Luis de Guindos: Coming to the forefront - the rising role of the investment fund sector for financial stability in the euro area

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the Opening Conference, 21st Euro Finance Week, Frankfurt am Main, 12 November 2018.

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I am honoured to speak at this Opening Conference of the 21st Euro Finance Week.

People often think that central bankers – by profession and perhaps even by nature – are predisposed to constantly warn about risks. We therefore need to avoid being perceived as ‘crying wolf’ too often. After all, persistently warning about threats that fail to materialise may be just as counterproductive as being over optimistic. Striking this delicate balance is crucial for central bankers – but also for markets. And looking at how markets currently price risks across a number of asset classes and geographies, I am not so sure that they are achieving this balance. I am raising these doubts in particular in light of the economic and political developments that we are currently witnessing – globally as well as in Europe.

In my remarks today, I will briefly discuss what we see as the main financial stability risks for the euro area, before zooming in on the situation in the investment fund sector. Over the past decade, this sector has almost tripled in terms of total assets and has taken on more risk. So it deserves greater attention from a financial stability perspective. I would also like to emphasise today that regulation needs to adapt to the evolving financial system. In that vein, I will discuss what remains to be done in developing macroprudential and other policy tools in response to evolving risks in the investment fund sector.

Financial stability risks in the euro area

In the euro area, we have now seen 22 consecutive quarters of economic growth and declining unemployment – a development which has also been bolstered by our accommodative monetary policy and which has supported financial stability overall. Notably, banks’ profitability has improved somewhat, though it is still at low levels, and they now have higher capital and liquidity ratios, making them more resilient than they were before the global financial crisis. Indeed, the results of the recent EU-wide stress test show that the banking sector has a good level of resilience overall, albeit with some pockets of vulnerability.

However, while the fundamentals for solid growth rates over the next two years are still in place, some risks are building up in the financial system. We are currently paying particular attention to three major developments that could trigger financial stability concerns globally and in the euro area.

First, the current expansion of the US is now significantly longer than historical norms and the second longest in US modern history. Looking ahead, a down-turn in the US macro-financial cycle could trigger a reassessment of riskier asset classes.

Second, at the global level, tensions have grown in emerging market economies on the back of a stronger US dollar and increased trade frictions. These developments may undermine global growth prospects and ultimately lead to abrupt increases in risk premia. This could trigger a domino effect – leading to a sharp sell-off and further price pressures in assets with stretched valuations – with the potential to spill over to euro area financial markets.

Third, in Europe we observe re-emerging debt sustainability concerns, both in the public and private sector. As regards public finances, Italy is the most prominent case at the moment in light of the overall debt level and the political tensions around the Italian government’s budget plans. The strong market reactions to political events have triggered renewed concerns about the sovereign-bank nexus in parts of Europe. Although contagion has been limited so far, it remains a possibility. This underpins the call for fiscal discipline and for observing and applying fiscal rules in Europe.

But in the non-financial private sector too, debt levels remain high by both historical and international standards. In a number of countries, debt is above thresholds that are normally associated with a debt overhang. And growing debt levels should also be seen in the context of buoyant real estate market developments in a number of countries.

In light of the current global and domestic developments, a common concern is that we may see a large and abrupt surge in risk premia, triggered or amplified by uncertainty about political actions or a shift in risk perception. At the same time, we are worried about the possible amplification of stress in financial markets through deleveraging and forced asset selling in a situation where asset prices are falling.

Now that the banking sector is shrinking and becoming more resilient, our radar is shifting to the non-bank financial sector, which is more lightly regulated. In particular, we need a better understanding of the role of asset managers and of the broader vulnerabilities inherent to investment funds. The asset management sector now plays a much larger role in financial markets than it did ten years ago. It may harbour leverage and liquidity risks that could amplify any potential shock from a reassessment of risks in financial markets.

I will now look in more detail at some longer-term developments and potential risks in the asset management sector.

Risks associated with liquidity, leverage and interconnectedness in the investment fund sector

One of the most notable developments since the financial crisis has been the rapid growth of asset management in the euro area and at global level. In the euro area, investment funds have been growing steadily, with total assets expanding by roughly 170% between 2008 and 2017[1], reflecting both continued net cash inflows and rising asset valuations. As a result, the structure of the euro area financial sector is changing. In 2008, total assets held by investment funds were only 15% of banking sector assets. In 2017, euro area investment fund assets had grown to 42% of total banking sector assets, amounting to EUR 12 trillion. This major growth in relative size is likely to have far-reaching implications for the ability of the financial system to absorb shocks and for the financing of the economy more broadly.

