Macroprudential Policy towards a Capital Markets Union

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Overview

- What is (or will be) capital markets union?
- Why a holistic approach makes sense
- Identifying the risk clusters
- Elements of a holistic approach
- Systemic risk management: static and dynamic tools
- An ideal agenda for systemic risk managers

What is (or will be) Capital Markets Union (CMU)?

- In its intention, the CMU project broadens the channels of finance to economic sectors that are important in the EU: SMEs and infrastructures
- A broader set of channels for financial intermediation is considered a way to make the whole financial system, including banks, more resilient
- In addition, the project aims at removing structural barriers, like difformities in insolvency procedures, withholding taxes, legal certainty on the ownership of securities

If successful, the project will bring about a more complex and interconnected financial system in Europe

Why a Holistic Approach Makes Sense

- In 1998 LTCM was the center of a market squeeze which risked producing systemic effects
- LTCM, a hedge fund, had a size comparable to that of a major broker-dealer

$ billions	LTCM (1997)	Morgan Stanley (1996)
Net Income	1.9	1.0
Assets	129	129.4
Equity	7.5	7.4
Contractuals	1.2 trillion	1.3 trillion

Why a Holistic Approach Makes Sense—continued

- On September 15 Lehman Brothers filed for bankruptcy. The following day Reserve Primary Fund, a US money market mutual fund, “broke the buck” because it held Lehman debt

- This triggered a run on money market mutual funds

- To stem the crisis:
  - The US Treasury announced a guarantee program for the US money market mutual funds
  - The Federal Reserve announced it would lend to banks to finance purchases of asset-backed commercial paper from money market mutual funds

- The last public initiative was the Money Market Investor Funding Facility created by the Federal Reserve on October 21

Identifying the Risk Clusters

- In a broader and more complex financial system sources of systemic risk are not only within the banking system (though it probably retains the most important spot)

- The canonical symptom of a systemic crisis is the breakdown of liquidity transformation, which occurs when agents behavior becomes correlated

Identifying the Risk Clusters—continued

- Any institution involved in liquidity transformation may become a weak link in the systemic risk chain

- These institutions could be:
  - Banks—financing less liquid loans with liquid deposits
  - Hedge Funds—shorting liquid assets to finance positions in less liquid assets
  - Mutual Funds—open ended instruments that might experience difficulties in dealing with sudden large redemption requests
  - Secondary Markets—they also are liquidity transformation technologies, as they allow investors with diversified (and diversifiable) liquidity risks to provide a stable pool of resources
  - Broker-Dealers—whose business and source of revenue is to provide liquidity to the market, thus being consistently short liquidity

Identifying the Risk Clusters—continued

- A time-honored distinction in the analysis of financial crises is that between liquidity problems and solvency problems
- This distinction becomes blurred when a financial institution’s marked-to-market balance sheet is made up of financial instruments that can lose a lot of their value due to a market liquidity crisis
- In general, the right approach is to identify the actors that need to settle disproportionate cash liabilities
- It is possible to identify such actors ex-ante: the ingredients are
  - knowledge of the network of cash assets and liabilities in the system
  - sensitivities of this network to changes in market prices

