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Safe Assets

The financial crisis and recent rating downgrades of sovereigns previously considered to be virtually riskless have reaffirmed that even highly rated assets are subject to risks. The notion of absolute safety—implicit in credit rating agencies' highest ratings and embedded in prudential regulations and institutional investor mandates—can create a false sense of security, and it did prior to the crisis. In this context, the latest IMF Global Financial Stability Report examines in detail the critical role of safe assets for the (international) financial system and the upcoming supply and demand pressures in the markets for safe assets (available at: http://www.imf.org/external/pubs/ft/gfsr/2012/01/index.htm).

Safe assets are used as a reliable store of value and aid capital preservation in investor portfolios. They are a key source of liquid, stable collateral in private and central bank repurchase (repo) agreements and in derivatives markets, acting as the "lubricant" or substitute of trust in financial transactions. As key components of prudential regulations, safe assets provide banks with a mechanism for enhancing their capital and liquidity buffers. As benchmarks, safe assets support the pricing of other riskier assets. Finally, safe assets have been a critical component of monetary policy operations.

Various groups of market participants place a different emphasis on specific safety attributes. From the perspective of conservative investors, for example, safe assets act as a store of value or type of insurance during financial distress. For official reserve managers and stabilization-oriented sovereign wealth funds, the ability to meet short-term contingent liabilities justifies a focus on the low market risk and high liquidity aspects of safety. From the perspective of longer-term investors—such as pension funds and insurance companies—safe assets are those that hold their value over longer horizons. Banks, collectively the largest holder of safe assets, demand safe assets for asset-liability management, for collateral, and for fulfilling their primary dealer and market-making responsibilities.

However, it is clear that market distortions pose increasing challenges to the ability of safe assets to fulfill all their various roles in financial markets. Even before the crisis, the rapid accumulation of foreign reserves and financial market underdevelopment in many emerging economies accounted for supply-demand imbalances in safe asset markets. For banks, the common application of zero percent regulatory risk weights on debt issued by their own sovereigns, created perceptions of safety detached from underlying economic risks and contributed to the buildup of demand for such securities. During the crisis, supply-demand imbalances and safe asset market distortions became even more obvious. Large-scale valuation losses on assets perceived as safe, first on AAA-rated tranches of mortgage-backed securities during the crisis, and more recently on some Organization for Economic Cooperation and Development (OECD) government debt, reduced the supply of relatively safe assets.

The number of sovereigns whose debt is considered safe has fallen, which could remove some $9 trillion from the supply of safe assets by 2016, or roughly 16 percent of the projected total. Private sector production of safe assets has also declined as poor securitization practices in the United States has tainted these securities, while some new regulations may impair the ease with which the private sector can produce safe assets. Meanwhile, heightened uncertainty, regulatory reforms—such as new prudential and collateral requirements—and the extraordinary postcrisis responses of central banks in the advanced economies, have been driving up demand for certain categories of safe assets.

Hence, safe asset demand is expanding at the same time that the universe of what is considered safe is shrinking, which can have negative implications for global financial stability. It will increase the price of safety and compel investors to move down the safety scale as they scramble to obtain scarce assets. Safe asset scarcity could lead to more short-term volatility jumps, herding behavior, and runs on sovereign debt.

To mitigate the risk to financial stability from a potentially bumpy, uneven path to a new price for safety, policymakers need to strike a balance between the desire to ensure the soundness of financial institutions and the costs associated with a potentially too-rapid acquisition of safe assets to meet this goal. On the demand side, careful design of some prudential rules could help increase the differentiation in the safety characteristics of eligible safe assets and would thus decrease the likelihood of cliff effects or runs on individual types of assets. On the supply side, desirable policies include improving fiscal fundamentals in countries subject to concerns about their debt sustainability, encouraging the private production of safe assets and building up the capacity of emerging economies to issue their own safe assets. On the latter, though shrinking, the disparity in the degree of financial depth between emerging markets and advanced economies is still considerable. At end-2009, emerging markets accounted for approximately 40 percent of global GDP, but their contribution to financial depth was less than 20 percent of that of advanced economies.

In emerging markets, prudent fiscal policies together with ongoing improvement in domestic financial infrastructure—including legal certainty, clearing and settlement systems, and transparent and regular issuance procedures—will support further deepening of local sovereign bond markets. Over the longer run, these improvements will facilitate the use of such securities as safe assets both within their domestic context and possibly in global markets.

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