BIS 1930 2020 Promoting monetary and financial stability

Discussion of “A congruence principle for financial regulation” by Andrew Metrick and Daniel Tarullo

Brookings Panel Spring meeting, 25 March 2021

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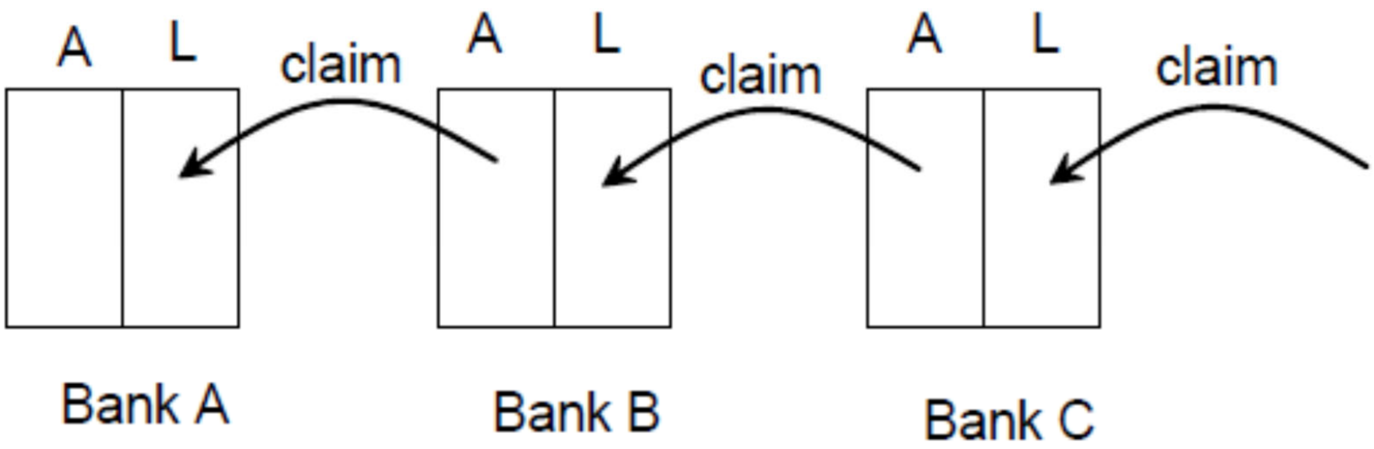
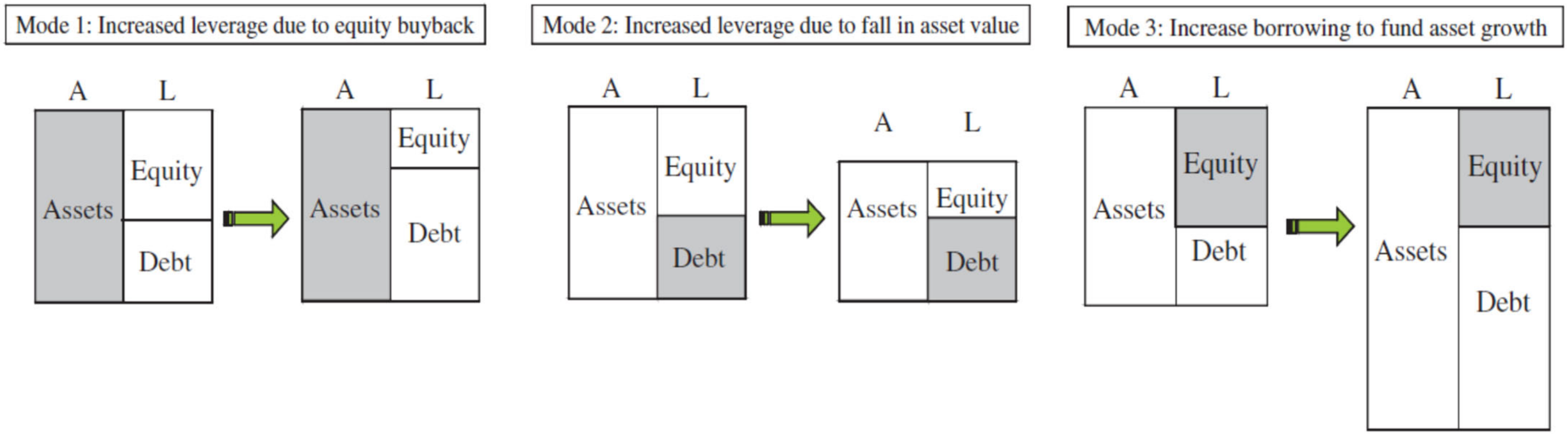
*The views expressed here are mine and not necessarily those of the Bank for International Settlements

