The system is not stable

Last week, in the Tuschinski Theatre back here in Amsterdam, we had the premiere of a movie called ‘Boom Bust Boom’, made by Dutch professor Theo Kocken and Monty Python icon Terry Jones. The movie is a humorous and sometimes hilarious description of various economic developments. Recurrent themes are the overrated belief in economic modelling, and the persistence of financial crises, like the Tulip Mania in 17th century Holland, the Railway Mania in Britain in 1840, and the Wall Street Crash in 1929 following the Roaring Twenties of the last century.

Notwithstanding the funny character of the movie, it’s message is rather serious. For me it all boils down to the notion that the financial system is not stable. In the movie we see interviews with well-known economists like Robert Shiller, Daniel Kahneman and Paul Krugman, who explain in their own words why financial systems have been and always will be unstable. This message is not new. The movie is just a modern way of illustrating existing economic wisdom about financial crises. John Maynard Keynes already pointed at the extreme instability that is characteristic of a highly developed capitalist economy. He saw ‘the violent psychological swings in mood among the entrepreneurs’ as a basic source of instability. John Kenneth Galbraith, in his book ‘A Short History of Financial Euphoria’, also traces financial bubbles through several centuries, and argues that they are inherent in the free market system because of ‘mass psychology and the vested interest in error that accompanies speculative euphoria’. Also, according to Galbraith, financial memory is notoriously short: ‘what currently seems to be a new financial instrument is inevitably nothing of the sort. […] The world of finance hails the invention of the wheel over and over again, often in a more unstable version’.

The financial crisis of 2008, which took many economists by surprise, seems to confirm these theories. We know that financial bubbles do exist, and yet, they often take us by surprise. It looks like there is a form of collective irrationality in the system that seems hard to escape.

Yet, for me, the recent financial crisis is different in two important respects. First of all, due to technological advances, we now have highly integrated financial markets. In the good old days of Keynes and Galbraith, the problems in the US housing markets would have been a problem of some states in the US, maybe leading to one or more bankruptcies of some local banks, before someone in Washington would realize that their housing program was a little bit too generous. But in our world of today this is quite different, because as a result of securitization and world-wide reselling of mortgages, also many international financial institutions were hit. This turned a rather national housing problem into a world wide credit crisis.

And I think there is reason to believe that this instability will increase even further in the near future. The very same technological advances and concurrent disintermediation of the last years – look at the success of services like Uber and Airbnb – will make these integrated financial markets change at a very rapid pace. As a consequence, there is considerable risk that policy makers are regulating the world of today, and not the world of tomorrow. Risks don't disappear by making regulation stricter, they will inevitably appear somewhere else in another form, like in an air cushion. Underpinning the instability of our financial system.

So what are the consequences of this? Because of the limited time I have, let me focus on some elements of financial regulation. What are the consequences for the financial regulators and policy makers, knowing that the instability is part of the deal?

Now, it would be easy for me to reply that we simply need less regulation and let risk prevail. That is not what I intend. Regulation *is* necessary: we need to prevent fraud, we need transparent information and a level playing field, and we need to address externalities in a free market system. My plea is simply that the regulator and the policy makers should be diligent in designing all kinds of regulations promoting stability, because regulations tend to cause unintended side effects. And these side effects may become by themselves a source of new instability.

Let me give you some examples for the financial sector, related to interest rates. I am NOT going to talk about the low interest rates, although the effects of Quantitative Easing would be an interesting example of the collateral damage that can occur from financial regulation. No, what I would like to discuss is the danger of *rising* interest rates and the possible side effects that can occur as a consequence of financial regulation.

Let me elaborate on this.

