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News release

Jon Cunliffe – Market-based finance: a macroprudential view

In a speech given at the FIA SIFMA AMG Asset Management Derivatives Forum, Jon Cunliffe addressed the growth of market-based finance and the different challenges it poses to regulators as compared with banks. He also touches on recent EU proposals for reform in this area.

Jon noted that market-based finance, as measured by the assets of non-bank financial institutions, grew to $150 trillion in 2015 – an increase of about 50% since 2008. It now represents nearly half of the assets of the global financial system. However, its growth since the crisis does not, as some have claimed, represent the movement of toxic risks out of the regulated banking sector into less regulated areas.

In Jon's view the opposite was true, in that we have seen a movement within market-based finance away from the more dangerous forms of 'shadow banking' - away from the types of activities that were at the centre of the financial crisis and that amplified and transmitted stress to other parts of the financial system.

Market-based finance, generally speaking, is more able to share risk and pass losses back to investors than the banking system. Investment funds do not carry the same solvency risks as banks as investors are entitled only to the market value of their investments. In a crisis, the valuation of the assets and of the liabilities of investment funds broadly move in the same direction, whereas for banks assets can go down in value while the liabilities remain fixed.

However, although there are benefits and the risks are different, Jon's view is that there may well still be systemic risks in the development of market-based finance, particularly around liquidity in times of stress, and that macro-prudential regulators need to be alive to them.

For instance, a survey conducted by the Bank of England showed that funds individually were assuming more liquidity than might be available if there was market-wide selling pressure.

And, given the growth of market-based finance into less liquid and more risky markets, investors might be more likely now to act pro-cyclically, selling into a falling market, than they had in the past.

He also raised concerns about leverage – particularly synthetic leverage – in the non-banks sector, with both IOSCO and Financial Policy Committee of the Bank of England developing better ways of measuring the risks this might pose. Jon said: “I do not start from the view that leverage poses the same scale or nature of risks in the market-based finance world as it does in banking. But nor am I confident at present that it is without systemic risk.”

Turning to the current EU proposals, Jon noted that Brexit did not represent a major regulatory risk to the EU given that only 10% of EU assets are managed in the UK. Jon noted that over 50% of the $8.5tn assets under management in the UK are pensions, insurance and investments of UK citizens. Another 20% comes from the rest of the world beyond the EU. Less than 20% of assets managed in the UK, are domiciled in the rest of the EU.

Jon said that “to the extent that these are sensible regulatory improvements in line with global norms intended to enable delegation and global business models to operate effectively and practically while managing risk, one would have little concern.”

However, he adds: “To the extent, however, that they are motivated by Brexit and a desire to pull activity and risk back within jurisdictional boundaries, contrary to current global practice, I do have a concern that they could act as the harbinger of fragmentation to come.

He concludes: “That would raise the cost and reduce the efficiency of market-based intermediation of savings in the EU and, if it led to wider effects, further afield. It would also slow, and perhaps frustrate, the development of market-based finance globally as a way of diversifying economic risks and benefits across jurisdictions and of dampening economic and financial shocks.”

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