Federal Financial Analytics, Inc.

New Study: Market Illiquidity, Flash Crashes Point to Potential Systemic Risk from New Rules

FOR IMMEDIATE RELEASE
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WASHINGTON, D. C., April 29, 2015 – Federal Financial Analytics, Inc. today released a study demonstrating that, for all the benefits new financial regulations have for the resilience of individual firms, the cumulative impact of the post-crisis framework poses an array of potential unintended and even high-risk results. The study assesses recent developments, including market operational volatility, the new enforcement action against one trader in the U.K. who sparked a near-systemic meltdown in U.S. equity markets in 2010, the October 2014 Treasury "flash crash," and the over-arching challenge of promoting sustainable recovery.

FedFin's paper connects these and other developments to the body of new financial rules, laying out which rules may play a part in each systemic threat, urging quick analysis of the current framework to determine high-risk impact points. Policy-makers are urged quickly to correct for looming adverse effects through a more balanced framework focused on activities and practices, not firm-by-firm regulation.

Critical also, the study argues, is ensuring that failure results in market loss, not taxpayer bail-out – a key goal of all of the new rules that remains far from assured in part due to the pile-up of unintended results.

"We aren't saying that all of the new rules are wrong," said FedFin managing partner Karen Shaw Petrou. "We are instead demonstrating by assessing the cumulative impact of the new rules that significant threats are posed by the interaction of new rules, accommodative monetary policy, and the rapidly-changing structure of global financial markets. If the new rules prevent another financial crisis, even these risks are worth it. But, if they instead sow the seeds for the next crisis, then benefits are of course far out-weighed by new risk," she continued.

Based on this, the study lays out near-term analytics assessing empirical changes in key financial markets and their possible link to the post-crisis regulatory framework. Risks include:

- Secular stagnation, i.e., slow or even no growth resulting at least in part from regulatory incentives that concentrate financial holdings in sovereign obligations instead of facilitating new loans and other economic stimuli;
- Market-risk transfers that result from diminished liability and asset holdings by institutions under prudential rules and established resolution protocols. Although "shadow banks" may promote short-term market liquidity, they can also pose acute risk due to lack of access to central-bank liquidity, lack of transparency, and yield-chasing incentives;
- Additional risk-taking incentives that concentrate intermediation and payment, settlement, and clearing activities in a few very large institutions, many of them exempt from prudential regulation and resolution protocols;
- Heightened market illiquidity, evidenced in all too many recent systemic near misses; and
- Operational risk resulting from systemic fragility to the acts of even one rogue trader as evidenced most recently in the U.S. enforcement action related to the 2010 flash crash.

If you have any questions or would like to discuss this with Karen Petrou, please reply by return e-mail or call Arezou Rafikian at 202-589-0880.

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