Central clearing obligations from the European EMIR regulation make regular interest rate hedging activities more expensive, mainly because of the margin obligations. At the same time we see that the Repo market becomes thinner and thinner because Basel III is stepping up leverage ratio obligations for banks. Now, the two separate measures may have their logic. In order to curb speculative strategies, for example by High Frequency traders, strict and daily margin calls may be a good thing. And improving the balance sheet ratios of banks also has its logic from a financial stability point of view. However, applying the daily margin call obligations to pension funds is less obvious, because they have long term investment strategies and – by law – only establish derivative positions for liability hedging purposes. And if the stronger regulations for banks imply that pension funds will have less and less access to Repo transactions for their margin calls, then liquidity risk become a serious – and I would say unnecessary – issue.

EMIR regulations are intended to reduce risks in the financial system, by making life harder for speculative traders. However, these changes also make derivative products more costly. Therefore, an unintended side effect could be, that it becomes less attractive for pension funds to use these products in their regular liability hedging activities. And therefore ending up in more risky positions.

The adverse effects of EMIR for Dutch pension funds could be aggravated by prudential regulations in the Netherlands. The so-called Financial Assessment Framework is used by the Dutch Central Bank to monitor and control the financial position of pension funds. One of the underlying principles in this framework is that pension funds need to hold capital buffers in proportion to the risk they take. More risk implies higher required buffers. As such, this is a very sound principle.

An important feature in this framework is that hedging interest rate risk always reduces total portfolio risk. However, given the current low interest rate environment, *reduction* of the interest rate hedge could be considered sound financial policy as well. The problem is that lowering the interest rate hedge is currently not allowed as the current financial position of many Dutch pension funds is too low. These funds are therefore trapped in a position where they could suffer when interest rates rise.

Let me give you some idea about the numbers. The Dutch Pension Fund Industry has total Assets under Management of roughly 1200 billion euros. Now assume that their interest rate hedge is somewhere around 50% on average. And let's further assume that interest rates rise by 100 basis points in a short period of time. Then the total amount of liquidity that has to be generated to satisfy the margin calls will be somewhere around 140 billion euros. That is quite an amount of money – even for the Dutch pension sector – that will surely cause some stress in the sector. And if you think such interest rate increases are impossible, let me then just mention that from April 20th to May 14th of this year, we have seen a spike in the 30 year swaprate of 70 basis points. So, it is not that theoretical.

There is no easy solution to this problem of regulatory changes having unintended side effects. Any framework will have its advantages and drawbacks. A possible improvement was recently put forward by my former colleagues professor Frijns and professor Maatman – the latter also being a former board member of the Dutch Supervisory Authority AFM. In a Dutch newspaper article they argued to rely more on the open norm of the prudent person principle. An open norm would have the advantage that it gives pension funds more freedom of choice in designing their financial policies.

Remember what I said about the fact that markets are becoming more and more intertwined. This effect is partly caused by the fact that strict regulations force large institutional investors to invest in a similar way, thereby promoting copy paste behaviour. From a *micro*-perspective such an open norm may be more difficult for a supervisor to monitor, but it might have a big advantage for the supervisor from a *macro*-perspective, as countercyclical investment policies will strongly improve the financial stability of the system.

So, where does this bring us?

Governments often see financial markets as a source of instability – and rightly so – as I have argued. But from the examples I have given, we may conclude that governments themselves may also be a source of instability. Let me give you another example. Several institutional investors have invested large sums of money in French motorways. The yield on this investment was linked to inflation, which as you know is quite important for pension fund investors. The French government, however, has jeopardized our investment strategy by imposing new restrictions on the fare that motorway companies may charge to motorists. A clear example of changing the rules of a game after it has already started. This type of government behaviour is highly detrimental to the long-term investment agenda of institutional investors.

If governments want to foster long term investments, they also should foster long term agreements with investors. This holds true on a national level and equally so on an international level. For instance the Long Term Investment Plan that was recently put forward by Mr. Juncker to boost long term investments in Europe. Investors must be sure that the rules do not change during the game. So that we can rely on an adequate risk-return profile – something we simply owe to the participants for whom we invest. If these conditions are met, we may be able to explore possibilities for new investments in Europe, for example in the securitization of SME Loans, Real Estate, and Infrastructure. These investments could support the European economic system, and could create some stability in the unstable world we live in today.

Thank you.