“Domino model” of cascading defaults gives an incomplete picture of systemic risk



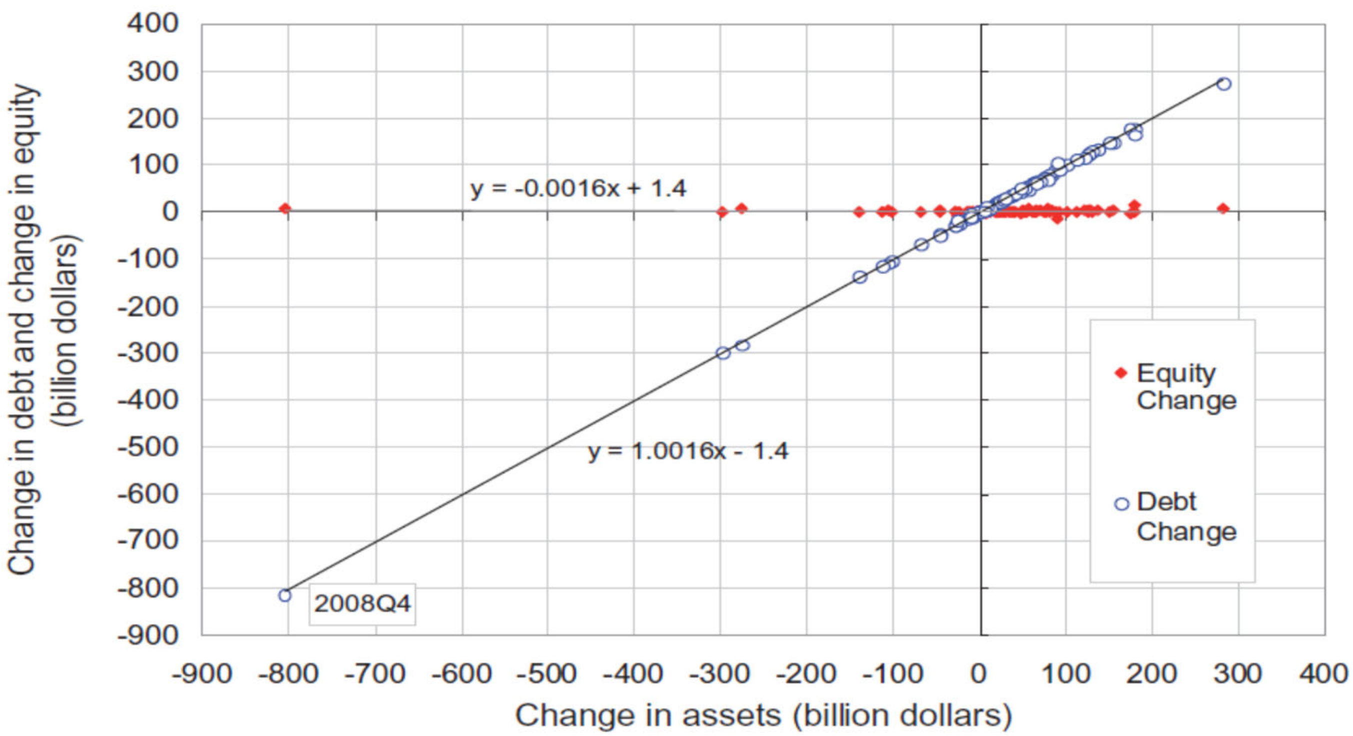
- Defaults need not figure in the propagation mechanism; deleveraging due to spike in margins / haircuts can be potent mechanism for stress propagation

Of three ways to increase leverage, the third is the relevant one for market intermediaries …



Equity buyback through a debt issue (mode 1); dividend financed by asset sale (mode 2); asset expansion due to reduced haircut. Shaded area is balance sheet component held fixed.