On the positive side, an increase in market-based finance through the issuance of debt and equity instruments can help diversify the funding base of the real economy. It also gives investors more choice and enables them to benefit from diversification effects offered by investment products. This holds true for retail and institutional investors alike, as an increasing share of institutional investors are using professional asset management services. The growing share of investors outside the core financial system tends to increase the system's risk-bearing capacity, as traditional end-investors, typically not leveraged, can absorb any potential losses more smoothly. One should also acknowledge that thanks to significant efforts in the last ten years, investment funds in the EU are subject to an enhanced regulatory framework. In particular, the fund specific regulation coupled with regulation covering certain activities, such as derivatives and securities financing transactions, have addressed investor protection issues and risks from a microprudential perspective.[2]

At the same time, the growing fund sector is creating emerging vulnerabilities from a system-wide perspective.[3]

The asset management sector is highly connected with other parts of the financial system through ownership links, common asset exposures and the provision of wholesale funding to banks. Investment funds are not only important depositors in banks; they also provide longer-term funding through the purchase of bank-issued debt securities. Euro area investment funds hold about EUR 400 billion or approximately 10% in outstanding debt securities issued by euro area banks. Banks, on the other hand, lend to funds mainly through repo transactions. So any potential shock to the investment fund sector may quickly spill over to other parts of the financial system.

When identifying possible weak spots in the financial system, it is sometimes useful to look back to past crisis events. I recall some 20 years ago, when Long-Term Capital Management (LTCM), a large and highly interconnected hedge fund, collapsed, in the wake of turbulence from the 1998 Russian crisis. The rapidly changing market environment effectively turned LTCM's business model into a key amplifier. LTCM was betting on longer-term developments in fixed-income markets using exceptionally high leverage. When the fund collapsed, fire-sale spillovers and counterparty exposures threatened to erode the stability of the financial system.

To be clear, I am *not* predicting another LTCM crisis any time in the near future. But I would like to use the case of LTCM to exemplify some key vulnerabilities which played a role in the collapse – acknowledging that LTCM was not an open-ended fund and did not face redemption risk, as most mutual funds do. In particular, let me focus on risks stemming from liquidity mismatches, leverage and interconnectedness across the financial system.

The asset management industry keeps reminding us that vulnerabilities in funds *cannot* be presumed to resemble those of banks. And it is true that investment funds do not issue deposits and that potential losses in a fund are borne by end-investors. But there is a fundamental difference between the equity in banks and the equity in funds. Investors in an open-end fund can run by *redeeming* their units, whereas equity holders in a bank can only run by *selling* their shares to other market participants. A run by investment fund unitholders can therefore resemble a run by bank depositors. In both cases, the institution is, in principle, forced to sell assets in a fires sale in order to meet its short-dated liabilities.

In general, asset managers are highly aware of their fund's liquidity position. In the interest of investors, the fund managers have incentives to minimise any impact from their own actions on financial markets, while at the same time accommodating share creations and redemptions. So a bank-like run by unitholders in a fund may not be very likely.

But a system-wide shock with a broader impact on market liquidity conditions could quickly change the situation. Liquidity at fund level may be squeezed if many investors wish to liquidate their unit shares at the same time. The resulting first-mover advantages and selling pressure could amplify stress in financial markets, especially if conditions are already fragile.

One reason why the Federal Reserve Bank of New York decided to facilitate the private-sector bail-out of LTCM was precisely because it was concerned about market dislocations should the company fail on some of its obligations. Letting LTCM go into disorderly fire-sale liquidation was seen as risking a severe drying-up of market liquidity, which could have damaged financial markets and the wider U.S. economy.[4]

Considering the current global and domestic uncertainties affecting financial market developments, I am seriously concerned about declining market liquidity and the role that investment funds might play in a possible stress scenario.

Liquidity mismatches and leverage are structural in nature and often build up slowly over time. In the euro area, we observe that investment funds have been taking on higher credit and duration risk in the current market environment. And we have strong indications that liquidity risks are building up in the fund sector. The share of less-liquid assets in that sector has been growing constantly since the global crisis, while liquidity and cash buffers have been declining.

