Do Global Banks Spread Global Imbalances? The Case of Asset-Backed Commercial Paper During the Financial Crisis of 2007-09

Viral V. Acharya and Philipp Schnabl

Discussion

Clara Vega

Board of Governors

Summary of the Paper

- ABCP conduits ($1.2 trillion in June 2007) were used by global banks to manufacture “riskless debt” by purchasing US medium-term asset backed securities using short-term debt and a bank-sponsored backup line of credit
  - Ormond Quay bought $11.4 billion of U.S. asset backed securities by issuing short-term asset backed commercial paper.
  - Ormond Quay had little equity ($36 million), but had a credit guarantee provided by Sachen Landesbank (large German state own banks), i.e. Landesbank pays off maturing asset-backed commercial paper if Ormond Quay cannot. Ormond’s cp is safe because it is backed by assets and because of the bank guarantee. US mutual funds buy Ormond Quay CP.
  - Ormond Quay is a credit arbitrage conduit: receive high (long term) interest rates from US mortgage payers, pay low (short term) interest rates to US mutual funds

Summary of the Paper

- ABCP conduits were sponsored by both current account surplus (Germany, Japan, and the Netherlands) and deficit countries (US and UK), but were more prevalent in countries with weaker capital requirements for backup lines of credit
- Banks with more ABCP exposure had more negative equity returns during August 2007
- Banks in “weakly” regulated financial systems had more ABCP exposure: Germany and US vs Spain

- Conclusion:
  - Decreasing global imbalances is not as important as
  - Decreasing propensity of global banking sector to manufacture tail risk (i.e. increase capital requirements or not distinguish between credit enhancement and liquidity enhancement)
  - Improve regulation of financial institutions

Comment 1

- Based on the evidence the paper presents, one cannot conclude that decreasing global imbalances is not as important as improving financial regulation
- My interpretation of the global imbalances literature is the stress on:
  - Money flows in the “wrong” direction from high productivity countries to low productivity countries. From China to the U.S., not from Germany to the US.
  - Artificially low interest rates in developed economies
  - Abundant liquidity → financial engineering
  - Today’s global imbalances may still have been the main driver of the financial crisis

Comment 1 (continued)

- Global imbalance literature predicts that financial engineering occurs in low productivity country, i.e., the US:
  - Predominantly U.S. assets backed the commercial paper of foreign banks
  - U.S. mutual funds bought the commercial paper
  - Foreign banks had a subsidiary in the U.S.
  - Foreign bank in surplus country further provided liquidity

Comment 2

- Important to understand what caused the financial crisis, why did it spread so quickly, how to stop the crisis, and how to prevent future crisis
- This paper makes a sensible suggestion:
  - New capital standards (Yes), what is the right leverage ratio, 8%? Effect on capacity to lend?
- Need a more thorough panel study to understand the crisis better, why did banks take on tail risk? Horse race of explanations
  - Agency problems?
  - Government guarantees?
  - Capital requirements?

