EDITORIAL

I noted with interest recently some academic research on the causes and impact of the 1929 Wall Street crash. No doubt the more recent financial crash will still be exercising minds some 80-odd years from today, so we shouldn’t be surprised that the effects of the crash are a big influence on current research output. In this issue we present three distinctly different but topical pieces that all reflect, in varying degrees, the impact on thinking since the events of 2008. Or should that be 2007? At least previous financial meltdowns could be identified explicitly with one year. Should our crash be dated to 2007, when the US sub-prime mortgage meltdown started hitting bank balance sheets to a significant extent? Or to 2008 when Lehman’s went bust? Or 2009 when markets were at their all-time low and central banks implemented extreme monetary policy measures? This might explain why I usually go with ‘2007-09’!

The paradox of risk and regulation in financial markets is that they are at their most conservative and (to the regulated) onerous immediately following a crash, when everyone is risk-averse anyway and in the least need of regulation by fiat. But implementing the various regimes from Basel III to Volcker to Dodd-Frank and everything in between takes a long time (for example, Basel III has a 2019 timeline for implementation in some jurisdictions, over ten years since the onset of the crash). Will it still be what is called for by then?

Take increased capital levels. In a remark attributed to former Deputy Governor of the Bank of England Paul Tucker, if a crash is severe enough, no amount of bank regulatory capital will be sufficient. In which case, is there merit in raising levels, as Basel III does? ‘Tail risk’, the risk attached to extreme events, has not been captured by bank risk models in the past and given that there has been no change in financial modelling methodology since the crash, probably still isn’t. No one can tell what the next crisis will look like, so what we are doing now is essentially fighting the last war.

Is there a solution? Possibly not, but a more worthwhile – and more beneficial for systemic stability – approach lies in a reversion to simplicity and conservatism. Complex valuation and risk measurement models can be inaccurate by such large orders of magnitude that one wonders what the point is in having them. A good example was the loss reported by J.P. Morgan at the time of the ‘London Whale’ episode, which was higher exponentially than what the bank’s published value-at-risk (VaR) number had been immediately prior. In the era before sophisticated financial mathematics and computer processing power, banks managed risk by following conservative asset origination principles and by sticking to the knitting – ‘know your risk’ is a good maxim to adopt at any stage of the economic cycle. Getting involved in products and markets outside your area of expertise is often a sure path to chucking shareholder value out the door.

In a previous era, banks also would not have bothered with the so-called ‘exotic’ derivatives and structured products that were around in 2008 and continue to be used today. Does anyone really need them? A very large proportion of the risk management, hedging and investment needs of the world’s companies, sovereign authorities and fund managers can be met using vanilla products. Kicking out the exotic stuff would make banks’ lives easier, because such instruments are harder to assess for valuation and exposure sensitivities purposes.

Ally a conservative approach to loan origination with simple models and products and one is on a more solid path to market stability than by simply raising capital and liquidity requirements.

The cultural change could also come about more easily if it was proselytised by risk management departments themselves. Too often I have observed a desire in the Chief Risk Officer’s (CRO) office to demonstrate a technical understanding of the products and debate their Greeks with the front office traders, and set exposure limits, when what the CRO’s office should be doing is saying, “Hold on, we can’t value or assess for risk this product, so we shouldn’t be transacting in it, let alone setting limits for it.”

Years after the crash there are still products out there to which one could attach accurately this description (and I’ve ignored the zero level of liquidity for some of these products, so one can’t observe any market prices to calibrate accurately this description (and I’ve ignored the zero level of liquidity for some of these products, so one can’t observe any market prices to calibrate models to) and yet risk management departments aren’t shouting that they should be dropped. Rather, they are keen to demonstrate a technical understanding of the maths and observe that limits are adhered to. It’s not just an odd logic, but bad policy.

Risk management, as one might say, begins at home. Keeping things simple would be a good start. I hope you enjoy this issue.

Professor Moorad Choudhry FCSI, Editor

ABOUT THE EDITOR

Moorad Choudhry FCSI FIFS is Professor at the Department of Mathematical Sciences, Brunel University. He is also Honorary Professor, Kent University Business School and Visiting Teaching Fellow, Department of Management, Birkbeck, University of London.