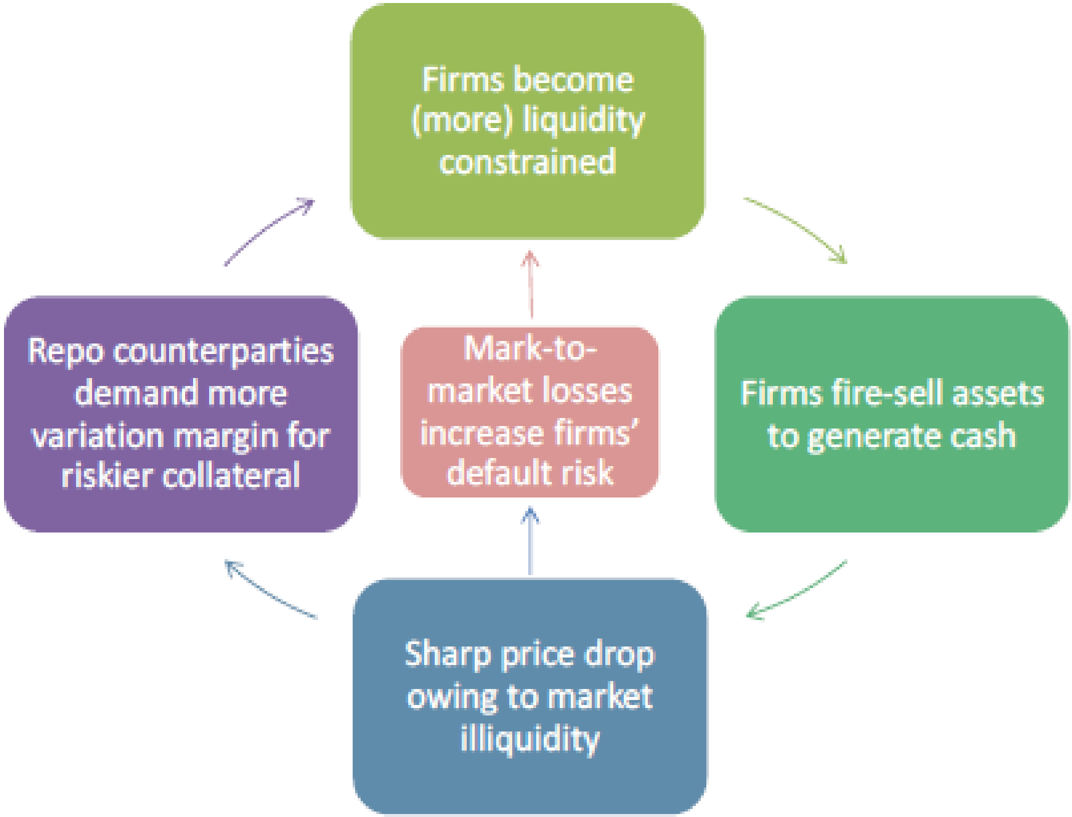
Elements of a Holistic Approach

- Clerc and others (Indirect Contagion—The Policy Problem, Occasional Paper 9, January 2016) provide a catalog of the mechanism in action when a crisis spreads through the financial system

- The channels through which a crisis spreads are two:
  - Market price spillovers
  - Information spillovers

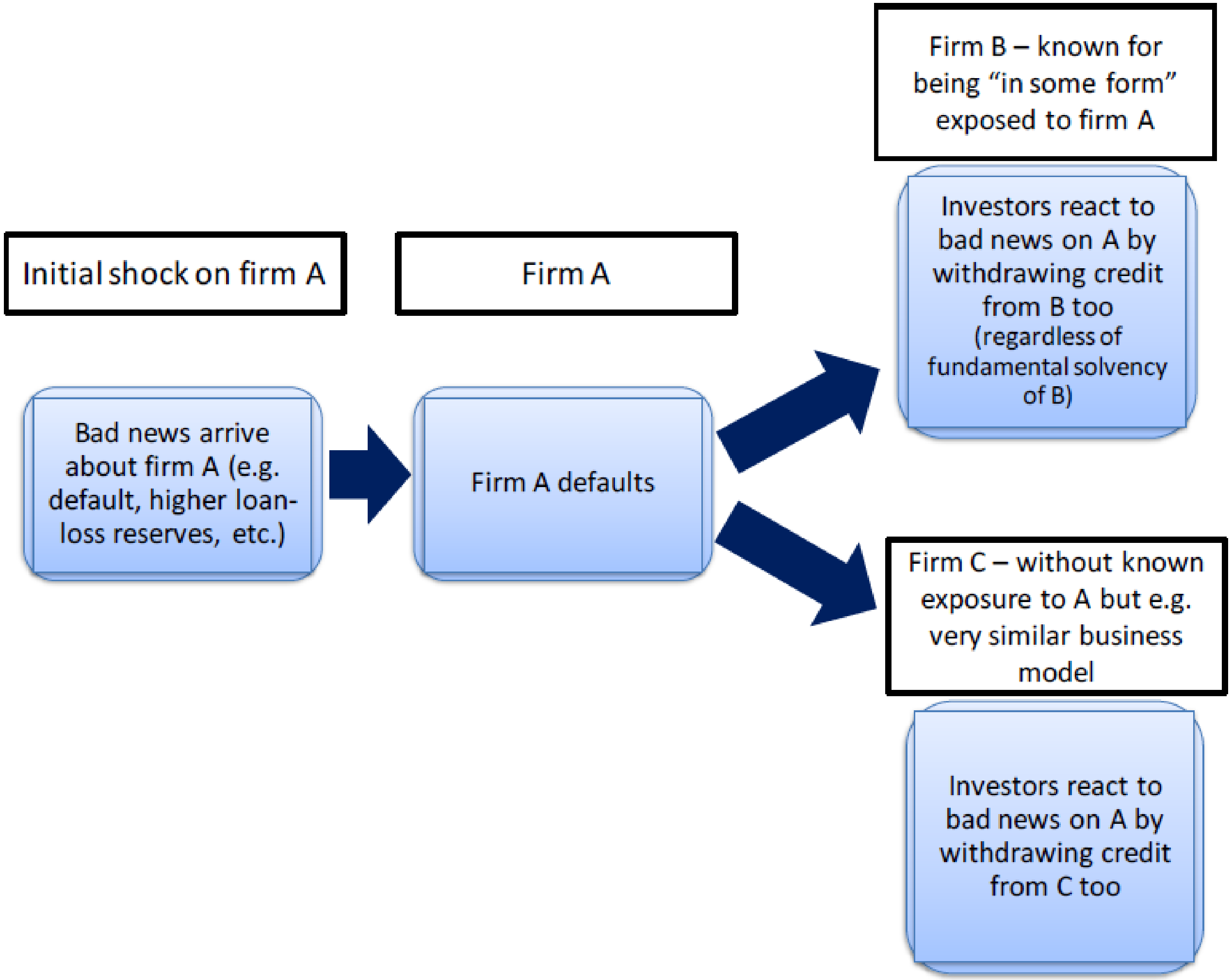
- The two mechanisms interact with each other whenever the general scarcity of information about the size and scope of a financial crisis leads agents to retrench from risk more than they should if they had the proper information about the state of the system

