DEUTSCHE
BUNDESBANK

Dr Jürgen Stark

Vice-President

Deutsche Bundesbank

Some new trends in financial markets

Keynote address

Symposium on building the financial system of the 21st century:
an agenda for Europe and the United States

in Eltville

on 23 April 2005

Check against delivery

Reproduction permitted only if source is stated

Contents

1 Introduction ... 2
2 Some reflections on financial stability ... 3
3 Some new trends to be watched ... 6
3.1 Risk transfer “to” the household sector ... 8
3.2 Unregulated financial business ... 12
4 Concluding remarks ... 15

1 Introduction

Ladies and gentlemen

It is a great pleasure for me to address this distinguished audience at Harvard Law School’s “Program on International Financial Systems”. Of course we should not misunderstand the title “building the financial system of the 21st century”. Financial systems don’t need to be actively built for they are great at evolving on their own, as can be seen in trends both past and present. What needs to be built, however, is a sound and proper framework, where evolution can safely take place. By “safely” I mean without compromising financial stability. The architects responsible for designing and adapting the framework need to monitor closely the permanent change in financial systems.

In this vein, I would like to comment today on two trends in financial systems: the phenomenon of risk transfer to private households and the recent strong growth in unregulated financial business.

2 Some reflections on financial stability

First, however, I would like to set the general backdrop of financial stability. Financial stability now is a very topical issue. A growing number of international committees regularly debate financial stability issues. The Financial Stability Forum that met last month in Tokyo is a good example. A growing number of central banks and other financial institutions have taken to publishing financial stability reviews. This is no different at the Bundesbank; we published our first financial stability review in December 2003.

The increasing preoccupation with financial stability is by no means just a fashion or due to central bankers' "search for new tasks". It is based on the recognition that financial stability is an important precondition for our economic well-being.

So, what exactly *is* financial stability? Up to now no generally agreed definition exists. Thus, many attempts have been made by describing its opposite, financial *in*stability. But then, no definition of financial instability exists either. Financial instability comes in various shapes. Charles P Kindleberger in his modern classic "Manias, panics and crashes" described financial crises as being "like pretty women: hard to define but recognizable when encountered". That's nicely put, but not quite operational.

The Bundesbank favours an eclectic approach to describing financial stability. Financial stability basically means that the financial system properly performs its functions of allocating capital and risk, even if put under pressure. Thus, robust financial institutions are one cornerstone of financial stability. A resilient market infrastructure, incorporating payment and securities trading systems, is another cornerstone of financial stability. And last but not least, there are transparency and market integrity. Thus, the three panels of this symposium—Basle II, market structure and IFRS—neatly cover three major facets of financial stability.

Why has financial stability attracted so much attention recently? During the second half of the 1990s a series of international financial crises set the spotlight on financial stability and its significance for steady economic growth. Financial instability comes at a great economic cost.

Monetary policy makes use of the financial system to transmit changes in official interest rates into the real economy. In a stable financial system, monetary policy signals are read and acted upon fast and reliably, thereby facilitating the pursuit of price stability.

Financial stability is a necessity. A modern necessity, yes, but not at all a new one. Financial stability in part is a new catch-all phrase for a set of tasks that have been conducted by central banks for a long time. In many respects, financial stability is little

more than just the same old thing in a new guise. It is just a new way of looking at old things. This is not to ridicule financial stability. Quite the contrary. I regard this concept as very useful to describe the second leg of central banking—the first leg, of course, being price stability.

If financial stability is so crucial to our economic well-being, then how can it be maintained? In a nutshell, it's the framework for the financial system that counts. A suitable framework for financial stability boils down to sound institutions and a proper set of incentives. Key institutions in this regard are

- first, central banks that deliver price stability
- second, a system of financial supervision that ensures the strength of financial intermediaries, as far as supervision can do that
- third, safe and efficient state-of-the-art market infrastructure
- and, finally, a trustworthy legal system.

As regards the incentive structure, financial stability can benefit tremendously if market forces are strengthened. Furthermore, this approach is the one that is most compatible with a market economy. Ideally, financial market participants foster financial stability as a by-product of their pursuit of their own best interests. If, for example, financial institutions expect to be bailed out, it might be optimal for them to divert some resources from risk management, a phenomenon known as moral hazard.

If no bail-out can be expected, risk management must be conducted thoroughly. Then, risk pricing in financial markets would correctly reflect the risks entrenched in financial instruments: market forces at work to underpin financial stability.

3 Some new trends to be watched

Global imbalances have taken centre stage in the debate on the international financial system recently. These may cause major disruptions if they are unwound in a disorderly way. Sharp and unexpected movements in exchange rates and interest rates would affect financial intermediaries directly and detrimentally—and all the more so if these were highly leveraged. Such turmoil would most probably produce spill-over effects in other financial markets and lead to adverse macroeconomic developments that would seep back into the financial system. The fact that these imbalances have been around for quite some time without spelling trouble must not lull us into complacency. Potential triggers—diminished expectations as to growth and inflation performance or reserve policy in Asia, to name but a few—are real, and they warrant attention.