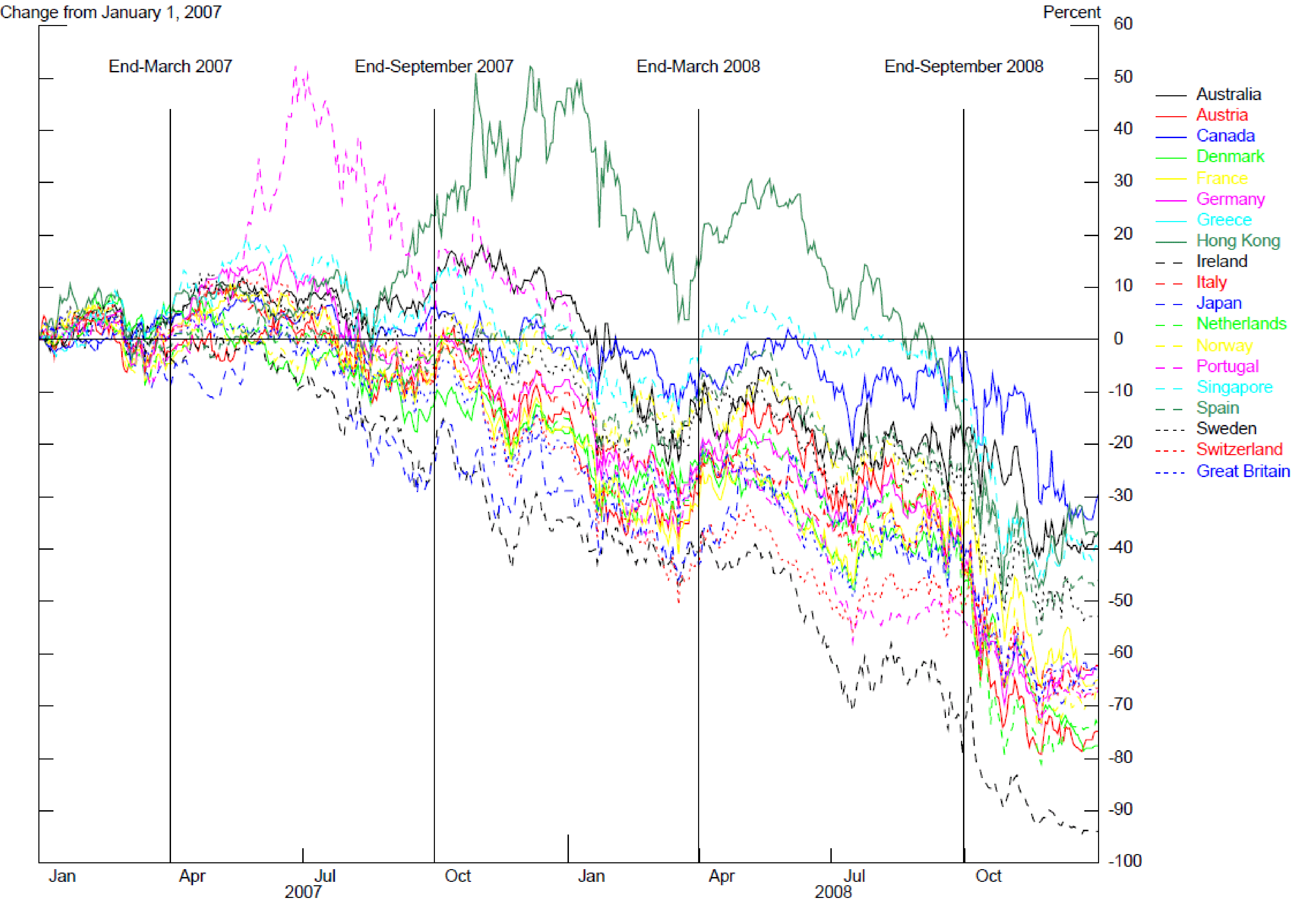
More Broadly

- Current debate, need more research to understand cost/benefits
  - Regulation of hedge funds (?)
  - Restrictions on trading (?)
  - Bank levies to fund future bailouts (?)
  - Tax bank profits (?)
  - Reform credit rating agencies (Yes)
  - Government deficits (Greece) (?)
  - Limit leverage of systematically important financial institutions to not exceed the fiscal capacities of their host governments (Iceland) (Yes)
  - Bank stress tests helped to identify ailing banks and end hoarding of cash. Is this what Europe needs now?

