance)

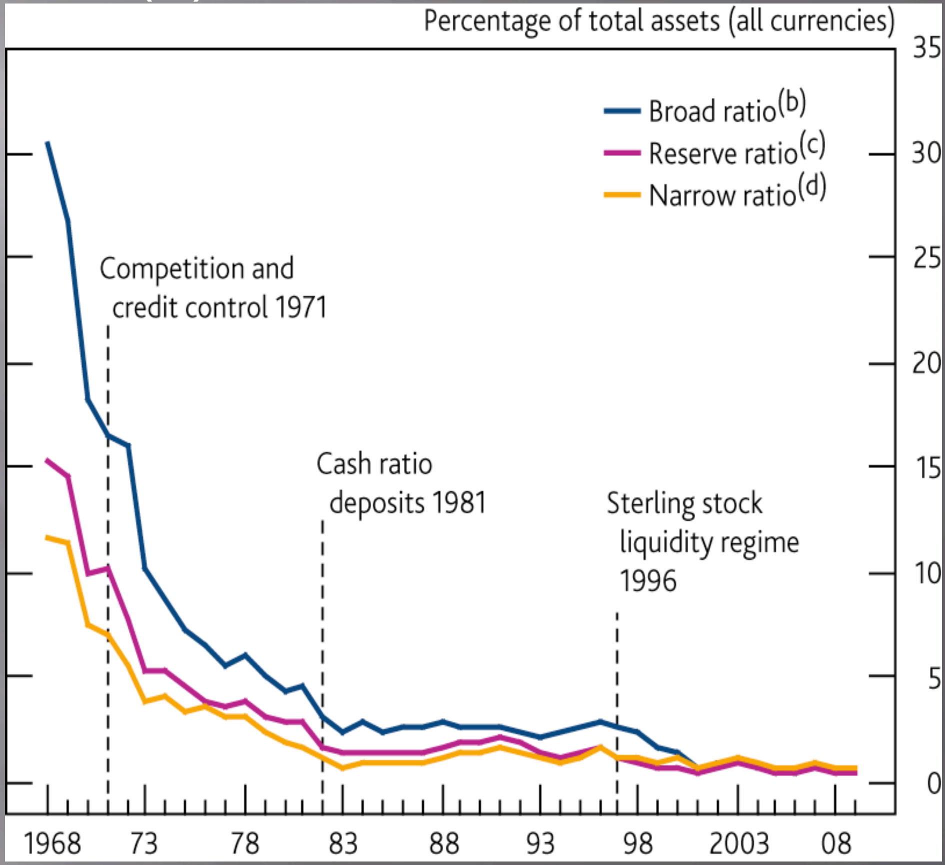
Bank of England, 2006:

While the originate and distribute model 'does not alter the financial sector's aggregate credit exposure to the non-financial sector',

it promises to 'improve systemic stability if risk is held by those with the greatest capacity to absorb losses'

(Bank of England 2006, cited in Langley 2009).

Chart 5.14 Sterling liquid assets relative to total asset holdings of UK banking sector(a)



Source: Bank calculations.

(a) 2008 data are as of end-August 2008.
(b) Cash + Bank of England balances + money at call + eligible bills + UK gilts.
(c) Proxied by: Bank of England balances + money at call + eligible bills.
(d) Cash + Bank of England balances + eligible bills.

SECURITISATION AND SYSTEMIC STABILITY

The illusion of liquidity arises from a linear link between financial innovation and systemic stability

Basel II was built on the assumption that the market was always liquid; regulating liquidity risks was delegated to individual institutions

Liquidity had come to describe the volume and speed of transactions rather than the content of those transactions

How it Worked: The Pillars of Liquidity Illusion

- Theory: The Paradigm of financial innovation and specifically, market completion
- Market mechanism - ‘liquidity as a state of mind’ or ‘appetite for risk’ allowed Ponzi structures to flourish beyond the subprime sector
- Validating bad debts: Credit Rating Agencies