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Market liquidity and volatility: what trends and impacts?

Speakers

Denis Beau
Banque de France , Director General of Financial Stability and Operations

Philipp M. Hildebrand
BlackRock , Vice Chairman

David Wright
EUROFI , President

Svein Andresen
Financial Stability Board (FSB) , Secretary General

Objectives of the session

The objective of this exchange of views was to discuss the current status and future trends of liquidity and volatility in EU capital markets, the main drivers and possible solutions for ensuring sufficiently resilient market liquidity.

Executive Summary

Current status of market liquidity and volatility

In recent years many regulatory initiatives had impacted the way institutions and financial markets worked. One issue of concern and under research was the change in market liquidity. The typical indicators of market liquidity had revealed no significant problem; liquidity conditions had returned to pre-crisis levels.

However quantity-based indicators were showing some changes; the depth of the market was decreasing. Issuance numbers were high but turnover had declined in a number of segments including some that were very liquid. There was also liquidity bifurcation, as well as more frequent short-term liquidity jumps, and it was becoming increasingly difficult to trade large quantities quickly in the market. Prices had not adjusted accordingly yet.

There was also increased volatility and volatility was affecting the most liquid markets, particularly US Treasuries. That had been illustrated by the “flash rally” in the US market and the “Bund tantrum” in the German market.

Main drivers of market liquidity trends

Regulation was thought to be merely one of many drivers of change in the liquidity of fixed income markets.

The first major driver was the widening gap between supply and demand for liquidity services. That was due to a reduction of market-making capacity, which was where regulation was possibly having an impact. At the same time regulation was making market-makers more resilient and the appetite for risk-taking in that activity had changed in many institutions. Second was the development of electronic trading, which had positive aspects for liquidity but also had possible negative effects related to the development of algo-trading in particular. The third was the development of non conventional monetary measures and asset purchase programmes, which could have both positive and medium term negative implications for liquidity.

The main source of the liquidity issue was a macro problem, a speaker considered: there was a global issue of excess saving and under investment, which policy-makers needed to respond to. Low interest rates were a response of central banks to under investment. In Germany for example there was too much investment in bonds, which were affected by low interest rates, and not enough in longer term riskier assets such as equities and infrastructure projects. Banking prudential regulation may amplify effects (for example the NSFR), but was not the main source of the problem.

The market needed to adapt to this new environment. Market participants were in the process of adjusting to these changes; and authorities were advised not to stand in the way of that adjustment. Adjustments could take place through pricing, business models or behaviours (e.g. risk management practices). Market participants were in an uncomfortable position because they were mid transformation and there were many changes happening. There had to be hope that those conditions would not last forever; and it was thought that once those conditions began to change, many of the concerns currently expressed regarding regulation would dissipate.

The effects of regulatory changes needed to continue to be monitored, and markets participants needed assistance in their adjustments to the changing marketplace.

Possible solutions and way forward to be considered

Encouraging more investment in a longer term perspective and mobilising excess savings back into investments would make a great deal of difference. Short term interest rates would then start to normalise and this would progressively allow moving out from unconventional policies, but this was still a remote objective. Investors who have a long-term business model such as insurance companies or pension funds should be encouraged to invest for the long term and in riskier assets. Making changes in Solvency II for example to allow more equity investment could be beneficial. Tax incentives or regulatory changes that would encourage investors to move to longer term and riskier assets would also help to address the current liquidity issues at the source.

However, more confidence was needed in the future development of the economy in order to address the imbalance between saving and investment. At present corporates preferred to buy-back their own shares and pay dividends to shareholders rather than reinvesting profits. Politicians and regulators had to come together to change the incentives for long term business and investment.

Technology and electronic trading platforms could help to stabilise the provision of liquidity services together with the development of new liquidity providers, although it was not yet clear if these new players would remain present in the market in periods of stress. Market-makers were also adjusting their business models. Further product standardisation would help to improve liquidity and facilitate electronic trading. The side-effects associated with the rise of electronic trading however needed to be taken care of. The development of high frequency trading which was felt to be a persistent trend which would eventually encompass broader markets over time was a particular issue as it was changing the way fixed income markets were functioning. It was however acknowledged that regulating high frequency trading was difficult. Market participants would have to accept a world with episodes of heightened volatility.

Work was moreover being conducted by the FSB and IOSCO looking at strengthening liquidity management practices in the asset management industry. A consultative document would be released in June/July. Asset managers were also in the process of reviewing the way they approached the liquidity risk management of individual funds. One solution was to raise cash buffers but that would reduce returns for investors. Another possible action was making sure that there was no mismatch between the perception that clients had of the liquidity terms of investment funds and the liquidity profile of the underlying assets in the fund portfolios. Other measures were to consider backup credit lines for the event of large redemptions after significant bouts of volatility, stress testing and redemption tools (e.g. redemptions in kind). Each of the measures considered had arguable benefits and drawbacks; the key was finding the right balance and adapting risk management to the current altered market conditions.

Detailed Summary

The objective of the session was to discuss the current status and future trends of liquidity and volatility in EU capital markets; the main drivers; and possible solutions to ensure sufficiently resilient market liquidity.