Professor Choudhry is Managing Editor of the International Journal of Monetary Economics and Finance and on the Editorial Boards of Qualitative Research in Financial Markets and American Securitization. He is also a member of the CISI Editorial Panel, which chooses key content for the Securities & Investment Review. He is author of The Principles of Banking (John Wiley & Sons Ltd 2012). mooradchoudhry@gmail.com

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- Original work and previously unpublished
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The timing and pace of exiting will vary depending on economic conditions in individual countries and their financial markets’ ability to withstand the shift toward a tightening of monetary policy. Central banks are expected to encounter the following challenges during the reversal of unconventional monetary policies.

Firstly, the financial markets have become increasingly reliant on central banks’ support ever since the financial crisis hit the global economy. They are so dependent on central bank liquidity that doubt remains whether they can sustain their gains once the exit process gets underway. Concerned about the risk of market disruptions, central banks can delay reversing accommodative policies, but that move would lead to a build-up of financial imbalances.

Secondly, managing expectations about the future path of short-term interest rates after signalling an end to easy policies would be a complicated task. It is possible that being uncertain about the pace of rate rises, market participants would start to price in rapid rises in short-term rates, thereby increasing the risk of a spike in long-term yields. To some extent, central banks can solve this problem by clearly communicating to market participants that the pace of tightening would be gradual.

Thirdly, emerging markets that had benefited from easy monetary policies in the advanced world would face the risk of reversal in capital inflows. Credited banks in advanced countries seem to disregard such concerns, arguing that domestic conditions determine their monetary policy responses. But one cannot ignore the fact that turmoil in emerging market nations could eventually spill over into advanced countries in terms of increased downside risks to their growth, not least because of the former’s growing importance in the global economy.

And finally, advanced countries are now saddled with high debt burdens and their servicing costs are at historically low levels. The cost of servicing those debts will increase once central banks start to gradually unwind unconventional policies and that should presumably make treasury departments uneasy.

Overall, the exit from unconventional policies will not be easy. Given the fact that available exit tools are not fully tested, there remain substantial uncertainties about central banks’ ability to ensure a smooth exit. Adding to the issue, the exit challenge has considerably increased as unprecedented easing measures have been in place for an extended period. Central banks might change their course of action if economies were badly hurt by a scale back in monetary easing, or if turmoil were to engross the domestic financial markets. Against this backdrop, as IMF head Christine Lagarde has opined, an exit from unconventional policies is likely to be slower and longer than one would expect.

According to the IMF (policy paper, 2013), the reversal of unconventional policies should be executed in three phases.

1. An exit plan should begin with altering conventional aspects like adjusting forward guidance on the future path of policy rates.
2. The short-term policy rate should be hiked even before a substantial reduction in excess reserves.
3. Finally, downsizing central banks’ asset holdings is essential to reduce excess reserves.

So, the exit process does not necessarily need to start with increasing the short-term rate, and central banks have various options to reduce the size of their balance sheets without embarking on trimming bond holdings. For instance, after signalling a reversal in easy-money policies, they could unwind normal liquidity enhancing facilities and allow short-term securities to mature while not using the proceeds to buy bonds afresh. Since improving economic conditions might fuel inflation expectations, it is important that central banks must hold...
high credibility for price stability; otherwise, the exit process would turn out to be bumpy. In the absence of high credibility, in order to contain inflation, central banks will have to bring forward selling of bonds while increasing the pace of interest rate hikes. Both actions would be risky to their domestic economies and financial markets.

