



THE LONDON SCHOOL  
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POLITICAL SCIENCE ■

# Systemic Risk: Creation and Perception

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## *Outline*

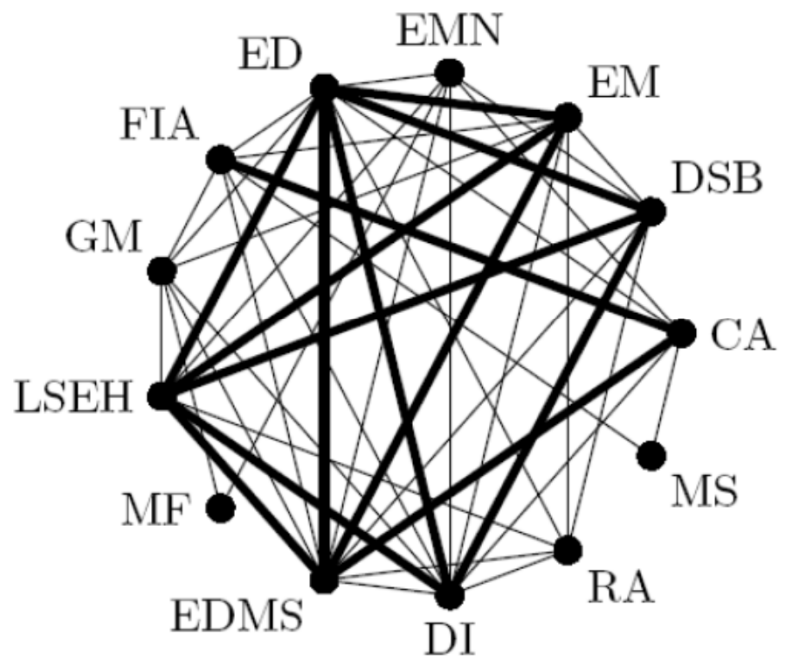
- What was new about the financial crisis in 2007-2008?
- Risk happens.
- Risk creation goes hand in hand with liquidity creation.
- To know where the risk is look at where the financial flows go.

# What was new about the financial crisis of 2007-2008?

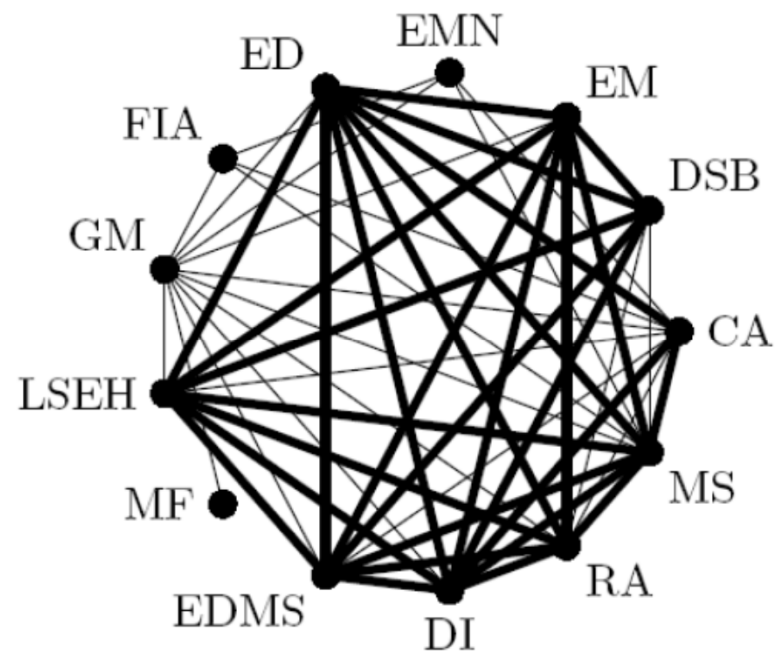
- from the de Larosière Group report:
  - “The extreme complexity of structured financial products...made proper risk assessment challenging.
  - “This was aggravated further by a lack of transparency in important segments of financial markets... and the build up of a ‘shadow’ banking system.”
  - “The lack of sufficient historical data..., the underestimation of correlations, ...and the inability to take into account the severe weakening of underwriting standards by certain originators have contributed to poor rating performances.”
- **Complexity, opacity and weak data analysis.**

# Risk happens.

- Knightian uncertainty versus risk.
  - Uncertainty (the set of unknown outcomes that the future holds in store) is everywhere.
  - Risk (a probability distribution over a set of possible events) comes from:
    - *Perceiving* the relevant set of possible outcomes. Framing.
    - *Assessing* the relative likelihoods through “modelling”
- Systemic risk emerges *endogenously* through the actions of investors and intermediaries in the face of risks as they perceive of them.
  - Example: “hidden concentrations”
- When systemic risks are finally perceived...*contagion*



1994-2000



2000-2007

A.Lo, "Hedge Funds, Systemic Risk, and the Crisis of 2007-2008"

# Risk creation goes hand in hand with liquidity creation.

- Role of the financial sector
  - To provide investors funding for productive, long-term investments under uncertainty
  - To provide savers reasonably sure returns at the times they need the funds.
- This involves:
  - Maturity transformation
  - Credit transformation
  - Liquidity Transformation
- In practice this involves institutions with this structure

Assets	Liabilities
Risky long term assets	Information insensitive, short term, liquid claims
	Information sensitive claims

# Risk creation goes hand in hand with liquidity creation (2).

- Regulatory reform constrains the banking sector in providing this function
  - Must hold more liquid assets
  - Must reduce maturity transformation
  - Must hold more risky liabilities (less leverage)
  - More capital
  - More risky debt (e.g., cocos, bail-in)
- This creates big pressure to create new institutions that will fulfil the maturity, credit and liquidity transformations that private agents demand.
  - Financial innovation (P2P, new securities)
  - New institutions
  - Revived securitization...
  - The “new shadow banking sector”

# To know where the risk is look at where the financial flows go.

- A key issue is what will be the funding model of institutions originating long term credits.
  - Key nexus is the “wholesale funding market”
  - Can involve many steps and many institutions in the chain from savers to real investors.
- Global imbalances will persist for the foreseeable future, but the way those imbalances are recirculated can change:
  - Changing status of banks and other intermediaries from emerging nations
  - Growth of wholesale markets outside established financial centre
    - Will dollar funding advantage of US banks persist?
- Infrastructure matters
  - Consolidation in CCP's
  - New settlement system in Europe (T2S) can change securitized lending



## Numbers of Margin Movements: Fragmented and Integrated Markets

mg	mkt 1	mkt 2	mkt 3	mkt 4	sum	portfolio
0.5	612	621	589	610	2432	331
0.75	472	485	441	459	1857	209
1	362	345	342	326	1375	130
1.25	270	272	242	264	1048	87
1.5	210	221	198	199	828	68
1.75	157	167	150	145	619	51
2	124	141	134	120	519	40

## To know where the risk is look at where the financial flows go (2).

- The new developments of risk management and risk modelling will need to keep pace with the needs of the institutions involved in this wholesale funding market.
- Macroprudential regulation aspires to supervise “shadow banking.” (see FSB reports)
- Both will need better information (repo, securities lending etc.)
- Open issue: how will information channelled to data repositories be aggregated and disseminated created as part of regulatory reforms (e.g., of OTC derivatives).



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Thank you for your attention

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