1. Current status of market liquidity and volatility

An official noted that there had been many regulatory initiatives in recent years that had impacted the way institutions and financial markets worked. The FSB regularly evaluated the effects of reforms and had identified a concern about changes in market liquidity. Many studies were currently being pulled together on the issue to make a judgment on what needed to happen next.

Looking at typical indicators of market liquidity had revealed that there were no significant changes or problems regarding market liquidity.

A regulator agreed that traditional indicators had not indicated significant change in liquidity conditions. They had returned to pre crisis levels. The indicators that had shown changes were more quantity based. The depth of the market was reducing, which had a number of implications.

A first implication was liquidity bifurcation which was analysed in a study conducted by the CGFS (Committee on the Global Financial System) group of the BIS. They had also seen more frequent short term liquidity jumps. There was also increased volatility and particularly volatility affecting the most liquid markets in the world, particularly US treasuries. That had been illustrated by the flash rally in the US market and the Bund tantrum in the German market. Liquidity risks were on the rise. A question was whether pricing was adjusting accordingly. The quick answer was: not yet. Adjustments were happening, but through prices; not quantities. It was becoming increasingly difficult to trade large quantities quickly in the market; that was the diagnosed change.

An industry representative emphasized that it was important to distinguish between liquidity and volatility. Issuance numbers were high, but turnover had declined in a number of segments, including some very liquid areas.

2. Main drivers of market liquidity trends

An official stated that regulation was one of many changes occurring in fixed income markets, but there were many other unrelated drivers of change. Fixed income market participants were in the process of adjusting to those changes and it was advised that authorities ought not to stand in the way of that. Authorities clearly had an interest in markets functioning well, and market liquidity was essential in an environment with an increasing amount of market based finance.

There had been a number of regulatory changes which had a bearing on market liquidity, but regulation was only one driver among others, a regulator agreed. Three major drivers could be identified.

The first was a widening gap between supply and demand for liquidity services on the supply side. That was due to a reduction of market-making capacity, which was where regulation was possibly having an impact. The second was the development of electronic trading. That initially appeared to have positive aspects, but also had side effects that could have contributed to the current liquidity changes. One of which was the development of algorithmic trading and the rising importance of high frequency trading in financial markets. The third was the development of non conventional measures and asset purchase programmes by the ECB, which also had ambivalence in their effects. The first impact had been positive in a number of markets due to the regular purchase of assets. The question was of whether it had a medium term side effect which could have a negative implication for liquidity.

He continued that it was fair to say that regulation was weighing on the capacity of market makers to provide liquidity services, but there were two qualifications to the observation. First was the appetite for risk tasking in that activity which had changed in many institutions. Second was that regulation was making the market more costly, but also making market makers more resilient to shocks. That was an important benefit for the stability of financial markets.

An industry representative stressed that the main source of these issues was a macro problem. The problem was that there was too much saving relative to investment. Ben Bernanke referred to this situation as a “savings glut”, Larry Summers called it “secular stagnation”. There was a global under investment phenomenon which policy-makers, including central banks had to respond to. Low interest rates were not caused by central banks; central banks were responding to the changes in the world, which were to do with excess saving and under investment. Consequently central banks brought down short term interest rates. He believed that it was flawed to say that liquidity issues were happening due to regulation. Regulation may have amplified effects in some cases, but was not the source. For example, the Net Stable Funding Ratio (NSFR) might amplify some of these trends but fundamentally these trends were structural.

Both the market and traders were adapting to this situation, according to the industry speaker, and asset managers had to adapt as a result, along with the entire value chain of the financial market industry. He felt that they were mid change, and not yet at a new steady state. Such an evolution could take place through pricing or change in behaviour, for example with changes in the way risk management operations around individual funds were run. Pricing, profitability and business models were all adapting to this new market situation. Once they reached a steady state, they would settle in, the speaker believed, but it was currently uncomfortable because there was change across the board.

An official agreed with the thoughts on macro drivers conditioning the current interest rate environment, the operations of central banks, and their effect on markets. That alongside a low growth environment and changing conditions in the financial system had contributed to the changing behaviour of savers and to increasing constraints put on institutions regarding the activities that they should be involved in. Everybody hoped that this environment would not last forever. It was suggested that when the conditions began to change, many of the concerns currently expressed regarding regulation would dissipate. The official added that there had been many regulatory changes and regulators needed to continue monitoring the effects of these measures. There were interactions that were difficult to predict. There was not yet cause to make changes, but regulators should assist markets in the adjustments undertaken.

3. Possible solutions and way forward to be considered

Encouraging more investment in a longer term perspective

An industry representative considered that one action that could make a great deal of difference was to encourage long term investors to invest for the long term and to help to mobilise some of the excess savings back into investments. This would spread out the risk and liquidity curve. Anything that could encourage investors who have a long term business model and perspective to invest for the long term would help address liquidity problems at the source, for example making changes around Solvency II for insurance companies that have a long-term business model and allowing them to invest more in equity. That would have more effect than a tweaking of banking prudential requirements. Much of the lobbying around regulation in the private sector was a distraction from the fundamental problem of excess savings relative to investment, the speaker believed.