**JAPAN’S EXPERIENCE SUGGESTS AN ORDERLY EXIT IS POSSIBLE**

It is debatable whether Japan’s exit from unconventional monetary policies was successful; it was even argued that the BoJ’s exit was incomplete as it still held long-term Japanese Government Bonds (JGBs) when it announced a new round of quantitative easing (QE) in response to the financial crisis (Syed and Yamaoka, 2010). The author believes the BoJ did succeed in aspects of its exit strategy. First, even after the BoJ ended its quantitative easing in March 2006, Japan’s recovery was not jeopardised and most importantly the domestic equity market was not engulfed by turbulence (see Figure 1). Second, the BoJ was able to sharply downsize its balance sheet – mostly through unwinding of funds-supplying operations and allowing short-term securities holdings to mature – within a short period of time after officially announcing the end of QE. Such an abrupt withdrawal did not kill the recovery but it was suspected that could have adversely affected Japan’s ability to grow strongly in the subsequent years. Third, the BoJ was able to initiate the exit process without embarking on selling long-term JGBs (Syed and Yamaoka, 2010), thanks to a self-imposed bank note rule that capped the central bank’s JGB purchases to money circulated in Japan during that time. Because of this rule, the BoJ had the flexibility of downsizing its balance sheet with other instruments, and there was no immediate need to offload accumulated JGBs (Syed and Yamaoka, 2010). Overall, Japan’s experience does show that central banks can withdraw unorthodox policy without stoking inflation and weighing on growth, provided exit plans are carefully framed and accompanied by effective communication strategies.

**SHORTENING EXPECTATIONS FOR POLICY DURATION COMMITMENT USING FORWARD GUIDANCE**

Four major central banks adopted some form of forward guidance on the policy rates after they hit the zero lower bound. The main idea behind forward guidance is to have market participants believe that the short-term interest rates will remain near zero even after the economy recovers, thereby enhancing monetary policy’s effectiveness. As we discussed in the previous section, when a central bank plans to exit, it should first prepare market participants for the end of the policy duration commitment. This can be achieved by tweaking existing forward guidance, along with effective communication strategies. In this section, we will discuss various forms of forward guidance and the effectiveness of each type in helping market participants adjust their expectations for the duration of the zero interest rate policy commitment.

Generally, central banks deploy three types of forward guidance to influence expectations and the Bank for International Settlements (BIS) defines them as follows: qualitative guidance (which doesn’t provide quantitative information about the path of the policy rate); calendar-based guidance (where policy rate is committed to remain near zero for a clearly specified time horizon); and threshold-based guidance (where guidance is linked to specific economic variables).

Let us consider an hypothetical situation in which a central bank pursuing unconventional monetary policies deploys qualitative forward guidance (ie, saying that the policy rate will remain near zero for an extended period of time) and wants to signal to market participants that it will gradually withdraw monetary stimulus. To do so, it will have to shift to a different form of forward guidance because simple qualitative guidance would not be an appropriate communication tool given its vagueness. The central bank has two options: either to shift to calendar based forward guidance or threshold-based guidance. Calendar-based forward guidance would tie the hypothetical central bank’s hands and therefore it could not act until the pre-committed time comes. On the other hand, threshold-based forward guidance would give the impression that the hypothetical central bank is giving more focus to real economic variables, thereby posing risks to its credibility for price stability (BIS Quarterly, 2014).

No sooner had Ben Bernanke, then Federal Reserve Chairman, first signalled a pullback in Fed’s bond buying programme last June than the bond market started pricing in rapid increases in the path for US short rates, which in turn led to abrupt moves in long-term treasury yields. The Fed attempted to anchor such expectations by enhancing its communication efforts to clarify to market participants that tapering was not the same thing as tightening while assuring that low rates would remain in place even after the unemployment period of time, they would have to persuade the market to adjust its expectations regarding interest rates smoothly before resorting to interest rate rises. In other words, an exit from the policy duration commitment is a prelude to monetary policy tightening. So, in order to exit smoothly, a central bank should deploy an appropriate forward guidance approach that is effective in shortening market expectations for the duration of the zero interest rate policy commitment.

**Review of Financial Markets**

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**Figure 1: An end to BoJ QE & Japanese economy**

Source: Cabinet Office, Japan
threshold was hit. But the US central bank was unsuccessful in reining in a rise in long-term yields because market participants had believed that the fall in the unemployment rate would soon prompt the Fed to start hiking the interest rate. The Fed eventually scrapped threshold-based guidance in March 2014 and shifted to new form of guidance that ties economic conditions to a tightening of monetary policy. The Fed's experience showed the level of importance market participants give to a single variable; they started looking for a rate hike even as underlying conditions in the labour market were not warranting a policy tightening. As a result, the Fed had to abandon its employment threshold, undermining its credibility by doing so.

