BANK OF ENGLAND

Speech

Liquidity matters

Speech given by

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Introduction

It's a pleasure to speak to you today in my capacity as an independent member of the Bank of England's Financial Policy Committee (FPC). The FPC was set up in the aftermath of the financial crisis, as the body charged with identifying and mitigating threats to the financial system as a whole. This is our primary objective. We also have what I believe is an important secondary objective – to support the government's economic policy, including its objectives for growth and employment. We refer to this as 'macroprudential' regulation, as distinct from 'microprudential' regulation with its focus on the safety and soundness of individual financial firms. I would stress here that this speech reflects my own views as an independent FPC member, not necessarily those of the Committee as a whole. And while one of my other roles is as an independent non-executive director of Nomura Holdings, I am not speaking here in that capacity.

I suspect we all appreciate the value of financial stability today. One reason is that the financial *sector* is a major part of the economy in its own right – for example, here in Birmingham, some 1,900 financial services firms employ over 20,000 people. But more important, the financial *system* provides key services to every other part of the economy: it intermediates between savers and borrowers, allows individuals and firms to manage their risks, and should ensure that capital is allocated to where it can be most productive. Any of you who require financing for domestic or international expansion projects, take out insurance against business risks, hedge currency or commodity risk, or simply make payments electronically, will know that you need a resilient and effective financial system.

Put simply: a stable financial system is one in which the real economy has continual access to the financial services it needs. Today I want to talk about some changes to their provision, and the risks they may carry for financial stability. In particular, I will focus on the growing importance of market based finance and the nature of change to the resilience of liquidity provision in key capital markets.

The provision of financial services has been undergoing significant change for some time now, with the financial crisis providing an important catalyst to a major shift to a new capital framework. Banking business models are adjusting to a new world, and households and corporates are exploring new channels for saving and borrowing.

For example, corporate bond issuance has more than quadrupled in the past decade. In part, this may be because many corporates were stung by the experience of tightening credit conditions as banks came under strain during the financial crisis – the so-called 'credit crunch' , which underlined their overwhelming reliance on bank credit.

But Europe remains over reliant on bank finance…

This represents only a tentative shift towards capital markets. In Europe, we remain over-reliant on bank finance. The numbers are stark; bank lending still accounts for three-quarters of corporate credit (albeit down from 85% in 2008) compared to just 20% in the US.[1] This illustrates the less-developed state of European capital markets.

In Europe, assets are concentrated in the banking sector, which accounts for over 300% of GDP, compared to around 70% in the US.[2] The corollary is that savings held in other investment vehicles, such as mutual funds and pension funds, are relatively small – at around 50% and 35% of US equivalents, respectively.

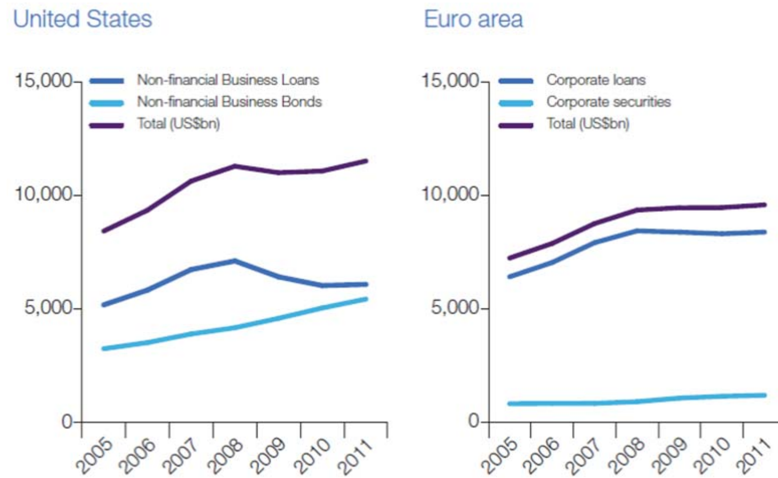
There is a corresponding lack of depth in European capital markets, with initial public offerings of equity at around half the level in the US, while secondary market trading for European equity and corporate bond markets represent around 70% and 60% of US counterparts, respectively. I should point out, however, that within this broader European picture, the UK stands out at some distance ahead of our European neighbours; closer to the US model as a result of our highly developed equity market.

