Comments on "The financial Turmoil of 2007-?: a preliminary assessment and some policy considerations" and " Central bank operations in response to the financial turmoil"

Stephen R. Ganns[1]

Introduction

It is indeed a pleasure to comment on and lend various points of view to this pair of inter-related writings by Caludio Borio and the CGFS Study Group chaired by Francesco Papadia. It would be impossible to begin without pointing out the elegant sense of clarity and incisiveness that the papers and their commentaries exhibit.

The conditions relating to "innovative" credit risk transfer driven illiquidity and the consequent pro-cyclical turmoil which has ensued, are covered nicely in BIS papers. Prudence however, dictates that some amplification of underlying evolutionary processes from not only an objective point of view, but also one that is subjective and visceral be examined.

My comments deal briefly with three aspects of the current situation, namely:

- Super anti-efficient markets
- Prudential regulation and free market economies
- Consequence and moral hazard

As a note, these comments are derived from one overarching premise, viz. goal, for any international financial system. From a wide view, this might be postulated as: providing efficient coordination amongst Central Banks toward the goal of global financial prosperity—a prosperity which prima fascia includes both sovereign states and importantly, individuals. The charge is significant in its purpose and unwieldy in its potential execution. It should however, be applicable to all developed economies, those in different stages of emergence, as well as to its individuals both stable and displaced.

In its essence, such a system would be as a working entity, functioning in an holistic fashion and based on inter-dependencies and relationships within and through its component parts—a financial universe operating with the precision of a Bach fugue, with one set of actions having much to do with the others.

The systemic disconnection, which had insidiously formed over the last two decades or so—and then accelerated—has finally achieved fusion at its core. As the true consequential nature unfolds and can be quantified, proactive opportunities will exist, if seized upon, to create policies that will have the capability of mitigating additional occurrences of threat to global prosperity.

With this in mind, I offer the following comments.

Super Anti-efficiency

"Markets can remain irrational longer than you can remain solvent." J. M. Keynes.

The current phenomenon occurring in the capital markets is aptly termed a "dislocation", as the primary ultimate intermediary—as the process proceeds and as a matter of fact—will be the Central Banks, as proxies for the Sovereign Governments and institutions which they represent.

[1] Managing Director of Situs Strategic Advisors, a division of The Situs Companies – an integrated global consulting firm which specializes in real estate advisory and derivatives support services. Commentary of August 2008.

Efficient Market Hypothesis whether one subscribes or not, concludes that financial markets are "informationally efficient". The current situation finds: these markets have gotten into their current state due to what might be termed a "super anti-efficiency"—in that data believed known or actionable was either not known or if known not acted upon. To be clear, the statement that the general markets in the main, were unaware and thus became stultified seems reasonable. But please note that in these premises, we have included by reference the rules of fiduciary prudence as "should have known" or more importantly, "should have acted upon".

What is manifest tends toward an abject systemic or asymmetric informational anomaly—coupled with lack of positive and clear-cut action. Was the notional value of "innovative" Credit Risk Transfer instruments and derivatives unknown? Were the off balance sheet operations of investment and commercial banks completely latent? Did Credit Rating Agencies have any semblance of true experiential and subjective understanding of the products being rated? Was the rapid vaporization of Enron not enough of a microcosmic event to warrant extrapolation?

From a subjective and visceral view, everyday actors for example, in Originate & Distribute model businesses and at all levels with the exception of certain investors, knew what was occurring at a daily functional level—however, sans any real understanding of the global-macro consequences. To say the least, the full picture was not widely known or if it was, not disseminated to the participants capable of realization and response.

Central Banks and Sovereign Treasuries, to be able to know and analyze macro consequences, must have access to accurate information and then the analyses are only as good as the data collected along with the concomitant ability to analyze, understand and predict distributive results and outcomes.

In the final analysis, most did not perceive the true circumstance—save on an idiosyncratic micro level—and of those who did, either the full consequence was not appreciated or as inheritors were confronted with an overwhelmingly daunting task. Thus, a condition of Super Anti Efficiency seems to have been born.

Prudential Regulation in Free Market Economies

The North American "experiment" has been instructive in many areas. Apparently, free market societies left to their own devices have a tendency to be highly creative and productive. GDP is but one indicator validating this phenomenon.