From our market contacts we also hear that investors are increasingly using exchange-traded fund (ETF) shares to gain exposure to less-liquid markets. ETFs have been growing extremely fast thanks to their comparably low cost and high liquidity. ETFs are traded at higher frequencies and are sometimes more liquid than the underlying instruments. But can we be sure that liquidity in ETFs, in particular in bond ETFs, would remain stable if a sudden repricing in the markets occurred? This is a concern in particular for bond ETFs – a small but rapidly expanding market – which has not yet been tested in a larger distress event. Alongside liquidity risks, the ETF sector is also subject to counterparty risks because of connections to banks through ownership links and derivatives. Again, the fast-growing ETF segment deserves further attention from a risk and policy perspective.

It goes without saying that leverage plays a critical role in any potential stress scenario as it forces companies to deleverage, generating potential spillovers to asset markets. Our analysis also shows that leverage increases the procyclical behaviour of investors and asset managers, even if they are not excessively leveraged.

In any case, it is quite comforting that leverage in the European investment fund sector seems to be low, on average. Average leverage multipliers reach only up to 1.3 across different fund types. This is partly because about 60% of all investment funds fall under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive and so face tight leverage constraints.

On the other hand, many alternative investment funds do not face any binding restrictions on leverage. Among those alternative funds, we find a tail of highly leveraged bond and hedge funds, which sometimes have a leverage multiplier of more than 30.

I urge authorities to use the new data which is available to shed more light on this highly leveraged part of the sector.[5] This may help to better understand some of the lightly regulated and less transparent activities where risks may be building up. For instance, private loan funds may potentially erode credit standards and take on higher credit risk in the current market environment, whereas private equity funds may facilitate excessive leverage in the non-financial sector.

Some of these activities may be escaping our attention, as statistics on them are scarce and they are often conducted by funds outside the euro area. Leverage may be building up, for instance, by the use of derivatives or in off-shore centres. Therefore, consistent reporting frameworks have to be developed with a view to gaining a system-wide perspective on evolving risks, also at global level. It will be important to develop comparable leverage measures in line with the recommendations of the Financial Stability Board (FSB) to the International Organization of Securities Commissions (IOSCO).[6] This will facilitate consistent monitoring and assessment of the build-up of risks in the investment fund sector.

As the global crisis has shown, we cannot afford to be complacent and must remain vigilant to possible new risks that might emerge in the financial system. So we need to better understand the macroprudential dimension of risk in the investment fund sector. And we need to further enhance the sector’s resilience to system-wide shocks.

Possible macroprudential and other policy responses – what needs to be done?

Let me now set out a few regulatory actions which could contribute to mitigating risks arising from interconnectedness, liquidity and leverage in the investment fund sector.

Let me start with interconnectedness and the links to banks in particular. The global financial crisis showed that banks sometimes have incentives to step in to support unconsolidated entities such as special purpose vehicles or investment funds with which they have a business relationship. Explicit contractual obligations are already captured by a number of post-crisis reforms, in particular by revisions to the securitisation framework and by enhancements to consolidation rules for off-balance sheet entities.[7] But the risk that a bank provides financial support to an unconsolidated entity that is facing stress, over and above any contractual obligations has not yet been addressed. Such risks may be particularly relevant in the context of close ownership links between banks and funds. For example, banks in certain circumstances may feel a need to step in to protect their brand. To tackle this issue, the Basel Committee on Banking Supervision (BCBS) has published guidelines on step-in risk that would require banks to self-assess and report their material step-in risk exposures to supervisors, who should have the possibility for supervisory action if deemed necessary.[8]

We also need to work on the different layers of interconnectedness between ETFs and their counterparties. In our view, the rapid growth of ETFs, coupled with their potential to transmit and amplify risks to financial stability, warrants further evaluation of regulatory action. [9] This may include enhanced rules to limit counterparty risk exposure of ETF investors, and measures that provide more transparency around ETF liquidity provision.

The enhanced microprudential framework for the European fund sector is a key element in boosting the resilience of the financial system overall. But the sector's rising role in shaping the financial cycle, and the potentially systemic nature of its risks, require a more ambitious approach. We should aim at extending the macroprudential framework beyond banks to encompass the asset management sector.[10]

In particular, we need to equip macroprudential authorities with the necessary tools to address systemic risks both ex ante and ex post. The recent ESRB recommendation to address systemic risks related to liquidity mismatches and leverage in investment funds[11] is a crucial step towards this goal. Most importantly, from a macroprudential perspective, the proposed measures would help national authorities in setting binding leverage limits for alternative investment funds to mitigate systemic risk. The recommendations foresee also a role of the authorities in suspending redemptions in a stress scenario.

