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Where Are The Risks? – Euromoney Global Borrowers And Investors Forum - Remarks by Paul Tucker

Paul Tucker – the Bank's Executive Director for Markets – today addressed a session titled 'Where are the risks?' at the Euromoney Global Borrowers and Investors Forum in London. Noting that in one form or another risks crystallise every day, Mr Tucker discusses whether today's capital markets are well placed to absorb any nasty shocks.

In particular, he offers some views on the debate about recent innovations in derivative markets. He argues that they have helped to disperse risks around and beyond the banking system, and that they have "plausibly taken us a further step towards complete markets...providing a richer market for credit insurance than previously existed". He concludes that "there are, therefore, tangible benefits from the new derivative markets for unbundling and transferring...risk."

Asking "So where's the catch?", Mr Tucker highlights the risk of herd like behaviour in markets if 'everyone' tries to sell – or buy – at once; panic in the presence of leverage is familiar from various past episodes. Derivatives have introduced variations on this, particularly where, as a group, leveraged firms or investors have structurally short positions in options which they dynamically hedge, buying when prices rise and selling when prices fall. In the face of shocks, dynamic hedging can, in consequence, amplify price movements and increase volatility in less liquid markets or markets that prove illiquid under stress. Mr Tucker points to a number of examples of this over the past twenty years, most recently briefly in the structured credit market.

Mr Tucker suggests that "…market participants have an interest in factoring into their risk management an assessment of whether a market has structurally imbalanced option (or option like) positions". The Bank of England's market intelligence work aims to pick up some such imbalances, as an input to the assessment in its half yearly Financial Stability Review, the next edition of which is published on Monday.

Mr Tucker says the underlying forces driving innovation in wholesale financial markets remain strong. Returns to intermediaries tend to be lower in efficient markets, encouraging firms to seek more attractive returns from new products and markets. Innovation leading, over time, to greater market efficiency and helping to distribute risk is by and large "…a benign story for society". But Mr Tucker identifies two corollaries. First, the need for investors to consider whether past returns can safely be extrapolated into the future. Second, the importance of controls keeping pace with new products and markets. Observing that the growth in the credit derivatives and structured credit markets has led to some concerns about backlogs in trade confirmations and assignments, Mr Tucker suggests "…market participants have an interest in working together to establish robust practices and infrastructure when a particular innovation takes off".

Both the issues Mr Tucker discusses entail understanding markets as involving more than individual firms operating independently. He concludes that firms "…can, and should, play a part in buttressing the system – by continuing to innovate, and by factoring collective outcomes into [their] private calculus and risk management".

Key Resources

Euromoney Global Borrowers and Investors Forum
Remarks by Paul Tucker, Executive Director and Member of the Monetary Policy Committee, to the session "Where are the Risks?" at The London Hilton on 23 June 2005
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2005/speech251.pdf