Beyond these topical issues, however, more fundamental and longer-term trends are arising in the international financial system. They are driven by financial innovation and technological progress, and they challenge financial stability on

an ongoing basis. Central banks, supervisors and regulators must therefore watch out for new trends and monitor them carefully. Potentially relevant changes need to be assessed at an early stage to ascertain their possible impact on financial systems and their implications for stability. Complacency never pays.

The two trends which I want to highlight today are both rather new, quite fundamental, and they share the key feature of reducing transparency.

In a market economy, transparency is a key tool for preserving financial stability. If a high degree of transparency prevails, market discipline can largely replace regulatory intrusion. Transparency enables market participants to monitor their counterparties and to manage their risks effectively. As long as incentives are undistorted, transparency can do its job.

Transparency also facilitates the supervisors’ job of identifying possible weaknesses early on. Supervisors need to have a clear picture of where risks are allocated and whether and where undue risk concentrations might be growing. Hence, developments in the financial system that impair transparency warrant scrutiny.

3.1 Risk transfer "to" the household sector

New techniques of risk transfer have greatly enhanced one of the core functions of the international financial system: the process of risk allocation and risk reallocation. A vast array of formerly non-tradable risks have become tradable. Financial institutions can now shed risks that used to be stuck in their balance sheets. Institutional as well as retail investors can much more easily diversify their portfolios. Risks can be transferred without difficulty to those who are best placed to bear them. Overall financial stability—and also economic efficiency—should benefit from such improved risk allocation.

Credit risk, for example, is no longer the domain of commercial banking. Insurance corporations and pension funds acquire credit risk both for portfolio diversification purposes and as a stable source of income. Beyond conventional asset-backed securities, financial intermediaries now have additional derivative instruments for credit risk transfer at their disposal: plain vanilla credit derivatives such as single name credit default swaps or, at the other end of the spectrum, complex structured products such as CDOs of CDOs. In some countries, even retail investors now have direct access to credit risk.

The prospect of new and increasingly risk-based capital requirements for banks and insurance corporations—Basel II and Solvency II—coming into effect over the next few years is reinforcing the financial industry trend of shifting risks. Mark to

market accounting sharpens the awareness of risks, thereby also setting incentives to adjust risk portfolios.

The flip side of the constant risk reallocation is a certain reduction in transparency. More and more often, risks end up in portfolios where you wouldn't expect them in the first place. Tracking the flow and the location of risks has become trickier for market participants as well as for supervisory authorities. The question is whether today's statistics are keeping up with this dynamic development and whether they accurately reflect reality, ie the overall risk allocation and risk concentration in financial systems.

At the end of the day, all financial risk is borne by private households. All the risks that financial institutions carry in their balance sheets are effectively held by their shareholders. These shareholders are ultimately private households, even if a chain of ownership relations may conceal this fact. The same holds true for risks assumed by the government or its institutions. The taxpayer, ie again private households, is the true holder of governments' financial risk.

Thus, talking of a "risk transfer to the household sector" is slightly incorrect. But the phenomenon of changing risk profiles *within* in the household sector is real. This subject is still under-researched, though.

Changes in an individual household's risk profile may be the result of active choice. However, even in the case of intended portfolio restructuring, we cannot be entirely sure that households fully understand all the risk which they take on, for example, when buying structured products. Given the low level of financial literacy revealed in some recent studies, unintentional risk acquisition is a possibility not to be underrated. Inadvertent changes in risk profiles may also occur via institutionalised investing, when financial intermediaries modify their investment habits. During the last decade, German life insurance companies had increasingly taken to riskier assets in order to bolster returns. Most probably, life insurance policy holders were not fully aware of these alterations in their individual risk profiles that more recently have been partially reversed.

Over the past couple of years, pension reforms have been a key driver of risk transfer. In recent reforms of pay-as-you-go public pension systems, benefits have been cut. Such reforms effectively shift a higher portion of the longevity risk that was previously borne by (payroll) taxpayers back to households. To the extent that households try to cushion their prospective loss of retirement income with private provisioning, they have to assume additional investment and market risk. Corporate pension plans migrating from defined benefits to defined contributions also burden households directly with market risk.

As ultimate bearers of all financial risk, private households also feature as the ultimate absorbers of shocks to the financial system. Solvency, liquidity, ability and willingness to ride out losses determine the shock absorbing capacity of the household sector. Therefore, striving to assess the scope and direction of risk reallocation among different groups of households is of the essence. Income, wealth and age have significant influence on the readiness to bear risk and tolerate possible losses. Knowledge of the nature of risks, how to measure and how to mitigate them becomes crucial for those households that have to assume more risk.