Going beyond the ESRB recommendation, I would argue in favour of complementing the powers that are currently envisaged for authorities with ex ante tools targeting liquidity risks at system level. Existing liquidity management tools may mitigate liquidity risk ex post, but they might not suffice to prevent the build-up of vulnerabilities in exuberant times ex ante.

The toolkit available to macroprudential authorities should therefore include additional ex ante requirements such as minimum liquidity buffers and redemption notice periods.[12] Mandatory liquidity buffers require funds to hold sufficient high-quality liquid assets for the fund to be able to meet redemptions and margin calls under many foreseeable scenarios. The introduction of minimum notice periods would help align a fund's liability structure with the liquidity- and risk-profile on the asset side. Overall, such tools could be used to raise the sector's resilience to potential investor runs or spikes in margin calls. Setting these requirements would greatly limit the sector's ability to build-up liquidity risk in exuberant times.

Finally, given the cross-border nature of the investment fund sector, we need to strengthen the European perspective in the supervision of investment funds while also ensuring a globally consistent approach to monitoring. Arguably, the investment fund industry in the EU is highly concentrated in a few jurisdictions, but – due to the diverse asset holdings and investor locations – the impact of adverse developments in this sector may be felt across the EU. Hence, I call for further investigation of the case for bringing investment fund supervision and the potential activation of macroprudential tools to the European level.[13]

In a related debate, the FSB announced recently that it will no longer use the term "*shadow banking*" in its future communications to avoid the pejorative connotations. Hedge funds and other asset managers will instead fall under a broader group of non-bank financial intermediaries.

We very much welcome the change in terminology, as it supports a closer focus on emerging vulnerabilities in the asset management sector, regardless of whether these are considered to be bank-like or not.

Concluding remarks

We have come a long way since the financial crisis. We have implemented a range of regulatory reforms that have addressed many issues that the crisis brought to light both in the bank and non-bank financial sectors. Nevertheless, the ever evolving nature of our financial system and the undisputable argument that the next crisis will be different require us to remain vigilant.

The tectonic shifts in the structure of the financial system brought about with the rise of asset management call strongly for further policy work in this area. We need to better understand what these shifts in the financial system imply for financial stability and the financing of the real economy. On the positive side, an increase in market-based finance can help to diversify the funding base of the real economy and investors are increasingly benefitting from diversification effects. However, as the risks arising from leverage and liquidity mismatches in investment funds are potentially systemic, we need to take a more ambitious policy approach to systemic risk. Extending the macroprudential framework to the asset management sector and developing policy tools to address emerging risks will be an important step in preparing for possible future stress scenarios.

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1 Figures exclude money market funds (MMFs).

2 These include the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive, the Alternative Investment Fund Managers Directive (AIFMD), the European Market Infrastructure Regulation (EMIR) and the Securities Financing Transactions Regulation (SFTR).

3 E.g. see International Monetary Fund, Global Financial Stability Report, Chapter 3: “The Asset Management Industry and Financial Stability”, April, 2015.

4 See Testimony of Chairman Alan Greenspan on private-sector refinancing of LTCM before the Committee on Banking and Financial Services, U.S. House of Representatives, October 1, 1998.

5 E.g. new data is reported under the Alternative Investment Fund Managers Directive (AIFMD).

6 See FSB “Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities”, 12 January 2017.

7 See Basel Committee on Banking Supervision, Guidelines on the identification and management of step-in risk, October 2017 and Financial Stability Board, Assessment of shadow banking activities: risks and the adequacy of post-crisis policy tools to address financial stability concerns, July 2017.

8 Ibid.

9 See ECB Financial Stability Review Special Feature C, Counterparty and liquidity risks in exchange-traded funds, forthcoming November 2018.

10 See European Systemic Risk Board, “Macroprudential policy beyond banking: an ESRB strategy paper”, July 2016.

11 See Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds (ESRB/2017/6) published 14. February 2018.

12 See ECB Macroprudential Bulletin, “Macroprudential liquidity tools for investment funds – A preliminary discussion”. The article states that redemption duration restrictions could be differentiated based on the fund type, or a limited number of fund “profiles” that represent a combination of key fund characteristics, including the asset and liability side of the fund.

[13] See also ECB contribution to the European Commission's consultation on Capital Markets Union mid-term review 2017.