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)