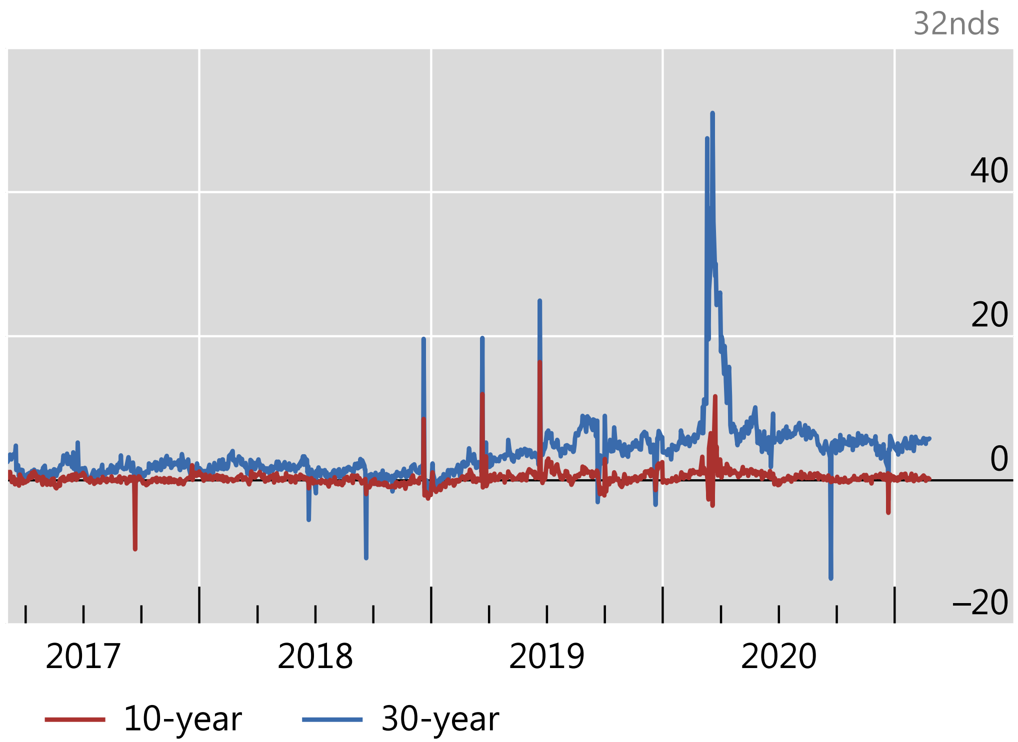
… as illustrated by the US broker-dealer sector