The overall dominance of the banking sector is underlined by the balance sheets of non-financial companies, with bank loans accounting for around 30% of these companies' liability structures in Europe; this compares to around 10% in the United States.[3] In fact, corporate loan financing in Europe outstrips bond financing by around eight times; in the US this sits at a roughly equal balance (**Chart 1**).

The desired balance between bank and market-based finance is open to debate. But if nothing else, the recent experience of the financial crisis suggests that the cost of excessive reliance on the banking system can be debilitating – during the crisis, Europe suffered a long and severe contraction in credit supply as the health of the banking system became impaired.

[1] 'Driving growth: making the case for bigger and better capital markets in Europe', *New Financial*, October 2014
[2] based on ECB, Eurostat, Federal Reserve, US Bureau of Economic Analysis data and Bank calculations
[3] based on OECD National Accounts Statistics

Chart 1: Bank versus bond financing



Source: Bruegel based on S&P calculations from central banks, Eurostat, IMF and Bank for International Settlements data

So it seems sensible to **secure the benefits that capital markets and market-based finance can clearly offer our companies;** namely, funding alternatives and risk management options against a more diverse group of counterparties. Indeed, pushing savings from a conservative bank deposit to real investment is critical to ensuring that risk-taking can produce future economic growth and prosperity. And without sustainable growth it is hard to imagine a truly safe and stable financial system.

A bank-based system is also a debt-based system. But strong capital markets create more scope for equity finance. And equity finance can confer financial stability benefits as it provides companies with far more flexibility. Funding can be staged as the company grows and dividend payments can be adjusted in light of corporate success and economic conditions, to name two advantages. Compared with long and painful debt restructurings, rights issues are typically far more successful, leaving companies fit for the future. A shareholder tends to buy into the company's strategy and can develop a sense of 'ownership' which subsequently supports the firm in a tangible and, hopefully, productive way.

Risks…

But market-based finance can also present systemic risk– an obvious example is the manner in which financing mechanisms outside the banking system helped to propagate the risk from US sub-prime to financial institutions internationally in 2007/8.

One of the Financial Policy Committee's responsibilities is to identify and assess systemic risks to the UK economy that may arise from across the global financial system – not just in the closely supervised banking

system but also, potentially, in broader capital markets. However, the Committee also seeks to improve the diversity and robustness of financing channels in the UK; this is to ensure stability in key financial services that support economic growth. And this suggests a role for the FPC in reducing impediments to their provision.

In the longer term, a more balanced UK financial system is desirable and should emerge. This greater diversity of finance should make both the real economy and systemic sectors, such as the banking system, more resilient to economic shocks.

The financial crisis has made central banks acutely aware of the challenges posed by an economy so reliant on its banking system. Nearly seven years after the white heat of the crisis, extraordinary measures by central banks continue. The development of market-based finance should also help central banks to step back from 'last resort' measures and allow private markets to operate more widely and efficiently. Provided that these markets are resilient, this will be a welcome transition.

The importance of banks in supporting market-based finance

The wind is blowing in this direction, as major banks review their business models and retrench – issuance of high yield bonds has trebled in the past decade.[4] The global asset management sector has also doubled in size in the same period;[5] supporting this trend with an increasing appetite for quality investment assets.

But as we transition to an economy more dependent on capital markets, their resilience to stress will matter far more.

Crucial to this will be an understanding of the interaction and complementarity of market-based and bank-based finance – and indeed the knowledge that capital markets can't and won't substitute for the banks, which play a key role in facilitating efficient access to markets.

For example, securitisation – the process by which bank-originated credit claims are packaged into marketable securities – can help to deliver credit by utilising banks' loan origination capability while attracting investors from outside the banking sector to fund and share the risks of this lending.

