

“Liquidity Risk Triggers: Lessons from 2007”

By Chester S. Spatt
Tepper School of Business
Carnegie Mellon University
(former Chief Economist, SEC)

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Systemic Risk

- Potential for correlated defaults across the economy
- Many hedge fund investors often invest on the same side of a position—e.g., long the ‘credit spread’--common training, expertise and tools
- ‘External Effects’ across investors—recently hedge funds are “blaming” their peers for following similar strategies and the large “price impacts”
- Bearing of risk reflects common incentive structure for the general partner and perhaps past Fed policies when turbulence (“moral hazard”)

Who Holds the Risk?

- Comfort from substitution of risk bearing from banks to hedge funds (example: liquidation of Amaranth)
- Banks and prime brokers as lenders
- Exposures less transparent than when directly held by bank—surprises during the last few months
- Recent difficulties started with high defaults in adjustable rate sub-prime loans, but then moved to better mortgages (e.g., jumbo market)

Opacity: A Source of Systemic Risk

- Who holds the exposures?—Counterparty risk
- Reliable and verifiable prices for illiquid instruments
- Changes in adverse selection and opacity (transparency) drive liquidity changes
- Reluctance to sell instruments with largest losses due to illiquidity, so selling and problems (e.g., LTCM) spill to more liquid assets (problems in prime jumbo loans!) when need to reduce leverage— “credit crunch” and recent actions of the Fed
- Transmission of liquidity problems across markets (including globally)

Credit Ratings as a Source of Systemic Risk

- Scope for mis-valuing an entire asset class rather than individual loan and idiosyncratic risk.
- Many participants relied upon these and so potentially a source of systemic risk

Regulatory Coordination as a Recent Concern

- Hedge funds—global strategies
- Consolidation of platforms, which operate globally
- Systemic risk spills across markets in global economy (e.g., sub-prime turbulence)
- Of course, broader risk sharing is good (compare to “home country” bias)

Systemic Risk and the Regulatory Response

- Multinational financial institutions—Suppose many customers are in one country and the regulatory authority is in another
- Will a bailout occur and who will pay?
- Do “interest rate cuts” bail out those who followed very risky strategies?
- Globalization, regulatory coordination and systemic risk--Sub-prime turbulence illustrates that problems not confined to individual countries

Regulatory Arbitrage

- Regulations oriented to specific types of markets or investors
- For example, suppose cash markets are more heavily regulated than OTC derivatives markets and that mutual funds are more heavily regulated than hedge funds
- Introduction of regulations perceived as burdensome can lead to changes in the form of transactions towards less regulated markets and/or investors
- Challenge to the “old” models of regulation—importance of regulatory competition—Does it matter where an instrument trades?
- Channeling transactions to hedge funds reduces transparency of risk bearing, which can heighten systemic risk