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Systemic Risk and Financial Regulation: Where Do We Stand?

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Financial Regulation Has Gone a Long Way toward Taming Systemic Risk in Banks

The Basel III/Financial Stability Board agenda has clearly helped bring about a global banking system that is much more resilient to insolvency and liquidity risks. If we consider both quantity and quality, capital buffers in the world's most significant banks today are at least six times higher than before the crisis; living wills and "bail-inable" capital should help further to contain the too-big-to-fail problem; and key supervisors everywhere are showing proactiveness with stress tests, which is key to having a dynamic view of risks. Equally important, investors are continuing to push for further changes and risk reduction in the business models of global banks.

So, while banks have by no means become risk free, I struggle to see further major banking regulation initiatives that would be critical at this stage. Personally, I still feel that more ambitious capital standards and less of everything else would likely have been a more effective and certainly much simpler way to respond to the crisis, but from a practical perspective, this is now a moot point. What I would say is that the priority now should be to hold the line and not roll back these improvements, and to have the courage to implement the crisis provisions now available if and when the time comes.

It is therefore sensible for the regulatory focus to have shifted to systemic liquidity risk and systemic risks from nonbanks, including asset managers. I will focus on these two types of risk.

Has Financial Regulation Created a New Systemic Risk in the Form of Liquidity Scarcity?

My short answer is no.

A number of recent market episodes have shown that even in some of the world's most liquid markets, prices can swing widely, and bid-ask spreads widen enormously, possibly suggesting a lack of liquidity. Some examples are the October 2015 flash rally in US Treasury prices after a weak data release (an eight-standard-deviation shock!); the 15 percent intraday swing in the value of the Swiss franc against the euro when the central bank dropped the exchange rate floor on January 15; or the 2.5 percent intraday move in the value of the USD against the euro on March 20, 2015 (after a Fed chair statement perceived, perhaps too hastily, as dovish), only to correct with an equally sharp swing the next day.

Conventional wisdom would have it that (1) such developments are very worrying and (2) they are the unforeseen and unfortunate result of the regulatory tightening imposed on banks, which can no longer afford the now much higher costs of market-making.

Both these contentions strike me as highly suspect, for a couple of reasons. First, in all these episodes, the bulk of the sharp price deviation was corrected within days, without any trace of a lasting misalignment or market malfunction. Second, we have (I hope) learned from the precrisis years that ultra-low volatility breeds excessive risk taking. Higher volatility is therefore welcome if it serves as a reminder that market prices can and do fluctuate.

That said, it is true that banks have cut their dealer inventory significantly in response to new capital requirements and changes in their business models, by about 20 percent overall, and this cut has been heavily skewed toward corporate bonds. (As a result, there is a sort of bifurcation in liquidity, with sovereign bond markets more highly liquid than before the crisis and corporate bond markets less so.)

What is much less clear is that reduced dealer inventory is the driver of large price swings (i.e., low liquidity) *in response to unexpected news*. Rather, one would expect it to lead to reduced liquidity all the time, as pointed out by Markus Brunnermeier recently.¹ But if we look at indicators such as transaction volumes or bid-ask spreads, we find very little evidence of that.

Most likely what is to blame for these wild price swings is the combination of an extensive search for yield from asset owners who find themselves forced by their liabilities to respond to the persistent highly unconventional monetary policy stance and the impact it has on the entire yield curve. This in turn leads to crowded trades in higher-risk positions. When you combine this with procyclical bank risk management models in which volatility can lead to capital shocks and fire sales, you certainly have a credible explanation for what we have witnessed on several occasions during the past year. (The data in the IMF's April 2015 Global Financial Stability Report [GFSR] chapter showing increasing herding in most markets over the past five years lends credence to this hypothesis.)²

In summary, the new regulations, aimed at making banks safer, have effectively curtailed what one might think of a liquidity illusion caused by intensive market-making by banks. This means that the liquidity risk previously borne by banks must now in part be borne by other market participants. With liquidity premia currently highly compressed because of unconventional monetary policies, there is likely underestimation by market participants of the liquidity risks they face. If they have not made necessary adjustments in their liquidity management practices by the time monetary policy normalizes, we could be in for repeated situations of extreme volatility.