As we discussed in the first section, an exit from unconventional policies would not be a straightforward process and would include a number of phases. Therefore, it is important for central banks to be trusted by market participants in order for their policy actions to be effective. As such, a central bank must protect its reputation when it prepares market participants for exit from the policy duration commitment. We suggest that the right approach for that would be qualitative forward guidance with additional information on policy reaction functions. Under this approach, the risk of a central bank being seen as reneging on its policy commitment is minimal while it has the flexibility to adjust its monetary policy settings when economic conditions change. Both the Fed and the Bank of England (BoE) have successfully stabilised the market's expectations with this approach (see Figure 2).

Although tying the response of policy to the economy magnifies the uncertainties about the path of future short-term rates, central banks' forecasts and policymakers' speeches should help market participants build consensus for the timing of a first rate hike. When economic conditions broadly improve, market participants will gradually begin to prepare for a tightening and will have fully priced in a rate hike before the time — when the majority of investors believe rates to be lifted — comes. More information about the likely scale and speed of rate rises could ease abrupt moves in yields during this period. Crucially, if a central bank deploys this approach, it should also include credible commitment to safeguard price stability in its communication strategies. This is because, when inflation expectations start to pick up, a central bank with high reputation for price stability would have the flexibility of unwinding other balance sheet instruments without engaging in selling long-term bonds.

The Bank of Japan's current easing programme (QQE) includes both threshold and calendar-based forward guidance. Its ability to exit from QQE without triggering disruptions in the financial market is questionable. For instance, unlike before, the scale of the BoJ's QQE is unprecedented in size and carried out without a self-disciplined rule. In case the BoJ succeeds in achieving the 2% inflation target, it will have to start offloading long-term JGBs because other strategies could not contain inflation expectations given the BoJ's already tainted credibility. That would in turn lead to a spike in bond yields, thereby substantially increasing debt servicing costs for the government. Needless to say, the value of the BoJ's bond holdings would see significant declines in that scenario.

CONCLUSIONS: FORWARD GUIDANCE AND CENTRAL BANK CREDIBILITY

While forward guidance plays a crucial role in helping central banks to smoothly unwind unconventional policies it does pose risks to their credibility; the exit process will become more complicated if central banks lose their reputation. Allan Blinder, former Vice Chair, US Federal Reserve, defines central banks' credibility as follows: a central bank is deemed credible if people believe it will do what it says. A central bank's credibility will be at stake if it first says that the zero interest rate policy will remain in place for two years but reneges on this commitment later. Likewise, a central bank that links its policy action to some real economic variable but abandons that relationship later will have its reputation severely damaged.
As Figure 3 shows, simple qualitative forward guidance does not pose risks to credibility as under this approach a central bank neither links tightening to an explicit economic variable nor commits to keep the zero interest policy in place for a clearly specified time horizon. But this approach would be ineffective in shaping private sector expectations in a manner consistent with policy goals, and thus a central bank that follows this approach could not begin a tightening of monetary policy without creating volatile moves in long-term yields.

On the other hand, a central bank deploying calendar-based forward guidance needs to keep the interest rate near zero for a specified time horizon. If improvements in economic conditions were to substantially exceed its expectations, then the central bank would have to start raising the interest rate even before the pre-committed time comes, a move that would badly damage its credibility. Nor can calendar-based guidance be seen as an effective tool to persuade the market to adjust expectations for the policy duration commitment. While threshold-based forward guidance increases a central bank’s transparency, it would significantly impair its credibility if an economic variable linked to a tightening were to move toward the preset threshold faster than the central bank initially anticipated. Both the Fed and the BoE had their credibility eroded by abandoning this approach in response to the faster-than-expected drop in the unemployment rate in the U.S. and UK. As the matrix shows, qualitative guidance tying economic conditions to policy actions is both effective and poses less risk to credibility than other approaches.

