IMF points to growing dangers in key area of financial system

Nick Beams
10 October 2022

A chapter in the International Monetary Fund's (IMF) *Global Financial Stability Report* prepared for this week's semi-annual meeting in Washington has identified the source of a potential crisis for the global financial system.

It concerns the operation of open-ended investment funds (OEFs) which allow investors daily redemptions of their investments while the funds invest in long-term illiquid assets that cannot be turned quickly into cash.

The mismatch between the conflicting short-term and long-term nature of investments is a permanent feature of financial markets and has always been a major factor in financial turmoil.

But the growth of OEF funds means they have become much more significant in the past decade and a half.

Summarising their expansion, the report said: "Since the global financial crisis, there has been a remarkable growth in the open-ended investment funds. The total value of their net assets has quadrupled since 2008, reaching $41 trillion in the first quarter of 2022 and accounting for approximately one-fifth of the assets of the nonbank financial sector."

While such funds play an important role in financial markets, it said, "those that offer daily redemptions while holding illiquid assets can amplify the effects of adverse shocks by raising the likelihood of investor runs and asset fire sales. This contributes to volatility in asset markets and potentially threatens financial stability."

The rise of these funds exemplifies a now well-established process in which attempts by governments and regulatory authorities to control one area of disruption leads to its re-emergence in another area as finance capital, ever involved in the search for profit, seeks new avenues for speculation.

Major banks were at the centre of the financial crisis of 2008 and measures were put in place to curb some of their more egregious speculative activities. But as the IMF report explained, the growth of OEFs "reflects the increasing shift in financial intermediation from banks to nonbank financial institutions, which can be attributed at least in part to the tighter regulations on banks as well as balance sheet deleveraging following the global financial crisis."

It noted that OEFs generally invest in equities in the advanced economies but "the share of funds investing in relatively less liquid assets, such as corporate bonds or emerging market bonds and equities, has been rising rapidly.

Financial stability concerns about OEFs arose during the financial market turmoil in March 2020, at the start of the pandemic. The "resilience" of the sector "may be tested again if financial conditions tighten abruptly as central banks normalize the stance of monetary policy."

Already the interest-rate hikes by the Fed and almost all other central banks, characterised by economic historian Adam Tooze as "the most comprehensive tightening of monetary policy the world has seen," have resulted in large outflows from high-yield corporate bonds and emerging market equity and bond funds.

The IMF analysis noted that despite financial stability risks, "effective implementation of policy measures or regulatory authorities to mitigate the vulnerabilities associated with OEFs holding illiquid assets has been lacking."

An existential problem facing any would-be reformers, however, is rooted in the very nature of this sector of the financial markets.

It was laid out by former Bank of England governor Mark Carney to a UK parliamentary hearing in June

© World Socialist Web Site

2019—well before the pandemic and associated financial turmoil had appeared—into the collapse of a British equity fund.

The structure of such funds was a "big deal" and "you can see something that is systemic."

"These funds are built on a lie, which is that you can have daily liquidity, and that for assets that fundamentally aren't liquid."

The lack of any adequate liquidity management by funds, the IMF report said, meant that "central banks have stepped in during episodes of severe markets stress to provide liquidity backstops to the financial sectors, including to OEFs."

This phenomenon was again seen in the £65 billion bond buying program initiated by the Bank of England when UK pension funds were threatened with insolvency because of the collapse in bond prices, which they had used as collateral to obtain loans to finance operations in derivative markets.

There was the real prospect of a "doom loop" in which the funds had to sell long-dated government bonds, gilts, to meet margin calls from their lenders, threatening to send down bond prices even further and exacerbating the crisis.

The same scenario could play out in the OEF sector, the IMF report noted. Those holding illiquid assets may experience outflows in times of market stress forcing them to sell assets and putting further downward pressure on prices amid tightening financial conditions.

"Moreover, in the presence of herding by funds, trading activity in the same direction could exacerbate selling pressure" leading to depressed asset values, inducing "further redemptions and asset fire sales, amplifying the impact of the shocks."

The liquidity of OEFs portfolios had "deteriorated dramatically during the March 2020 market turmoil and has been worsening in recent months."

"The liquidity of funds' portfolios worsened again in the first half of 2022, especially for high-yield and emerging markets bond funds. In fact, for the latter, liquidity reached levels similar to that observed in March 2020."

OEFs are by no means the only source of the mounting crisis in the global financial system. Another is private equity funds which are heavy investors in so-called junk bonds, those which have a less than investment-grade rating but bring a higher rate of return.

As *Financial Times* (FT) columnist Gillian Tett has commented, junk bond prices "have recently tumbled" and it was not possible to track the true values of the assets held by private funds. "Maybe they are marking these down correctly. But I doubt it, particularly given that they are increasingly selling assets to each other. Expect a future reckoning."

This phenomenon was highlighted in an article published last month in the FT citing comment by a top executive of the largest Danish pension fund in which he compared the private equity market to a pyramid scheme.

According to the report: "Mikkel Svenstrup, chief investment officer at ATP, said he was concerned because last year more than 80 percent of the sales of portfolio companies by the private equity funds that ATP has invested in were either to another buyout group or were 'continuation fund' deals, where a private equity group passes it between two different funds that it controls."

Svenstrup used measured language. But he said this was "potentially" the start of a "pyramid scheme" before going on to describe what is taking place. "Everybody's selling to each other… Banks are lending against it. These are the concerns I've been sharing," he said.

The FT report noted that similar comments were made back in June by the chief investment officer at Amundi Asset Management, Vincent Mortier. He told a private equity conference in Cannes, that parts of the sector "look like a pyramid scheme in a way."

That description can increasingly be applied to the financial system as a whole.

To contact the WSWS and the Socialist Equality Party visit:

wsws.org/contact

© World Socialist Web Site