Do Global Banks Spread Global Imbalances? Asset-Backed Commercial Paper during the Financial Crisis of 2007–09

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Abstract

The global imbalance explanation of the financial crisis of 2007–09 suggests that demand for riskless assets from countries with current account surpluses created fragility in countries with current account deficits, most notably in the United States. This paper examines this explanation by analyzing the geography of asset-backed commercial paper (ABCP) conduits set up by large commercial banks. The paper shows that banks in surplus countries as well as banks in deficit countries manufactured riskless assets, totaling over $1.2 trillion, by selling short-term ABCP to risk-averse investors, predominantly U.S. money market funds, and investing the proceeds primarily in long-term U.S. assets. As negative information about U.S. assets became apparent in August 2007, banks in both surplus and deficit countries experienced difficulties in rolling over ABCP and as a result suffered significant losses. The paper concludes that global banking flows, rather than global imbalances, determined the geography of the financial crisis.

Notes

1. Bernanke (2009) and Portes (2009) also argue that it is impossible to understand the financial crisis fully without appealing to global imbalances and that they are the underlying cause of the crisis. Jagannathan, Kapoor, and Schaumburg (2009) argue that imbalances in labor supply can help to explain the financial crisis.

2. See “BNP Paribas Freezes Funds as Loan Losses Roil Markets,” Bloomberg.com, August 9, 2008.

3. We do not have information on the maturity of Ormond Quay's ABCP but, according to the Federal Reserve, most conduits have ABCP outstanding with a maturity of 30 days or less. The majority of issuance is with a maturity of 1 to 4 days. Regarding outside investors, we have no information of their identity but according to the Federal Reserve's *Flow of Funds,* the main investors in ABCP are U.S. money market funds.

4. As noted in a report by Price Waterhouse on the “Great Accounting Debate:

Conduits off or on balance sheet under IFRS," IFRS does not recognize the usual structure employed by U.S. banks to circumvent consolidation under FIN 46.

5. Under the internal-ratings-based approach, the difference in regulatory capital between off-balance-sheet and on-balance-sheet financing may be even lower, because this approach is based on modeling assumptions which make less distinction between credit and liquidity enhancements. In 2007, however, the regulatory treatment of ABCP conduits under the internal ratings based approach was still under discussion.

6. To validate these findings, we also consult a market-level report issued by Moody's Investor Service (2007). The report provides summary statistics on assets held by credit arbitrage conduits in March 2007. Based on conduits with assets outstanding of $196 billion or more Moody's find that 53 percent of assets measured by outstanding principal amount are originated in the United States and that 99 percent of rated assets are rated "Aa" or higher. These results support the findings based on conduit-level data.

7. An alternative measure of the size of the banking sector is bank assets. For our purposes, we prefer bank equity because, as discussed above, countries vary in their financial reporting of ABCP on bank balance sheets.

8. For example, Keys and others (2008) show that loans eligible for securitization had higher default rates relative to comparable loans not eligible for securitization. If outside investors are unable to assess loan quality properly and instead rely on information provided by banks or rating agencies, banks have an incentive to originate low quality loans and sell them at inflated prices.

9. For example, a report commissioned by the Swiss Banking Regulator documents that UBS, one of the world largest banks by assets in 2006, actively

sought to keep and purchase assets they had previously securitized.

10. Stiroh (2002) shows, for example, that the component of revenues earned through interest payments by commercial banks in the United States has been dwindling steadily, and it has been replaced by fee-based income and trading revenues. While interest and fee income is relatively stable over the business cycle, trading revenues are highly volatile and in fact much lower in Sharpe ratios. This can be considered evidence supportive of a gradual trend in banking to engage increasingly in short-term, speculative activities, a phenomenon only further facilitated by the repeal of the Glass-Steagall Act (separating commercial and investment banking activities) and enactment of the Gramm-Leach-Bliley Act in 1999 (allowing commercial, investment and insurance activities within a single bank).

11. For example, the Swiss bank regulator issued a detail report on how the universal bank UBS suffered huge losses because of its exposure to the U.S. housing backed AAA-rated tranches.

12. The term "manufacturing tail risk" is used by Acharya and others (2010) to describe the evolving model of banks and financial firms as regulation restricting risks effectively weakened whereas access to government guarantees remained or in fact strengthened.

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