- The views expressed in this article are solely those of the author and do not necessarily reflect the opinions of IDEAglobal

References cited in this paper are listed at cisi.org/rofmjune2014

THE EFFECTIVENESS AND CHALLENGES OF ESG INTEGRATION
Robert Schwarz MBA MS, an ESG Analyst living in New York City
apostrate@yahoo.com

ABSTRACT
The use of the sustainable and responsible investing strategy of ESG integration (ESGI) is well established; certain empirical data support its success in achieving superior risk-adjusted returns over the long-term, there is notable use of it among investment managers, an industry to support its use, and demand among investors for it. Many investment managers, however, have not implemented ESGI and attempts by ESGI’s advocates to inform them of its benefits have seen limited success. Using sociological theory as a guide, this article provides an explanation for the limited success of these attempts by suggesting that acceptance of the effectiveness of ESGI represents a threat to an investment manager’s identity. The article goes on to offer proposals for how to circumvent this challenge to getting investment managers to implement ESGI by appealing to their competitive nature.

INTRODUCTION
The objective of sustainable and responsible investing (SRI) is to generate long-term, risk-adjusted financial returns that outperform the market through the integration of environmental, social and corporate governance (ESG) criteria into investment decision-making processes throughout the investment cycle. Although there is considerable evidence demonstrating the achievement of this objective and concerted efforts among its advocates to induce investment managers (IMs) to employ this strategy, it has not been widely implemented. The author believes that part of the reason for this is the challenge involved in the implementation of this strategy and the approach used by its advocates to overcome IMs’ resistance. Given the evidence in favour of ESGI’s benefits and the persistence of the efforts of its advocates, however, one would expect a greater degree of adoption despite the associated challenges. In search of reason(s) for this disconnect, the author sought answers in socio-behavioural theory. The answers found provide information useful in better understanding resistance to ESGI as well as in enabling advocates of SRI to formulate a more effective approach to getting IMs to implement ESG criteria into their investment decision-making processes.

In this article, ESG and ESG integration (ESGI) are defined and evidence supporting the benefits of both presented. Next, an overview of the challenges associated with ESGI and its implementation is set forth. The article proceeds with a brief discussion of the approach that has been used to argue in favour of ESGI and why the strategy employed has seen limited success despite the evidence demonstrating its benefits. From there, an exploration of socio-behavioural motivators and the ways processes provide a deeper understanding of IMs’ resistance to ESGI. Finally, based on the reasoning offered, suggestions for a new approach to getting IMs to implement ESGI by appealing to their competitive nature are provided.

DEFINITION OF ESG
For the purposes of this article, environmental, social, and governance (ESG) refers to the consideration of how these factors affect and are affected by the operation of a business entity. The proper management of ESG performance involves the consideration of these extra-financial factors at the operational level and within a company’s overall business strategy. The actions needed to accomplish such an organisational synchronisation require a comprehensive understanding of the operational, financial, regulatory, and reputational risks related to global environmental, social, and economic issues that affect the viability of a company. Environmental risks such as those related to climate change and resource scarcity; societal issues such as supply chain labour conditions and maintaining environmental, health, and safety standards; and governance issues such as executive pay and board diversity. On top of this understanding, a significant commitment of organisational resources, courage, and conviction is required from corporate executives in order to institutionalise these considerations into decision-making and management processes.

These resources and efforts, in turn, enable the identification of opportunities that arise from the aforementioned risks. Such opportunities include improving upon environmental and social outcomes and the optimisation of corporate decision-making capacity through the implementation of technologies, programmes, and behavioural incentives. Due to the breadth and interdisciplinary nature of the competencies involved in managing such endeavours, it is a widely accepted notion that the management of ESG performance is a strong indicator of a well-managed operation. This positive correlation is supported by the highly qualified and capable leaders, managers, and staff needed to capitalise on the available opportunities.

The investment in organisational capacity required to successfully institutionalise ESG brings rewards in quantifiable forms such as increased operating and profit margins; improved access to capital; stronger brand reputation, enhanced employee satisfaction, and workforce and community development. These benefits drive long-term overall outperformance of the market, thus demonstrating the value inherent in managing ESG performance.
REVIEW OF FINANCIAL MARKETS

An example of how ESG performance management can affect stock price is provided by results of a Harvard Business School study shown in Figure 1, which compares, over the same 19-year time period, the stock performance of a portfolio of firms that successfully manage ESG with a portfolio of firms that do not manage ESG. The red line shows that US$1 invested in a portfolio of firms that manage ESG would have grown to US$22.60, whereas US$1 invested in a portfolio of firms that do not manage ESG would have only grown to $15.40.