However, all systems need essential policy guidance—rules causing behavior to function optimally. The inclination toward deregulation in the mid 1980's began various processes that although lofty, were never intended to supplant any "built in stabilizers" or importantly prudential regulation and monitoring. Without regulatory schemes and mechanisms put into place for risk management, anomaly and turmoil are subject to a high probability of occurrence and with severity.

BIS WP No 251 by Claudio Borio cogently points out turmoil aspects:

a. "The sustained global rapid increase in credit and asset prices, the exceptionally low risk premia and volatilities across asset classes on the back of widespread search for yield and the accompanying evidence of a relaxation of underwriting standards and aggressive pricing were all unmistakable symptoms."
b. Incentives: "…the key limitation here refers to the fact that actions which are individually rational and compelling may not result in desirable aggregate outcomes."
c. "Since credit ratings only capture expected losses or probability of default, it can be highly misleading for investors to extrapolate the credit risk profile of these securities from these ratings."

BIS CGFS No 31 goes on regarding pressures in funding markets:

a. "Overall, the judgment was that tensions would have been more acute and more damaging without the forceful interventions of central banks".
b. "...however, if they were driven by counterparty risk concerns, then central bank liquidity operations would be ill positioned to tackle the problem."
c. "Furthermore, the rising prospects of having to take some off-balance sheet exposures back onto balance sheets led some banks to cut back on credit extension."

Clearly, these phenomena are axiomatic and have led to unprecedented policy operations and interventions by the Federal Reserve and other Central Banks. These efforts were aimed at calming a plethora of short term pressures. "Discount" or Central Bank refinance timing is elongated. Collateral swaps are re-defined. Various central banks have acted in consort to provide emergency liquidity. FASB directives are subject to attempts at suasion. These are very fascinating solutions. However, do they truly reach the core? Simply put, confidence in the system has been shaken. What will renew a sense of confidence, the fundamental premise in any non-commoditized, fiat monetary system?

If free market economies (not to be confused with financially anarchistic non-regulation) are judged by the quantity of their actual production, then there can be no argument that they should be highly evolved economically and monetarily. Conversely, without regulatory schemes and "prudential prudence", how easily we become the creators our own ethical dilemmas.

Consequence and Moral Hazard

If a system's goal is to accommodate expansion and prosperity throughout regions, then we need to consider the broad effect all the way to a participant from a disadvantaged or emerging market. How long will they or for that matter the global society, be set back?

The un-checked "innovative" market had a boomerang effect—it turned right back onto itself. We could easily contemplate game theory and whether or not states of equilibrium or optimal solutions or various dilemmas were conceived or played-out by different actors. Moreover, we could continue describing quite succinctly, these "occurrences". But in the end, about the best we can say, is that it was a very unkind act.

Issues of moral hazard aren't necessarily difficult, just hazardous. Central Banks by their nature are compelled to act toward the greater societal good. Pressure alleviating actions are expected to occur with great speed and execution—no margin for error. Some actors or institutions will survive, some will not.

The true moral hazard in this sense really deals with not assigning responsibility to correct sources and thus by corollary, validating non-optimal acts. However, the first order of business is still to contain systemic pressures. Later through regulation whether legal, procedural or prudential, responsibilities and consequences can be assigned.

Conclusion

"…But the years of anxious searching in the dark with their intense longing, their alterations of confidence and exhaustion and the final emergence into the light – only those who have experienced it can understand it." A. Einstein

Absence of free-flowing and accurate information being exchanged, abstention from clear cut policies with procedural and reporting frameworks for credit instruments, coupled with a failure to realize, appreciate and act quickly on anomalous events have led us to this current set of dilemmas.

Confidence, to be restored, would embrace very particular and decisive action. Moving to the beginning of these evolutionary processes one might consider, “What policy actions could have been instituted that might have created systemic regulatory and prudential framework control?” Those omitted probably are capable of acting positively today. The categories contained in the frameworks could be easily defined and enumerated.

As a note, the Credit Rating Agency waning of confidence should be resolved quickly—as they are at least perceived to function as the last arbiters of risk management to the domestic and international sectors. Perhaps a system in which entities with strong oversight control, would rate various public or private offerings (possibly two separate functional groups, one for each) based on a very quantitative set of standards and procedures could also engender confidence and security.

I have written these comments as a stream of ideas, but hopefully with a point; and that might only be that problems, if fully defined, eventually do have solutions.

The quote above presents a framework capable of “its” resolution—although any of us might have done without this experience.

Thank you.