Press Points for Chapter 3:

SAFE ASSETS: FINANCIAL SYSTEM CORNERSTONE?

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Key Points

- Market distortions pose increasing challenges for the ability of safe assets—assets which include U.S. Treasury securities, German bunds, or perhaps, high-grade corporate bonds—to fulfill their pivotal role in global markets. Heightened uncertainty, regulatory reforms and the extraordinary post-crisis responses of central banks in the advanced economies have been driving up demand for safe assets.

- The supply of safe assets has contracted as the ability of the public and the private sectors to produce such assets has declined. The number of sovereigns whose debt is considered safe has fallen. Poor securitization has curbed the role of securitized instruments as safe assets.

- The shrinking universe of safe assets and the upward demand pressures have negative implications for global financial stability. Safe asset scarcity will increase the price of safety and compel investors to move down the safety scale as they scramble to obtain scarce assets. It will also lead to more short-term spikes in volatility, and shortages of high-grade collateral.

- A smooth adjustment in the markets for safe assets would require more flexibility in policy design and implementation. Policymakers need to strike a balance between the desire to ensure the soundness of financial institutions and the costs associated with potential overly rapid acquisitions of safe assets to meet such goals.

The global financial crisis and the heightened concerns about sovereign debt sustainability in many advanced economies have shown that no asset can be viewed as truly safe. Recent rating downgrades of sovereigns, previously considered virtually riskless, reaffirm 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—created a false sense of security prior to the crisis. While some safety features are reflected more accurately now, upcoming regulatory and market reforms and central bank crisis management strategies, combined with continued uncertainty and a decreasing supply of assets considered safe, will increase the price of safety beyond what would be the case without such distortions.

This chapter examines the various roles of safe assets, the effects of different regulatory, policy, market distortions, and potential future pressure points that may arise from these.

On the demand side, heightened uncertainty, regulatory reforms, and crisis-related responses by central banks have been driving up demand. Prior to the crisis, the key external factor were global current account imbalances which encouraged safe asset purchases by reserve managers and some sovereign wealth funds. Now, attention has focused on safe assets' capacity to meet new prudential requirements; increased collateral needs for over-the-counter (OTC) derivatives transactions or their transfer to centralized counterparties; and the increasing use of such assets in central bank operations. On the supply side, fiscal concerns have led to a decline in the perceived safety of sovereign debt. Analysis shows that some $9 trillion (or roughly 16 percent of the projected sovereign debt) can be taken out from safe asset supply by 2016. Private sector production of safe assets has also declined as poor securitization has tainted use of these securities.

The shrinking universe of assets perceived as safe and growing demand for such assets have negative implications for global financial stability. Safe asset scarcity will increase the price of safety and compel investors to move down the safety scale as they scramble to obtain scarce assets. It could also lead to more short-term spikes in volatility, and shortages of liquid, stable collateral that acts as the "lubricant" or substitute of trust in financial transactions.

Policy Proposals

Policy responses should allow for flexibility and gradual implementation to mitigate potential financial stability risks from an uneven adjustment to a new price for safety.

New prudential rules should provide sufficient differentiation in the safety characteristics of eligible safe assets. The risk categorization of eligible assets, both in terms of creditworthiness and liquidity, should be reviewed at appropriate intervals to ensure that it reflects the differential risks across the assets. Sufficient differentiation in the risk categorization of assets would avert cliff effects in which deterioration in market conditions and a downgrade could result in an automatic reclassification of assets to a lower category and a sudden drop in prices. For capital adequacy requirements, this means that sovereign debt should eventually carry assigned risk weights that more accurately reflect the relative credit risk of the issuing sovereign. For liquidity requirements, it suggests regular revisions in the calibration of haircuts for the liquidity coverage ratio.

Demand pressures related to the use of safe assets as collateral for CCP default funds would be alleviated by flexibility in the definition of acceptable safe assets. By ensuring a sufficiently broad range of collateral—including appropriate risk-based haircuts and minimum criteria for inclusion—CCP oversight could alleviate undue pressures on certain types of safe assets without compromising the soundness of the CCP.

Policy measures on the supply side would stem upward price pressures on highly demanded safe assets. Strategies to lower debt levels, improve debt management, and put in place better fiscal infrastructures are needed as they improve governments' creditworthiness, lower borrowing costs, and enhance economic growth prospects. The private production of safe assets—an important source of supply—would be supported by a recovery of securitization on a sounder footing, and well-conceived and regulated covered bond structures. The build-up of the capacity of emerging economies to issue their own safe assets via the improvement of domestic financial infrastructure would also alleviate the imbalances in the global safe asset markets.