DEFINITION OF ESG INTEGRATION

ESG integration (ESGi) involves the incorporation of metrics associated with the results of managing ESG performance into traditional financial analysis. As ESG considers factors that fundamentally affect a company’s ability to create economic value, it enables a more comprehensive assessment of a company than financial analysis alone can. In doing so, ESGi enables the identification of market leaders and laggards in terms of their ability to capitalise on ESG-related risk-mitigation and margin-improving opportunities. These determinations are possible because ESG metrics provide analysts with quantitative and qualitative data, which enable operational insights across the value chain. Integrating these metrics into traditional financial analysis enables the construction of more informed risk profiles and financial models with greater explanatory and predictive power than conventionally built models, thereby enabling better evaluations of long-term potential to outperform the market. In the same vein, ESG metrics can be used to determine and monitor companies’ ability to adapt to changing market conditions; quantify managerial performance beyond financial measures; enable more accurate industry peer comparisons; mitigate and take advantage of, respectively, newly identified ESG-related risks and opportunities, and to keep track of ESG-related incidents that may adversely affect a company’s brand and value.

EVIDENCE OF ESGi’S EFFECTIVENESS

The theoretical benefits of ESGi are borne out in its practice. An example provided by AXA Investment Managers, which illustrates the identification and integration of ESG metrics into financial analysis is provided in Figure 2.

Figure 1: The effect of ESG performance management on share price

Figure 2 demonstrates that the share price of the companies with the best board scores¹ outperform the companies with the worst board scores, ie, those with the best board scores returned 40% on an annualised basis, whereas those with the worst board scores returned -0.3%. Although this may not seem all that insightful, ie, one would expect poor leadership to result in poor company performance and vice versa, the fact is that analyses such as these are not undertaken outside of firms that have adopted ESGi. The potential negative consequences of not doing so are missed investment risks and opportunities that can affect portfolio value as exhibited in the above example.

In addition to the example above, there exists a body of evidence in support of the realisation of superior long-term, risk-adjusted returns by employing ESGi. Two² study-of-studies are here presented, which examined multiple academic and investment management firm conducted studies regarding the use of ESGi. The first, performed by United Nations Environment Programme Finance Initiative and Mercer, found that four of the five studies, which employed a pure ESGi strategy, outperformed the market. The second study, performed by Deutsche Bank Group, reviewed 100 academic studies, 56 research papers, two literature reviews, and four meta-studies of sustainable investing and found that 89% showed companies with high ESG ratings outperformed the market and 100% of the companies had a lower cost of capital in terms of debt (loans and bonds) and equity.

Further evidence of ESGi’s effectiveness is found in the multitude of investment managers, pension funds, and private equity firms, collectively representing hundreds of billions of assets under management (AuM), which have implemented ESGi and outperform the market. Investment managers include: Calvert Investments, Parnassus Investments, HERMES, Deutsche Bank, Robeco SAM, PNB Paribas. Pension funds and endowments include: Harvard Management Company, Ontario Teachers Pension Plan (OTTP), APG, PGGM, HESTA, and CalPERS. Private equity firms include: TPG Capital Advisors, LLC, Apollo Global Management, LLC, The Blackstone Group, and The Carlyle Group.

1 ‘Board score’ is a governance metric devised by AXA that rates corporate boards of directors on a scale of 1 - 5 using the following criteria, “A] an appropriate mix of directors with the right skill sets that evolve in line with company strategy [B] Healthy turnover and proper succession planning [C] A board composition that reflects workforce diversity and the firm’s geographic footprint.”
2 A compendium of additional studies can be found here: http://www.sristudies.org/
A specific instance of an IM who has achieved alpha using ESGI is Andre Bertolotti, Chief Investment Officer at Quotient Investors. He has outperformed the Russell 1,000 by 4.88 percentage points over the last three years. Extolling the effectiveness of ESGI he flatly states: "Without ESG, my portfolio would look like that of many other managers... But when you bring ESG into the picture, I end up buying a different set of stocks."

