

# Outline

- Was securitization/transparency the problem?
- The difference between liquidity provision and risk sharing
- The role of government: public versus private liquidity supply

# Was lack of transparency the problem?

- Nothing transparent about traditional banks
  - No mark to market
- De Beers and diamonds: customers aren't allowed to inspect quality
- Liquidity = symmetric information about payoffs
- Scandinavian 90-91 crisis happened without any securitization

# Nature of liquidity provision

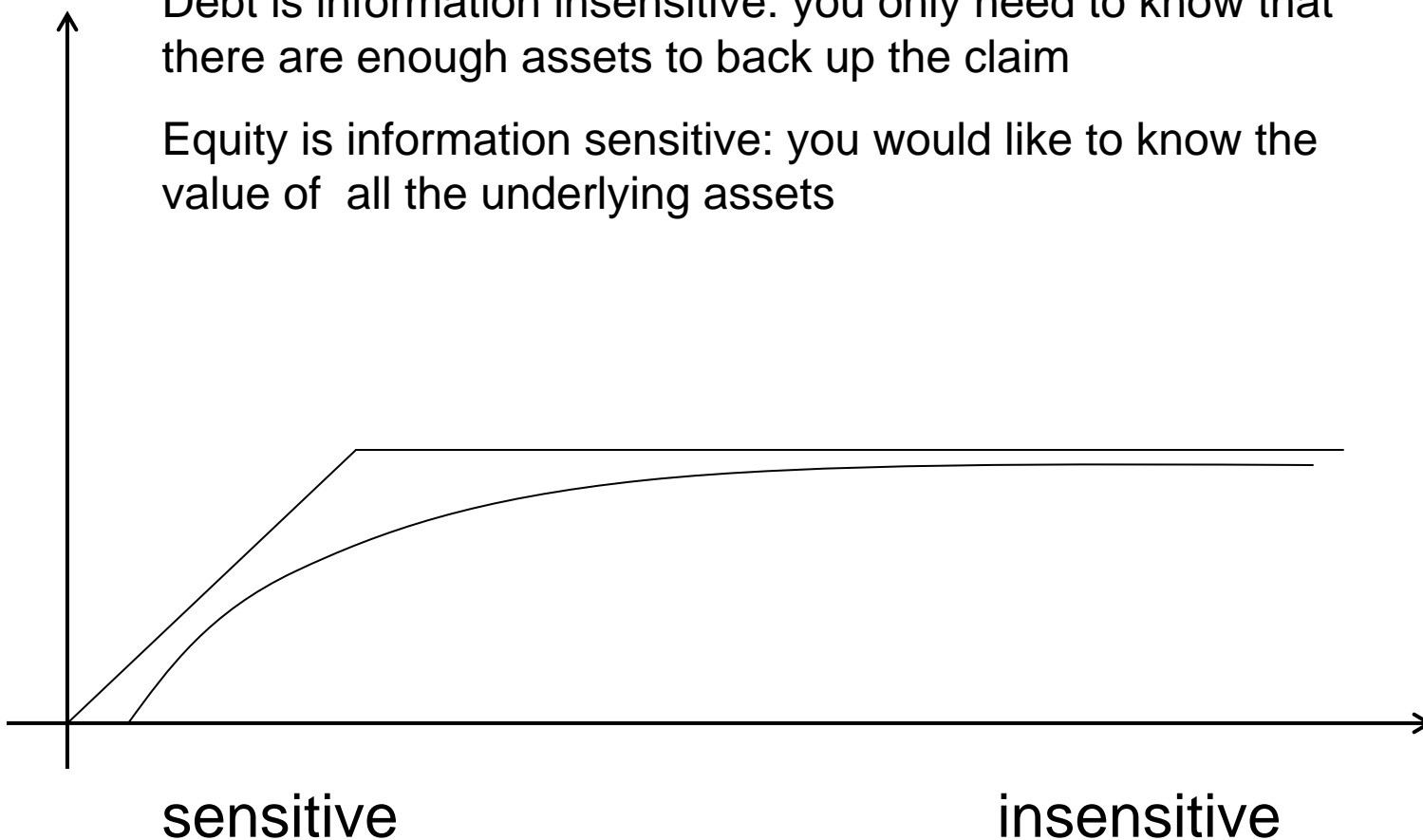
- High velocity markets
  - No time to evaluate creditworthiness

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- **Information insensitive instruments**
  - Low volatility assets (mortgages, securitization)
  - Over-capitalized
  - Rents for reputation capital

# Liquidity and information sensitivity

Debt is information insensitive: you only need to know that there are enough assets to back up the claim

Equity is information sensitive: you would like to know the value of all the underlying assets



# Supply of liquidity

- Increased foreign demand for savings (“parking space”)
- Creating parking space:
  - Home equity loans
  - More housing
- Structured securities = contingent liquidity = more efficient use of parking space
- **Who should hold the aggregate risk?**
  - Not the liquidity providers

# Public vs private liquidity

- Liquidity supply = insurance
- Private insurance must be ex ante
  - Limited by supply of assets in critical states
- Public insurance can be ex post
  - Supply of treasuries (ex ante)
  - Bailouts, recapitalizations, etc (ex post)
- **Public insurance most valuable in rare events**

# Summary

- Transparency not the primary problem
- Liquidity provision very different from risk sharing – should be regulated accordingly
- Regulatory focus on leverage rather than transparency (reduce LTV procyclicality)
- Crisis will recur:
  - keep up with market developments
  - look beyond financial markets (macro issues like current account)