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Emerging risks and vulnerabilities: Liquidity

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Introduction

I will speak briefly about liquidity and the ongoing debate on the state of liquidity in markets. I want to make a few comments on the current concerns, and also on the longer term concern that exists.

We all know that liquidity in securities markets is central to a well-functioning financial system. It is key to investor trust and confidence that securities markets are seen as positive channels for investment and savings. In turn, with this trust and confidence, securities markets can be a sustainable source of funding for the real economy.

Current concerns

Turning to current concerns, for some time now, market participants and policymakers have expressed concern about the systemic risk posed by market illiquidity, especially in the corporate bond markets.

However, I think that we need to ask whether there really is a liquidity problem in the securities markets. Are buyers and sellers in fact finding it increasingly challenging to buy or sell over a short period of time without price volatility?

Some have attributed this apparent shortage of liquidity to the impact of regulatory reform on banks and dealers. This has led to a retreat from trading as part of wider deleveraging across the financial system.

These concerns, especially within the Financial Stability Board (FSB), were particularly targeted at the asset management sector. Some regulators and market commentators voiced concern that continuing illiquidity could expose structural vulnerabilities within the sector and that asset management could become a source of future global financial instability.

The International Organization of Securities Commissions (IOSCO), which I chaired at the time, and industry more generally, were rightly concerned about this line of thinking. We urged the FSB and others to first focus on better understanding the nature of market liquidity and the risks that asset managers and funds might pose, before designating any funds or managers as systemically important financial institutions (SIFIs) or imposing any new regulation. Our efforts on this, I am glad to say, were successful.

Work is ongoing by the FSB and IOSCO to determine whether we are in the midst of a structural decline in liquidity. This work is evidence-based and the conclusions will be drawn from the extensive analysis carried out to date.

I want to make a few comments about this work.

- The view so far is that the evidence is equivocal – that is, there is no clear evidence of a major deterioration in liquidity in those markets, under normal market conditions. I recognise, however, that others do not necessarily agree with this view and that we may need to look further at liquidity settings in a greater range of stress scenarios.
- We should also not rule out that this may be a case of liquidity levels finding a 'new normal' after the global financial crisis and that the market is taking its time to adjust to this.
- In addition, an emerging finding is that it can be difficult to measure liquidity simply. Liquidity may mean slightly different things in different markets; and even to different market participants.

We can also draw a clear lesson here: that is, there is a real need to do the necessary analysis, and consider all the relevant evidence, before making concrete decisions about regulation in this area.

Longer-term concern

I would also like to mention the longer-term concern about liquidity that we all need to be thinking about.

Perceptions that bond markets are increasingly illiquid may negatively affect the use of those markets as a funding source. Given the decline in traditional lending, this perception could further restrict sources of funding for companies and entrepreneurs, and so adversely affect real economic growth.

The challenge, as I see it, is to create the right environment for sustainable liquidity to develop. This will involve considering the structure of markets and how they operate and ensuring that investor trust and confidence is further developed and maintained.

We see greater trust and confidence emerging through the development of regulatory tools focused on market structure and on how markets should be operating from an issuer and investor perspective. These tools could include, for example:

- market structure measures such as:
  - increasing post-trade transparency and improving price discovery
  - developing new market platforms and a sounder derivatives market, and
- investor- and issuer-focused steps such as:
  - further standardisation of documentation in bond market transactions
  - larger liquid benchmark issues and issuance that is eligible for inclusion in indices.

Tools such as these can provide a foundation for enhancing liquidity. They are being considered by a range of market participants in their response to the liquidity debate.

Conclusion

In closing, I should say that the FSB and IOSCO are well advanced in their work and we look forward to the upcoming public consultation on their conclusions, although I suspect that this will be a continuing discussion around global markets for some time.

Thank you.

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