Tradable financial products are (also) fundamental to capital markets – whether shares listed on a stock exchange, corporate bonds, exchange-traded funds, foreign exchange derivatives, or investment trusts, to name a few. Potential issuers seeking a stock exchange listing value a marketplace in which investors can make an initial investment and take a stake in their business; but these investors would be far less likely to

[4] Based on Dealogic data
[5] Based on measures compiled by Boston Consulting Group and TheCityUK

do so without the presence of a liquid secondary market in which they could adjust their holdings as their requirements and circumstances change.

In this way, liquid financial markets are a key element in a well-functioning financial system that facilitates investment in the real economy and supports economic growth. These primary issuance and secondary trading markets have developed over time, and have generally been facilitated by investment banks and broker/dealers on behalf of their clients – both issuers and investors.

Recent reforms in the regulation of investment banks – including enhanced capital and liquidity standards – have made the core of the system much safer. But one concern for me, in light of recent developments in financial markets, is that reduced activity by investment banks in capital markets could be making some markets more fragile, hindering their ability to provide essential services to companies and investors in a resilient and cost-efficient way.

Resilient market liquidity is key to successful market-based finance

Market liquidity is the ease with which one asset can be traded for another. In financial markets, this relates to the ability to transact in a security at a level close to the prevailing market price, and in a way that promotes price discovery in line with fundamental factors, such as the outlook for future cash flows. It is strengthened by the presence of a diverse range of market participants, high quality research and analysis, open and cost-effective access to markets and transparency.

Improved market liquidity is therefore positive for the financial system; enabling the efficient allocation of capital to economic opportunity– intermediating savers and borrowers and insuring against and dispersing commercial and financial risk appropriately and cost-effectively.

But the quality and resilience of liquidity can be difficult to assess. A market may appear to be highly liquid due to demand for assets driven by broader conditions in the financial system. 'Funding liquidity', the ease with which banks and other financial intermediaries can raise funding, and 'monetary liquidity', the counterpart to credit creation in the financial system, can interact to create a veneer of abundant liquidity. For example, rising demand for assets created by a relaxation in funding and monetary conditions (in part from low interest rates and quantitative easing) can undermine the price discovery process, leading to apparently stable prices, an under-pricing of tail risk and insufficient compensation for liquidity risk.

The activities of investment banks play a central role in supporting capital markets

Investment banks have traditionally been key to the resilience of market liquidity through their trading operations, especially their market making activity. Market makers facilitate trading for their clients in secondary markets by standing ready to buy or sell securities at the so-called market price and making a

margin on the spread – while seeking to manage the financial risk arising from these trades and the securities they hold on their market-making books to facilitate them. This service provides a degree of certainty that an investor will be able to trade a given security at a reasonably predictable price at short notice.

Investment banks may be better placed than other market participants to provide such services. The client relationships which they seek to maintain have provided an incentive to commit their own capital towards this. As an example, investment banks generally provide liquidity to secondary markets after facilitating an equity or bond issue for a corporate client. Their knowledge of the company and its business should also assist in the proper pricing of a new security brought to market.

The importance of keeping primary markets open and active for corporates seeking to fund enterprise means that secondary markets must work effectively. Investment banks have traditionally supported market liquidity in times of stress, providing prices even during periods of great uncertainty and volatility; effectively acting as a buffer and shock-absorber as investors adjust to unexpected news. Securities financing and 'repo' markets, essential to the management and hedging of these intermediation risks have been called 'the silently beating heart' of the capital markets.[6] But there are, of course, limits to the willingness of investment banks to provide this service. Faced with an extreme shock, they have also withdrawn from markets in order to contain their own risk – as was illustrated dramatically in the financial crisis.

But investment banks have withdrawn from such activities in recent years…

The severe trading losses that many suffered during the crisis also triggered a reassessment of their risk profiles and business models. In 2008 alone, aggregate trading losses in the UK banking system were over £40bn.[7] The scale of these losses has been a major impetus for regulatory reform.

