“Liquidity Crisis, Runs, and Securitiy Design: Lessons Learned from the Collapse of the Municipal Auction Rate Bond Market”

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Disclaimer

- The views herein are those of the author and do not necessarily reflect the views of the any government agencies, including the Fed, DOJ, SEC, IRS, or CFTC, and do not necessarily reflect the views of the officials of those agencies.

A Long Time Ago – February 2008

- Bear Stearns
- Fannie Mae and Freddie Mac
- Lehman
- Merrill Lynch
- AIG
- What today? WaMu? Morgan Stanley?

Ongoing Liquidity Crisis

- Banks balance sheets are stressed, implying pressure to deleverage.
  - Bank borrowing spreads much higher than in distant past (CDS spreads)
  - Banks do not want to get stuck with inventories of bonds they cannot easily sell
- Financial weakness at monoline insurers, such as Ambac, MBIA, etc.
  - Lowers credit quality of MARS insured by monolines
  - Banks should raise capital charges on MARS inventory, as banks increase Basel II capital charges for monoline exposure.

Two Intersecting Stories

- Panic by Retail Investors
  - If auctions start failing, then investors run.
  - Stresses banks balance sheets more, since inventory will wind up with lead manager banks.
  - Banks see more selling, so let auctions fail.
- Economics of Bank Reputation
  - Banks do not want to be first to let auctions fail, due to loss of reputation.
  - When other banks move first, relative cost to reputation diminishes.
  - What is “duration” of bank reputation in today’s markets?

Two Stories Amplify Each Other

- Panic by retail investors increases the cost (stress on bank balance sheets) of absorbing more inventory.
- Potential costs of reputation are lower if banks believe that their own “franchise value” is diminished due to ongoing crisis and other banks are behaving in the same manner.

Insights from Theory

- Equilibrium is very fragile: multiple equilibria from auction theory
  - If multiple equilibria, what does this mean?
    - Bad model
    - Or implications for empirical work?
  - Paper suggests fragility implies auction outcomes could easily change from low rate to high rate outcomes, depending on coordination mechanism for choosing among multiple equilibria.
  - This further amplifies two previous intersecting stories.

Key Empirical Fact Documented by Paper

- Auction failures occurred all of a sudden.
  – Once failures started, quickly spread to issues backed by multiple banks.
- Paper is mostly very useful descriptive empirical work.
- But descriptions of events are consistent with related theories.

Suggestion for Exposition of Empirical Facts

- Make paper more accessible to non-academic audience
- Logistic regressions are somewhat confusing
- Better to do explain apparent story with more detailed sorts of auction rate failures, sorted by: lead manager, maximum rate buckets, credit quality.
  - Maximum rate as spread over “appropriate” rate based on underlying credit quality and quality of bond insurance.

Are ARS a Good Idea?

- Depends on costs lead managers incur in supporting market
  - Costs seem low in stable credit markets.
  - Costs blow up when overall system liquidity is stressed.
  - Banks routinely underestimate costs of liquidity at times of stress.
  - ARS provide an illusion of liquidity
    - The illusion disappears at times of stress

Implicit Support and Basel II

- Implicit support = support not based on contractual obligation
- Basel II discourages implicit support for securitizations
  – Clean line between bank balance sheet and securitizations
- But ARS are not exactly securitizations
- Should implicit support for ARS also be similarly discouraged by requiring capital charges for liquidity backstop provided by lead managers, even in states where support of auctions is not needed ex post?
  – Treat ARS as a repo provided by lead managers where repo creditor is investor in ARS?
  – But lead manger treated as if it owns the collateral?
- At a minimum, need a clear line between what is on and off leading banks balance sheets.

Recent ARS Settlements

- Recent settlements with NY suggest that non-contractual support should be treated as if it is contractual.
- Therefore two alternatives going forward:
  - Banks commit not to support auctions, and do not support them in fact.
  - Banks commit to support auctions, and do so.