As an example he outlined that the German population was investing massively in bonds and then complaining that interest rates were too low. But a major reason why interest rates were low was because Germans savers in particular were investing heavily in fixed income instruments, rather than investing more into longer-term riskier assets such as equities or infrastructure projects. Much of the infrastructure in Germany needed reinvestment. Tax incentives or regulatory changes that would encourage the investor base to move to longer term and riskier assets would help to address some liquidity issues at the source.

He hoped that a steady state could be reached in the on-going adaptations in the market where they could address the imbalance between saving and investment. The whole system needed more confidence to allow for more investments which would deploy some of the excess savings. Short term interest rates would then begin to normalise, first market rates and then central banks. This would allow moving out from unconventional policies, but this was still a remote objective. The main reason why there was not enough investment was because private capital did not have much faith in the future. This was true in Europe but also in Japan or China. The question was how to restore faith in the future.

There was a fundamental lack of confidence in the political system, at least in Europe, to deliver the measures that would lead private capital to have more confidence in the future. The corporate sector was doing well, but rather than reinvesting they preferred to buy back their own shares or pay dividends to shareholders, which was not a productive long term paradigm.

Rather than blaming central banks, politicians needed to ask what could be done for the private sector to regain faith in the future and begin to deploy excess savings. Both regulation and politics could make a difference by changing incentives so that participants with long term business models (e.g. pension funds, insurance companies) could invest more capital for the long term.

Alternative liquidity providers and electronic trading

A regulator emphasized that market making was important for the functioning of financial markets. In fixed income there was a reduction of supply from the traditional providers, who were changing their business models and differentiating their services according to their clients. The market was also adjusting. There were newcomers that could have a different way of providing liquidity and could play a role, although they might not be as present as traditional market-makers in periods of stress.

There were also changes in technology which could help to stabilise the provision of liquidity services. The side effects associated with the rise of electronic trading however needed to be taken care of. No fundamental changes were needed, but a review of the regulatory framework for high frequency trading could be needed in particular to ensure that it was adapted to the rise of those kinds of players in financial markets. In fixed income that was changing to a certain extent the way markets functioned.

An official replied that regulating high frequency trading was probably quite difficult. It had slipped out of the hands of regulatory authorities and market makers to a certain extent. They all knew that those grappling with it had difficulties. However he felt that it was also clear that there would be persistent development in that area and that it would encompass broader markets over time.

The official argued that there would also be more Fintech implementation over time. It had been suggested that if they had everything in a Blockchain with high frequency trading, the system would be ‘on steroids’. He wondered if that would be a good thing and if the authorities could have any influence on such evolutions. This would be needed if the system broke down and important functions of the financial system did not work anymore. There was work to be done in that area, but they would have to wait and see what came out of it.

An industry representative emphasised that asset managers had to accept a world with episodes of heightened volatility. The rise of high frequency trading could be a contributing factor, but was not the only one. As asset managers, it was their fiduciary duty to adapt to the world as it was.

Further standardisation of products would also help to improve liquidity, the industry representative believed. Asset managers were seeing that they had to move more towards electronic trading platforms. That was the sort of adjustment process occurring as a result of the current market conditions.

Liquidity management measures in the asset management sector

There had been work looking at strengthening liquidity management practices in the asset management industry, particularly around issues of leverage and others, which the FSB, along with IOSCO, would release a consultative document on in June/July, an official explained. That was amongst the adjustments that needed to take place, and would help the move towards a sufficiently resilient market liquidity environment.

An industry representative explained that his company was in the process of significantly changing the way they approached liquidity risk management operations for the individual funds that they managed. They could respond by increasing the cash levels in funds to prepare for bouts of volatility; but that came at the expense of returns in an environment where people needed yield. If the whole industry were to raise cash buffers, the overall return would be even lower for investors. Moreover cash reserves would only be possible for funds and probably not for mandates, which may create a bifurcation between funds and mandates, which was not desirable.

Another effort they were undertaking was a greater focus on ensuring that the liquidity terms that their clients thought they had corresponded to the liquidity profile of the underlying assets in the portfolios and that there was no mismatch. That was particularly relevant at a time when they had lots of people trying to invest and extract yield from instruments that were perhaps less liquid than the traditional instruments that the clients were used to.

A further element was to consider backup credit lines for the event of large redemptions after significant periods of volatility. The question came down to how they interacted with banks to ensure that, in extreme cases, they could meet redemption flows from clients. Stress testing and hypotheses about what could happen in a fund in those heightened volatility episodes were very important. Those were some of the ways that they were adapting their risk management and control operations to a world where flash crashes and heightened volatility could occur from time to time. Redemption tools e.g. redemptions in kind were also a solution in some cases.

The industry representative felt that there were a finite number of things that regulators could do to address liquidity risks in the asset management sector Each of these regulatory measures had pros and cons. The key was finding the right balance and asset managers had to adapt their risk management to the current altered market conditions.