What is the upshot of all this risk redistribution?
Up to now little is known for sure about the macroeconomic consequences of altered risk profiles in the household sector. Macroeconomic dynamics might change. For example, in the wake of risk transfer from relatively wealthy households to those less well-off, consumption and saving levels might become more volatile. This appears to be a reasonable guess, if financial institutions, ie their rather wealthy owners, shed risk, while the man in the street is being switched from a defined benefit to a defined contribution pension plan. In the course of such risk transfer and due to uncertainty as to their future income, households will tend to increase their savings rate, at least during a transition phase.

As to financial stability, the jury is still out on whether large-scale risk reallocation has rendered financial systems more

stable. Initial evidence seems to point in this direction because financial institutions on the whole proved quite resilient during the market downturn and recession following the new economy boom.

Instabilities typically arise when financial intermediaries run into trouble—irrespective of who the ultimate bearers of risks are. Financial intermediaries' risk management techniques are deemed to have been greatly refined and improved. State-of-the-art risk management systems, however, have not yet been tested in adverse market developments. We must beware both overconfidence and outright complacency.

3.2 Unregulated financial business

Over the past couple of years, financial intermediation that is not subject to prudential regulation and reporting has experienced rapid growth. In an environment of low interest rates and abundant liquidity the inevitable search for yield has tempted many investors to take on more risk than they used to. Large amounts of money were channelled into risky and scarcely regulated asset classes. Hedge funds and private equity recorded sizeable inflows.

The growth of the hedge fund industry has drawn particular attention and controversy. As this industry is not subject to official reporting, we can only guess its true size. Commercial hedge fund databases tend to provide only partial coverage of

the industry. Therefore, we cannot preclude that this industry is considerably larger than the well-known ballpark figures of 8,800 hedge funds with USD 1 trillion assets under management suggest. The fact that these investment entities are often domiciled in off-shore locations does not help their transparency either.

But let me make it clear about one thing: the existence of the hedge fund industry benefits the international financial system.

- As active traders hedge funds provide liquidity to financial markets. Thus, they contribute to the breadth and depth of markets and promote the price discovery process.
- Hedge funds are constantly on the spot to find and thereby eliminate arbitrage opportunities. Thus, they strengthen market efficiency.
- Hedge funds acquire risks unwanted elsewhere. Thus, they can contribute to a more efficient overall risk allocation and expand opportunities for portfolio diversification.

The flip side of this coin are financial stability concerns arising predominantly from the substantial lack of transparency. Even if comprehensive data on hedge funds' assets under management were available, we would still have a hard time assessing the true economic risk they carry. For they typically make extensive use of derivatives and hold leveraged positions, not least in rather illiquid markets. A partial industry survey conducted by the FSA in the UK found out that hedge fund

equity of USD 250 billion translated into gross counterparty positions in the range of USD 860 billion.[1]

The opaqueness of risk profiles is an issue in at least three respects. First, with their high leverage and active trading, hedge funds now wield considerable clout in some financial market segments. Second, hedge funds are important counterparties to systemically relevant financial intermediaries, for example, to their prime broker banks. And, third, institutional investors such as pension funds have turned to hedge fund investing, a trend that is expected to continue.

What does all this mean for the international financial system?

- There are some blind spots in the system.
- These blind spots have recently grown in size and number.
- And more and more often, these blind spots are related to systemic players.

Owing to the lack of transparency, the overall risk allocation in the international financial system and the potential for disturbances have become harder to gauge. Possible systemic risk has become harder to spot. The lack of transparency hampers market discipline and, as a logical consequence, its use as an important pillar of financial stability.

[1] Dan Waters, FSA, ”Regulation and the Hedge Fund Industry: An Ongoing Dialogue”, 8 February 2005, Speech at Hedge Funds Blueprint Europe Conference.

However, direct regulation of the hedge fund industry is hardly feasible, if not impossible, and the efficiency of indirect regulation via the regulation of counterparties is limited. This means that authorities responsible for safeguarding financial stability have to rely on banks monitoring their hedge fund credit clients. However, aggregating their total hedge fund exposure and assessing their hedge fund clients' total risk profile have become more difficult for lending institutions since hedge funds are being served by multiple prime brokers.

When looking at new trends in the financial system, we need to consider both sides of these coins. Shining improvements to financial stability must be weighed against the darker side of stability-impairing features. The challenge is to harness the benefits of new financial trends while minimising their potential costs. Unfortunately, there is no instant recipe for safeguarding the stability of evolving financial systems. Case by case assessments are required.

4 Concluding remarks

Ladies and gentlemen

The financial industry is one of the most globalised industries in the world. Supervisors cannot limit their attention to what is going on within their national boundaries. If they don't see beyond the ends of their noses, they will not be up to dealing with financial stability issues. The appropriate response is

cooperation of supervisors on an international scale. As financial globalisation progresses, new challenges will arise providing not least plenty of topical issues for future seminars on the international financial system. International co-operation is essential, and symposia such as today’s help to deepen the mutual understanding that is so indispensable for effective co-operation.

*   *   *