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Time to Worry about Illiquidity

At a time when central banks have injected unprecedented amounts of money, worrying about illiquidity may appear odd. However, if poorly understood and unaddressed, illiquidity could be the foundation of the next financial crisis. Market liquidity is defined as the ease of trading a financial security quickly, efficiently and in reasonable volume without affecting market prices. While researchers find that it has been positively correlated with central bank's liquidity injection, it may no longer be the case. The combination of tightly regulated banks, loosely regulated asset managers, and zero (or negative) policy rates could prove toxic.

One recent volatile day on the markets, an investor called her bank manager asking to convert a reasonably small amount of foreign currency. The sales person was quick to respond: “I will hang up now and we will pretend this call never happened”. In other words, the bank was not ready to quote her any price. The typical academic measures of market liquidity, such as bid-offer spreads, remained tranquil on Bloomberg, there was no transactions taking place.

When the investor was finally forced to exchange, the result was messy: currency price gapped—fell discontinuously—causing alarm among other market participants and policymakers. All that due to a transaction of roughly $500,000 in one of the top emerging market currencies in the world according to the BIS Triennial Central Bank Survey at an inopportune moment.

Markets becoming less liquid

Post crisis, G-7 central banks have embarked on unconventional monetary policy measures to boost liquidity and ease monetary policy at the zero-lower-bound, while tightening bank regulation and supervision. On net, however, the ability to transact in key financial assets in adequate volumes without affecting the price has fallen across a range of markets, including the foreign exchange markets that are traditionally assumed to be the most liquid compared to bonds, other fixed income instruments and equities.

Financial market participants have reported a worsening of liquidity, particularly during periods of stress. Event studies include the 2013 “taper tantrum” episode, where emerging markets’ financial assets experienced substantial volatility and liquidity gapping that did not appear justified by the Fed’s signal to reduce marginally its degree of monetary policy accommodation, as well as the recent shocks to the US Treasury market (October 2014) and Bunds (early 2015).

Banks are retreating

Market-makers (international “sell-side” or investment banks as in the introducing example), which used to play the role of intermediators among buyers and sellers of financial assets, are now increasingly limiting their activities to a few selected liquid assets, priority geographies and clients, thus leading to a fragmentation of liquidity. Market-makers have also been reducing asset holdings on their balance sheets in a drive to reduce risk-weighted-assets, improve capital adequacy and curb proprietary trading. As a result, they are less willing to transact in adequate volumes with clients.

In the past, leverage by banks has been associated with higher provision of market liquidity. Loose regulation and expansionary monetary policy has been conducive to higher leverage by banks pre-2008. It is therefore puzzling that, now, at the time of unconventionally large monetary expansions by central banks, sell-side banks are unwilling to provide market liquidity. The answer may lay in tighter bank capital and liquidity regulation as more stringent definitions of market manipulation. Risk aversion by banks has also become harsher, a trader stands to lose a job and little to gain on a $2 million swing in her daily profit and loss, while in the past a swing of $20 million at a same bank would have hardly warranted a telling-off. Banks have become safer, but can that also be said about the financial system?

Asset managers growing in importance

Ultra-accommodative and unconventional monetary policies have compressed interest rates across all maturities. In a world where US Treasuries at two-year maturity do not even yield 1%, and Bunds are yielding negative rates even beyond 5 years, investors in search for yield are looking at longer (and less liquid) maturities and riskier assets. If banks are unable to meet this demand, others will: assets under management

(AUM) by non-bank financial institutions, specifically real asset managers have expanded dramatically in recent years. Total size of top 400 asset managers' AUM was EUR50 trillion in 2015, compared to EUR35 trillion in 2011 according to IPE research, with the largest individual asset manager in excess of EUR4 trillion. A fundamental problem arises when such asset managers are lightly regulated and very often have similar investment strategies and portfolios.

In the industry jargon, these asset managers are called long-only or real-money. Why the funny names? Long-only means they cannot short financial assets, as opposed to hedge funds. For every $100 collected from a range of individual investors' savings via mutual funds, pension and insurance fund contributions, a small share (say 5%) is set aside as a liquidity buffer and the rest is invested in risky assets. Real money refers to the fact that these managers should not be levered. However, that is true only in principle as leverage is related to volatility.

Performance of real-money asset managers is assessed against benchmark portfolios. For emerging markets, the portfolio would typically be a selection of government bonds according a range of criteria, including size of outstanding debt, ease of access by international investors, liquidity, and standardization of bond contracts. Investors more often than not do not hedge foreign currency exposure. The benchmark for emerging markets sovereigns could have 10% allocated to Brazil, 10% to Malaysia, 10% to Poland and 5% to Russia, for example. India, on the contrary, would be excluded, as it does not allow foreign investors easy access to government bonds.

Benchmarks and illiquidity dull investor acumen

Widespread use of benchmarks among institutional asset managers can steer the whole market to position in "one-way" or herding, contributing to illiquidity and moral hazard risks. Benchmarks by construction reward profligate countries with large and high-yielding stocks of government debt.

While each individual portfolio manager may recognize the riskiness of highly-indebted sovereigns, benchmarking makes optimal to hold debt by Venezuela, Ukraine or Brazil as each year of missed performance (before default) is a risk of being fired, while if the whole industry is caught performing poorly, it is likely that the benchmark is down by as much.

Furthermore, real-money asset managers have become disproportionally large relatively to the capacity of sell-side banks (brokers) to provide trading liquidity. In fact some positions have de-facto become too large-to-trade. Even a medium-sized asset manager of no more than $200bn under management (industry leaders have $2-$4 trillion AUM) that attempts to reduce holdings of Ukraine, Venezuela or Brazil at the signs of trouble, is likely to trigger a disproportionate move in the asset price. This further reduces incentives to diligently assess each individual investment. In such environment, risk management has become highly complex, stop losses may no longer be as effective, while more stringent cash ratios would put an individual asset manager at a disadvantage to others.

Conclusion

Anecdotal and survey-based measures from the market demonstrate that liquidity is scarcer and less resilient during risk-off episodes. While regulation has made banks stronger, it may have rendered the financial system less stable. Lightly regulated real asset managers are increasing assets under management, are often positioned "one-way" and are becoming too-large-to-trade.

Nonetheless, systemic risk stemming from illiquidity in the new structure of the market remains little researched and poorly understood by policymakers and academics. Most models of the monetary transmission mechanism and

exchange rate management do not incorporate complexities of market liquidity.

While regulatory changes have been largely driven by policy makers in the developed markets (naturally since they were at the epicenter of the global financial crisis), it is the emerging markets that in my view are most at risk. They tend to have less developed and less liquid domestic financial markets, and be even more prone to liquidity gaps with higher risks of negative financial sector-real economy feedback loops.

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