Market Price Spillovers



Reproduced from Brunnermeier and Pedersen, ***Market Liquidity and Funding Liquidity***, **Review of Financial Studies**, 2009

Information Spillovers



Reproduced from Clerc et al., *Indirect Contagion—The Policy Problem*, ESRB Occasional Paper 9, 2016

Systemic Risk Management: the Current Toolbox

- The static (structural) features of prudential regulations include:
  - Capital requirements
  - Liquidity ratios
  - In regulated market platforms: obligations to quote
  - Counterparty rules for derivatives transactions
  - Trade repositories

- Their positive impact on market resiliency is easy to argue, reaching out beyond the banking system

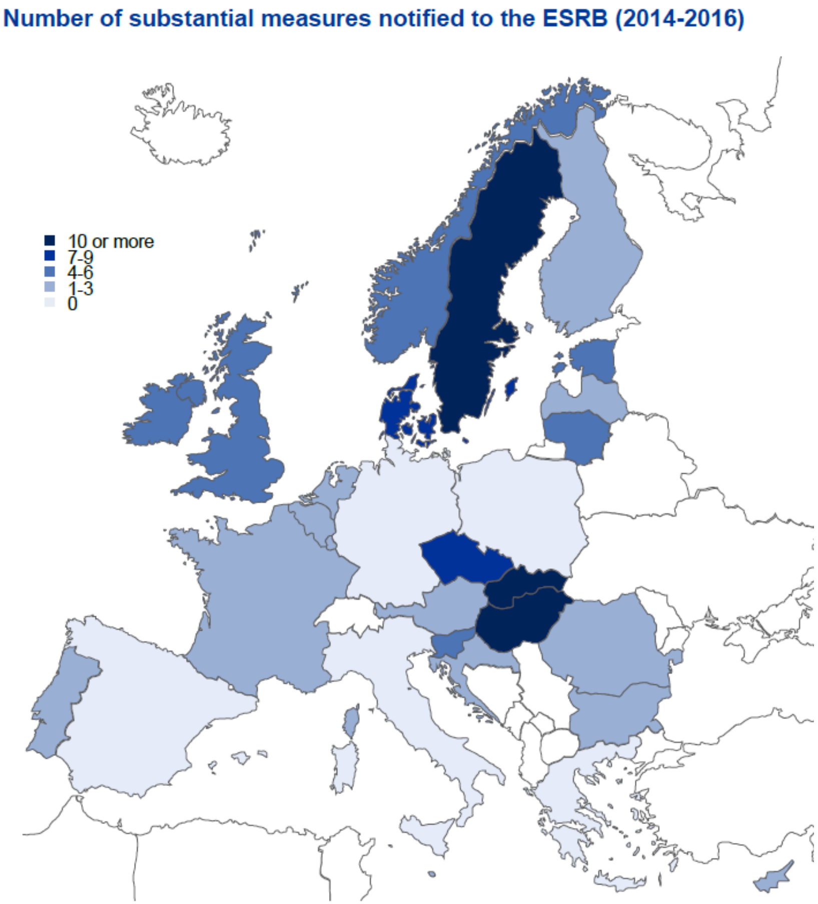
- There may be some tradeoffs: for example, capital and liquidity requirements increase the cost of the business of dealership in government bond markets, and a number of exits have occurred lately

Systemic Risk Management: Macro-Prudential Policies

- Implemented at the national level (see chart) and notified to the ESRB

- Current tools (appplied to the banking system) include:
  - Countercycical capital buffers
  - LTV ratios
  - Stress tests

- Potential new instruments:
  - Dynamic liquidity regulations
  - Restrictions on margins or haircuts



Reproduced from ***A Review of Macroprudential Policy in the EU in 2016***, **ESRB April 2017**

An Ideal Agenda for Systemic Risk Managers

- Systemic risk management should rely on a sufficiently accurate real-time description of the state of the financial system, including:
  - The entire network of debit/credit relations among financial intermediaries and between financial intermediaries and the non-financial sector
  - The sensitivity of such debits/credits to financial market prices

- Since the financial crisis there has been giant progress, but much needs to be done

- In general, a robust systemic risk management system would minimize the risk of information externalities like those described above

- Ideally, accurate knowledge of the systemic risk should precede activism