OPINIONS

July 11, 2022

Liquidity Strains in Markets Need Structural Fixes

Opinion Markets Insight

Liquidity strains in markets need structural fixes

It might be easier to target funds but broader remedies are required to deal with times of stress

Eric J. Pan

The writer is president and chief executive of the Investment Company Institute

(As published in Financial Times, 5 July 2022)

While high inflation is making the headlines, another potentially worrisome development for markets this year has been the deterioration of liquidity in trading.

As the US Federal Reserve discussed in its latest Financial Stability Report in May, liquidity has been falling since late 2021 in US Treasuries as well as in futures contracts on the S&P 500 index and oil.

Liquidity — measured in the ease with which buyers and sellers can transact — is critical to a well-functioning market for everyday investors and borrowers. Seeing strains across these multiple markets ought to be raising real concerns.

In fact, underlying structural weaknesses have been evident for some time. This is particularly so in wholesale funding markets where historically banks, acting as dealers, have played a key role in providing liquidity.

More stringent regulatory capital regulations adopted in response to the financial crisis are often cited as making intermediating fixed-income trades more costly.

This means dealers are committing less of their balance sheet to market-making activities. While others — such as trading firms — may have stepped in to provide liquidity, their objectives and incentives are different. Now, to add to these structural changes, the Fed is reducing its Treasury holdings and no longer buying bonds.

To their credit, policymakers — both in the US and globally — have identified that there may be some fundamental structural issues at play in market-making activities. But supposed weaknesses in money market and open-end mutual funds have also been subject to scrutiny.

Policymakers have been looking at the risk that money market and open-end mutual funds might amplify liquidity shocks — whether any advantage in being the “first-mover” in fund redemptions could spur further selling or create challenges in offloading assets during stress.

So we are seeing a raft of proposals aimed at money market and open-end mutual funds to increase liquidity buffers and require measures such as “swing pricing” which seek to pass on some of the costs of redemptions to the sellers in times of stress.

Some of this is due to a misreading of the evidence from previous episodes of stress, in particular the events of March 2020 when the pandemic caused an abrupt shutdown of the global economy. The fact is that money market and open-ended mutual funds were not the cause of the March 2020 liquidity crisis, and their supposed role in amplifying the crisis is not supported by data.

Our research shows funds’ total net sales of bonds, especially Treasuries, were much smaller than has been claimed by policymakers. And the timing of bond mutual funds’ daily net sales don’t align with the evolution of the dislocation in the Treasury market at the time. In addition, their small share of Treasury market trading volume indicates little, if any, amplification of stress.

The main lesson to be drawn from the experience of March 2020 is this: we need to ensure that secondary markets can supply adequate liquidity to all when investors most need it.

A menu of promising steps to do this has already been drawn up by policymakers. Ideas include:

- Modifying the so-called “supplementary leverage ratio” that stipulates how much capital banks must hold as a percentage of their assets. This ratio should exclude Treasuries and deposits at the Federal Reserve. With greater capacity on their balance sheets, banks and their dealer subsidiaries would be better positioned to facilitate trades in bond markets during times of stress. This modification worked well on a temporary basis during the COVID-19 crisis;
- Studying the potential benefits of central clearing of trading to reduce financial institutions’ exposure to counterparty risk. It could also expand their balance sheet capacity to facilitate trading because of netting, which allows offsetting trades with the same counterparty;
- Promoting the expansion of “all-to-all” trading that allows buyers and sellers to interact with each other directly without a bank as a middleman. This can take pressure off dealers’ balance sheets in times of stress;
- Evaluating the impact of regulations on market participants that provide substantial liquidity and perform similar activities as dealers in the markets.

Taking this agenda forward requires a sustained, multilateral and multi-sector effort, which policymakers should take up at once. Even though it is easier to propose new rules for money market and open-end mutual funds, these efforts won’t address the liquidity challenge. Improving market structures will.