Comment 2 (continued)

- Banks who had direct exposure to U.S. mortgage-backed securities (MBS) experienced a greater degree of financial distress during the crisis
- But not the whole story

Bank Stocks by Nation*

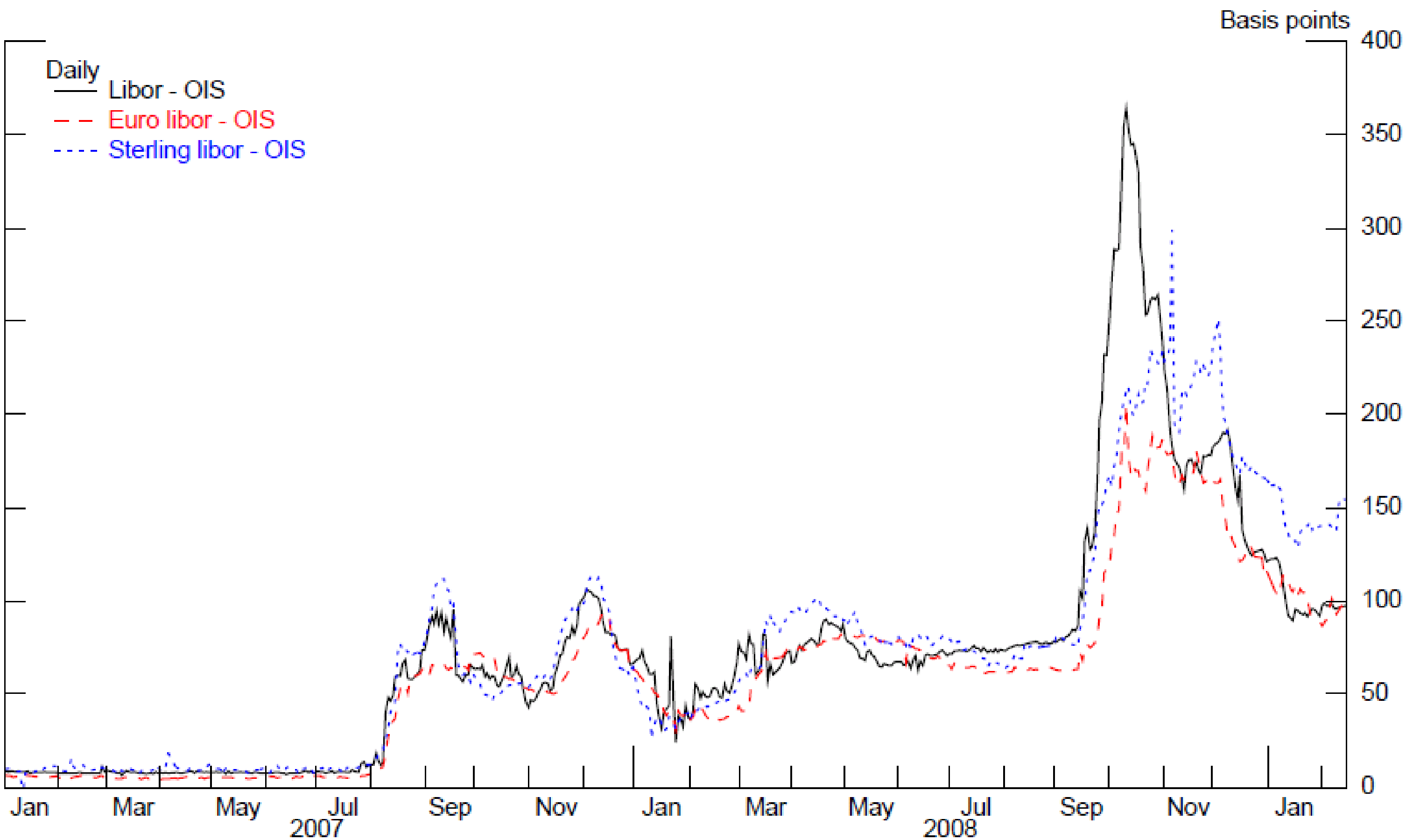


*Individual bank premia weighted by total assets

Comment 2 (continued)

- What about high dependence on short-term lending? And foreign demand for dollar funding?

Spread of LIBOR over OIS (3-Month) Interest Rates



Summary

- Global imbalances played an important role in the crisis
- Global universal banks did spread the crisis
- Banks took systematic bad tail risk
- We need more research to understand why and how to stop/prevent future crisis