Since then, much has changed. Five years after the peak of the crisis, global investment banks had reduced their trading inventories by nearly 25%. The figure for major UK banks is closer to 30%.[8] Current inventory levels are now at levels last seen in the early 2000s – and the relevant markets are now very much larger and far more international, following the rapid globalisation and economic growth of the pre-crisis decade.

While much of this fall in inventory was driven by investment banks unwinding large structured credit books, this has been extended and reinforced by regulatory reform. As we know, the post-crisis package of prudential measures included multiple adjustments to capital requirements from levels that were far too low. This has greatly increased the resilience of the core banking system. However it has also altered the economic model for capital markets intermediation, and will have acted as an additional disincentive to such activities, especially those related to low-margin market-making.

[6] http://www.treasury.gov/resource-center/data-chart-center/quarterly-refunding/Documents/Charge_2.pdf
[7] Bank of England data
[8] Bank of England, *Financial Stability Report,* December 2014 pp 13-14, 18

Proprietary trading has also largely disappeared from major investment banks' American and European operations – mainly as a result of regulation designed to protect bank depositors from the potential for losses, in extremis, arising from the existence of these trading books. While regulatory reform was clearly needed, the decline in proprietary trading also reduces the depth and diversity of capital markets participation.

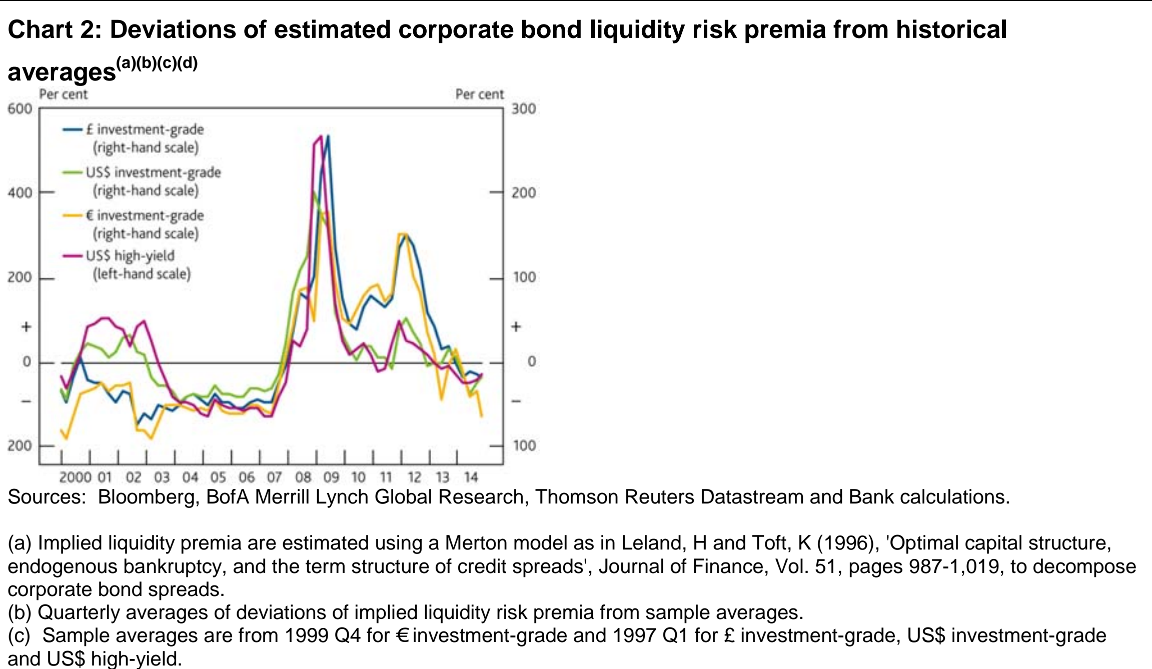
…contributing to a more fragile market liquidity environment

The decline in investment bank market-making has been a growing theme in recent years. It looks structural. Some banks have responded by moving to more of an agent role in some markets, thereby reducing balance sheet risk. Asset managers report an increased need to split larger transactions across dealers. As a consequence the financial system has less capacity to absorb market shifts and periods of higher volatility are more likely.

