

Remarks

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This panel session offers us an opportunity to reflect on broader ideas concerning the relationship between the institutional architecture of financial risk bearing and systemic risk. This relationship has been touched on throughout this conference. Indeed, at our first conference this was the focus of Professor John Campbell's remarks as the moderator of the wrap-up panel session when he spoke of the need for innovations in the means through which concentrations of risk exposures can be dissipated.

In my remarks today, I thought that it would be most relevant to explore some of the issues of financial architecture raised for me by recent failures and near-failures of financial firms. These issues are concerned with the relationships between leveraged specialized financial firms and the major international dealers in risk transfer products in periods of financial stress. I have chosen to get at these issues by reviewing the case of Criimi Mae, a publicly traded U.S. financial firm that filed for protection from its creditors under Chapter 11 of the U.S. bankruptcy code in early October 1998. The filing, in addition to extensive routine public financial disclosures, has made public much information concerning the activities of Criimi Mae and recent disputes with its creditors that precipitated the bankruptcy filing.

In its court filing, Criimi Mae outlined the following chain of events. The very recent (post Russian debt default) turmoil in global credit markets precipitated collateral calls by its secured creditors. The collateral calls created an extraordinary strain on the firm's available cash resources at a time when it was extremely difficult to raise capital or secure cash from market sales of "in the money" risk exposures. That is, Criimi Mae holds itself to be a victim of global financial market contagion, and, therefore, entitled to protection from its creditors. The protection, if granted, will afford Criimi Mae an opportunity to stabilize its operations and reorganize its business.

By way of background, Criimi Mae is a full-service commercial mortgage company that is operating as a real estate investment trust (REIT) to benefit from U.S. tax law. Criimi Mae's primary activities include (i) acquiring non-investment (rated and non-rated) grade subordinated securities backed by first mortgage loans on multi-family properties and other commercial real estate and (ii) origi-

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nating, servicing and securitizing commercial mortgage loans and mortgage-backed securities. Press reports have characterized Criimi Mae as the single largest holder of non-investment grade commercial mortgage-backed securities, complex structured securities with concentrated credit risks.¹

Criimi Mae financed its securities positions through collateralized borrowings from major dealers in risk transfer products, a number of U.S. money-center banks and U.S. investment banks. In the wake of the generalized surge in credit risk premia over recent months, these counterparties upped the face amount of the securities to be placed with them as the collateral they required from Criimi Mae to secure their financing. In public statements on the case, Criimi Mae's management commented that the firm's creditors had been using financial news reports of general market turmoil to rationalize low prices for performing mortgage assets that were generating as much cash flow as they did three months earlier.² The creditors responded by commenting on the risk to their interests involved in a delay of their liquidation of the collateral holdings.

In a post-filing discussion of the firm's financial situation, Criimi's management acknowledged that the market for the types of securities that were held by the firm is not highly liquid. They asserted that this condition explained the absence of a reliable public benchmark to be used in the valuation of the mortgage-backed security collateral that Criimi had provided its creditors to secure financing. Nevertheless, the 30 percent discrepancy in valuation that emerged in Criimi's lawsuit against Morgan Stanley has to be considered surprising in view of the prominent professional roles played in the market for commercial mortgage-backed securities by both firms.³ This very large discrepancy in the supposed mark-to-market valuations of securities possibly highlights why there are concerns about the limited information content of mark-to-market based valuation data for non-traded securities or, for that matter, customized OTC derivatives positions.

The bottom line of my remarks for research on systemic risk issues is straightforward. The volatile conditions that we have witnessed in global credit markets over recent months have stressed important elements of the current system for the distribution of financial risks in global markets. These experiences should be recorded by researchers as case studies since such efforts promise to produce data on questions related to the usefulness of public and private disclosures of information in controlling risk taking by leveraged financial firms. In turn, such case studies, in aggregate, can provide a body of evidence required for our making judgements about judging the structural integrity of the system as a whole.

¹ A discussion of securities held by Criimi Mae is found in the motion filed by Merrill Lynch Mortgage Capital Inc. on October 16, 1998 in United States Bankruptcy Court for the District of Maryland (Southern Division) – Chapter 11 Case No. 98-23115.

² An overview of the public positions that have been set out in the Criimi Mae can be found in a November 4, 1998 article in the *American Banker* entitled "Credit Drought Withering Speciality Finance Firms."

³ For a background discussion of Criimi Mae's now pending lawsuits against its creditors see an article by Jerry Knight entitled "Criimi Mae Sues 3 Major Creditors," *Washington Post*, October 22, 1998.