Incidentally, this is an underappreciated channel through which highly accommodating monetary policy may fuel financial instability: not by fueling bubbles, as the typical narrative would have it, but by creating a liquidity illusion that could catch many unprepared when it dissipates.

Against this backdrop, some are asking, will other market players with deep pockets, such as asset managers, step in and make markets? I expect not, and I think it would be wrong if they did. Our objective cannot be to recreate the liquidity illusion that existed pre-Basel III. Rather, the entire market and its plumbing need to evolve, and all market participants need to adjust to a world in which liquidity cannot be taken for granted, and price it accordingly.

Are Large Asset Managers a Source of Systemic Risk?

Again the answer is no, though some of their activities and products may be.

It is very important to make a clear distinction between asset management entities and activities or products. As I will explain, the risks reside predominantly with the latter.

The bulk of global financial assets are managed by asset owners, not by asset management companies. And asset management companies themselves to a very significant extent do what asset owners tell them to do.

Asset management entities themselves pose minimal credit and counterparty risk, again for a couple of reasons:

Asset managers' balance sheets are many orders of magnitude smaller than those of banks, and these balance sheets do not embed any significant leverage.

Even if a major asset manager were to go under, whether struck by bankruptcy or by lightning, counterparty risk would be limited because the asset manager doesn't hold the assets it manages (they are held by custodians). Moreover, an asset management company does not trade securities on its own account but only as a fiduciary on behalf of clients.

An important question is whether large asset managers can be a source of herding, or can otherwise cause wide swings in valuations.

Size needs to be put into perspective:

The assets under management (AUM) of even the largest asset management companies represent only a fraction (about 2–3 percent) of the universe of global financial assets, most of which—between two-thirds and three-quarters, depending on estimates—are managed in-house.

The AUMs of large asset managers tend to be split among a multitude of *independent* investment strategies, which have no reason to be correlated more closely among themselves than strategies of different asset managers.

Certainly, some of the individual funds' positions may be large in certain markets, but there are exposure limit rules—both internal ones and, what is quite important, those stemming from investment mandates given by asset owners. Concentrated exposure is also curtailed by way of counterparty rules imposed by trading platforms. So I don't think there really is much risk of a “large fish in a small pond” effect.

Moreover—and this is often not sufficiently appreciated—asset allocations within each fund of a large asset manager are typically quite sticky, at least when measured at the asset-class level, for multiple reasons.

First, a large proportion of assets are passively managed. In other words, they are not subject to discretionary allocation decisions but

instead track an index, which actually results in countercyclical investment decisions as long as the index doesn't change (as securities whose prices fall must be purchased in larger amount to retain the same weight in the portfolio as in the index).

Second, of the remaining actively managed funds, the overwhelming majority are subject to investment mandates imposed by asset owners and requiring relatively fixed allocations to given asset classes. So portfolio managers' decisions could certainly move the prices of certain securities, but they couldn't really destabilize entire asset classes, which is what we are presumably talking about with the concept of systemic risk.

One can certainly think of extreme cases in which a fund or several funds of a large asset management company might be forced to sell significant fund holdings. Typically this could happen in the event of large redemptions, which are, of course, possible in open-end funds.

Here it is perhaps helpful to look at history. The data suggest that at least so far, redemption concerns are overblown:

A recent Oliver Wyman/Morgan Stanley study, corroborated also by the IMF's April 2015 GFSR, found that over the past twenty years, redemptions on average have not exceeded around 5–6 percent of the AUM of a fund over the worst three months, even in times of great market stress, including the global financial crisis.³

Moreover, redemptions, even if they snowball, as happened over the past year to one large asset manager, do not necessarily lead to fire sales or herding, for the following reasons:

First, virtually all funds have some form of liquidity buffer (including cash, repo lines, credit facilities, and so forth).