- Change in assets matched dollar for dollar by change in debt, not equity

Source: Adrian and Shin (RFS, 2014), data from Federal Reserve, *Flow of Funds*

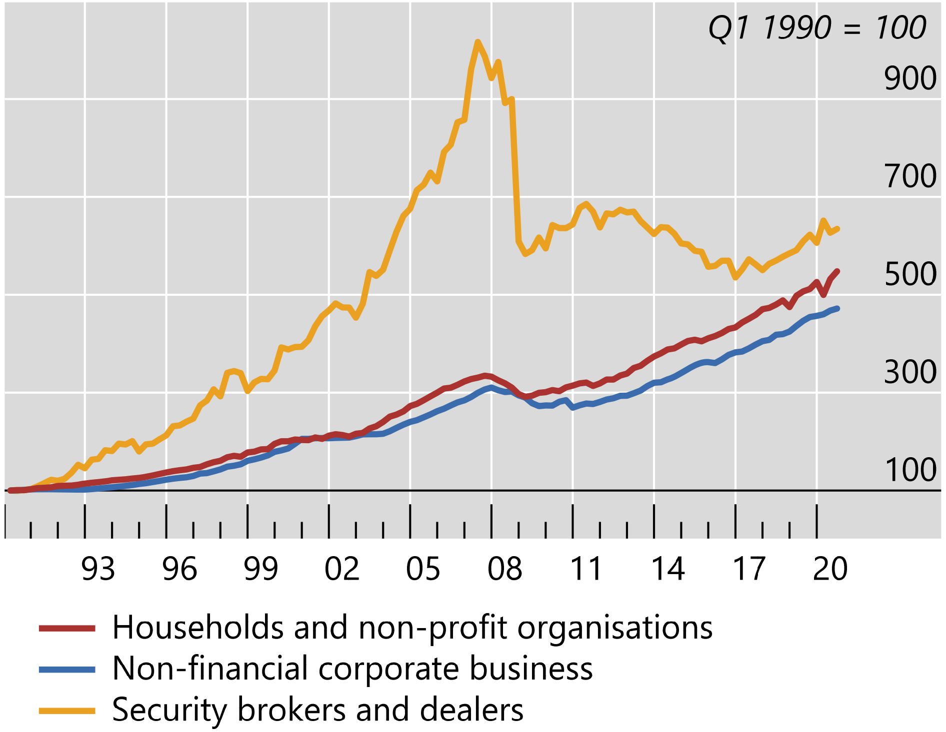
Spillovers through pricing channels ("pecuniary externalities") and margining may propagate stress, even when the underlying asset is default-free



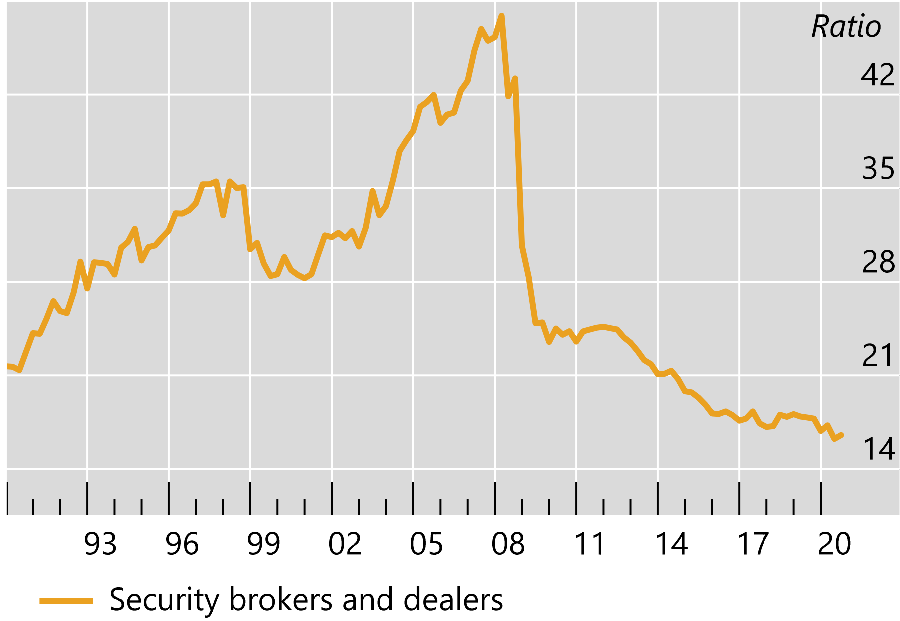
- Chart shows the price difference between the futures-implied price of US treasury securities and the cheapest-to-deliver treasury, adjusted for carry

Broker-dealer balance sheets have smaller heft in the financial system post-crisis, as market-based intermediation has migrated elsewhere

Total assets (1990Q1 = 100)



Leverage (=assets/equity)



Source: Federal Reserve, *Flow of Funds*