But despite these changes, some measures of liquidity risk premia appear compressed; the compensation that investors require for bearing liquidity risk in some corporate bond markets has actually fallen to below its long-term average (**Chart 2**). Fragile liquidity conditions in these markets render them vulnerable to sharp correction.

Such risk may have crystallised to some extent in the summer 2014 'wobble' in high yield markets and then, in mid-October, in the extreme volatility seen in the US Treasury market. Neither of these episodes can be adequately explained by significant news triggers.

Chart 2: Deviations of estimated corporate bond liquidity risk premia from historical averages[(a)(b)(c)(d)]



Sources: Bloomberg, BofA Merrill Lynch Global Research, Thomson Reuters Datastream and Bank calculations.

(a) Implied liquidity premia are estimated using a Merton model as in Leland, H and Toft, K (1996), 'Optimal capital structure, endogenous bankruptcy, and the term structure of credit spreads', Journal of Finance, Vol. 51, pages 987-1,019, to decompose corporate bond spreads.
(b) Quarterly averages of deviations of implied liquidity risk premia from sample averages.
(c) Sample averages are from 1999 Q4 for € investment-grade and 1997 Q1 for £ investment-grade, US$ investment-grade and US$ high-yield.

Few other market participants can support market liquidity in the same way as investment banks…

This suggests that we are on a path to a new market structure, with established investment banks acting more like brokers, increasingly acting as agent rather than principal. Their clients – institutional investors, pension funds and hedge funds – are increasingly being seen as the true providers of market liquidity. But this is clearly not the same as an intermediation or market making role.

Theoretically, a liquid and efficient market for securities can exist without a market-making function. Exchanges like the London Stock Exchange do this job, particularly when securities are numerous, fungible and regularly traded. But while efforts are being made to move more financial instruments to various trading platforms, intermediaries have a vital role to play – especially in markets for securities that are less amenable to exchange trading, like corporate bonds or bespoke derivatives. These will each have distinct characteristics, geared to the specific needs of the company at that point in time.

Central banks can and did act to backstop financial markets in the crisis in a 'market maker of last resort' role. But, while it is important for investors and issuers to have confidence that their funding channels will be there when they need them, there can be moral hazard in an expectation that liquidity risk will be taken off the table by central banks in circumstances that may compel them to intervene. The Bank was cognisant of these issues in drawing up its published principles for any future 'market maker of last resort' intervention – which make it clear that this would only happen under 'exceptional' circumstances.[9]

To conclude:

The shift to a greater use of market-based finance is desirable in Europe, given our overreliance on the banking system for the provision of finance to the economy.

But as it develops we will need to ensure it is resilient and that it underpins the stability of finance to the economy. That will depend on the resilience of liquidity in capital markets.

The post-crisis regulatory reform agenda has benefitted financial stability materially, by reducing the probability and likely cost of financial crises. However, there is evidence that liquidity in some key markets has become more fragile. And there may be unforeseen consequences for the intermediation and market making functions performed by broker/dealers and investment banks that are a source of market liquidity – and liquid markets are necessary to support a shift to resilient market-based finance.

In order to ensure that capital markets can contribute to the stability and prosperity of the economy, without recourse to 'last resort' liquidity provision, it is imperative that more thought is given to how we promote resilient capital markets during what could be a bumpy transition at a time of heightened geo-political risk. As

[9] http://bankofengland.co.uk/markets/Documents/money/publications/redbook.pdf

I mentioned earlier, the FPC considers diverse and resilient sources of market-based finance to be a key priority.

As the post-crisis reform agenda beds down, it will be important to take stock of the cumulative impact and interaction of all the recent reforms, which may at times be attempting to reduce the same risks in a number of different ways. The goal is to achieve the right calibration for a financial system that is able to work towards a sound and strong economic future.