Second, internal liquidity management practices, which seek to match buyers and sellers internally before going to the market, can certainly be helpful in such circumstances, particularly in the presence of large positions.

Third, asset owners can and do switch asset managers without any sale needing to occur at all. Indeed, this is a common practice among institutional investors. Or they can choose to redeem their shares in kind rather than in cash.

Last—and here I depart from the IMF analysis—with the exception of cases of reputational concerns with a given asset manager, I am not at all convinced that the market impact of mass redemptions is worse when asset holdings are pooled in mutual funds than in a completely atomistic

market. If all the individuals who take fright on seeing bad economic news managed their assets directly through smart apps on their phones, would they be less prone to sell? It seems to me the answer is no. At least in theory, one would expect the greater professionalism of mutual fund managers, as well as the presence of internal market and liquidity buffers, to mitigate a rush to the exit from a particular asset class.

In sum, I don't see how nonleveraged asset managers, even very large ones, constitute a source of systemic liquidity risk.

But we need to be aware that there are certainly possible risks from open-end funds that promise generous liquidity to their clients while being invested in less liquid assets. The fact that they have not materialized despite many episodes of market stress is comforting, but it shouldn't breed complacency, as the scale of these funds relative to the market increases continuously and, as noted earlier, underlying liquidity conditions are changing by becoming more demanding.

What Can Usefully Be Done to Contain What Does Exist in Terms of Systemic Liquidity Risks?

I find myself in general agreement with the recommendations of the IMF's April 2015 GFSR study, but let me emphasize a few points:

- There are market structure issues: encouraging greater standardization of bond issues, electronic trading on exchanges, and so on certainly makes sense.

Regulation of mutual funds may need to focus more on circuit breakers against potential mass redemptions, such as fees, gates, share pricing that internalizes the cost of redemptions, and greater incentives to invest in vehicles that investors can get out without reducing the size of the fund, such as ETFs, where investors get out by selling their shares on the secondary markets, or closed-end funds, where investors can sell their shares only if a willing buyer is available.

- What is most important, in my view, is that both supervisors and risk managers need to step up their surveillance of exposures to high price volatility, that is, crowded trades, particularly for assets that are less likely to be dubbed safe assets in a stress episode. This may mean accepting lower returns in the short run but will surely lead to

higher risk-adjusted ones. In that spirit, I fully support the idea of stress testing of funds, as already practiced in Europe by the European Securities and Markets Authority and as announced by the SEC in the United States.

- Last but not least, there is a need for the asset managers' supervisory community to continue to develop a strong financial stability focus alongside its well-established consumer protection one. This is easier said than done because while the two go together—consumers who feel well protected are less likely to run—the issues have nothing in common: to caricature, securities regulators struggle to grasp financial stability issues, and bank regulators, who are now on top of the latter, struggle to understand the asset management business. Things have improved already, but having worked on both sides of this divide, I know this will be a big challenge, but one that is critical to tackle.

Notes

1. See Markus Brunnermeier, “Liquidity Illusion and Segmentation,” presentation at the Stanford Conference, “Financial Market Adaptation to Regulation and Monetary Policy,” Palo Alto, March 20, 2015, <https://www.gsb.stanford.edu/sites/default/files/Brunnermeier%2C%20Markus%20-%202015a%20Liquidity%20Stanford.pdf>.

2. See International Monetary Fund, “The Asset Management Industry and Financial Stability,” in *Navigating Monetary Policy Challenges and Managing Risks*, Global Financial Stability Report, IMF, April 2015, <http://www.imf.org/external/pubs/ft/gfsr/2015/01/>.

3. See Oliver Wyman/Morgan Stanley, “Liquidity Conundrum: Shifting Risks, What It Means,” Blue Paper, March 19, 2015, http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2015/mar/2015_Wholesale_Investment_Banking_Outlook.pdf.

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The State of Macroeconomic Policy

Edited by: Olivier Blanchard, Raghuram Rajan,
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