A similar example demonstrates how ESGI enables investment managers to avoid losses. Through its use of ESGI, Domini Social Investments, which manages mutual funds with a combined AuM of US $1.3 billion, became aware of the type of regulatory and worker safety compliance issues at British Petroleum (BP) that were eventually recognised as the cause of the failure of the Deep Water Horizon oil rig. Based on its ESG analysis and rating, Domini did not purchase BP shares. This decision avoided what would have been a significant loss in the value of their fund.

Finally, there is an industry dedicated to providing ESG data precisely to enable ESGI and other SRI strategies. Companies in this industry include: Sustainalytics, TRUCOST, Asset4, MSCI, CSRHub, Bloomberg ESG, RepRisk, FACTSET, and smaller boutique firms that often bundle consulting services with their data. In addition to these resources, there is an abundance of thought leadership, networking opportunities, information services, and other types of support for the use of ESGI available through organisations that exist to advance responsible investment practices, eg, United Nations-supported Principles for Responsible Investment (UN PRI), European Sustainable Investment Forum (EuroSIF), US Forum for Sustainable and Responsible Investment (US SIF), and many others.

DEMAND FOR ESGI

Connected to the empirical evidence supporting ESGI's effectiveness, there is demand for its use by investment managers from investors. For instance, US SIF reports that client demand is the top reason investment managers are implementing ESGI. Considering future demand, one may conclude from the following three findings that, "the emerging generation of investors is likely to seek achievement of social objectives in addition to financial returns," 1) 36% of respondents to a study of 5,000 millennials ranked 'to improve society' as the primary purpose of business, 2) millennials value price over brand, are not known for brand loyalty, are not averse to switching costs and, 3) millennials' use of the internet is significantly different than that of baby boomers. As such, an equally reasonable conclusion is that in order for investment managers to be able to take advantage of the expected wealth-transfer from baby boomers to millennials over the next 40 years, which is valued at US$41 trillion, they will need to adopt ESGI in order to accommodate the disparate investor profiles of these two generations.

CHALLENGES ASSOCIATED WITH ESGI

As with any new investment strategy, resources are required for its implementation. In the case of ESGI, these resources could be considerable, as this investment strategy requires an entirely new set of skills and procedures to be included in investment decision-making processes. As such, consultants may need to be brought in, staff will have to undergo extensive training and/or new staff may need to be hired. Furthermore, depending on the degree to which ESGI is implemented, the following types of changes, potentially among others, may need to be planned and executed at a firm: 1) organisational structure adjustments, 2) data acquisition and integration, 3) development of website and other marketing material, and 4) workflow reengineering. Moreover, from a Human Resources perspective, these types of changes require executive level support and a culture and level of employee engagement that is able to cope with the disruptions and natural resistance to change involved. Without these success factors in place, declines in morale and productivity are likely.

In addition to the resource and organisational level challenges, ESG data is known for having availability, consistency, reliability and verifiability issues. These issues are mainly related to the nature in which companies report ESG data, the frequency they do so, and legal concerns regarding data sensitivity. In some cases, these issues render the data difficult to work with in general and for the inexperienced, can lead to the misidentification of leaders as laggards and the converse. Similarly, there is an absence of a standard framework and methodology for scoring companies based on ESG performance, which can lead to misconceptions regarding which ESG data is material and which is not, the latter being irrelevant to ESGI.

EXPLAINING RESISTANCE TO ESGI

As counterarguments to the above challenges, ESGI advocates offer IMs variations of the benefits and demand for it previously cited. However, they also typically include fear-mongering, plays at sympathy, and information overload. Which is not to claim that the assertions made regarding, eg, habitat loss, sea-level rise, the health effects of pollution, etc. are not true and relevant, rather, that they are not effective towards inducing behaviour change among IMs' for which these negative consequences have no immediate bearing or significance. Also included in ESGI advocate's strategy to relay its benefits are the use of terms such as sustainable, responsible, environmental, ethical, etc., which for many IMs carry negative connotations. The thinking behind this strategy is that if the information and implications are properly explained and the data and methodology verified and substantiated, it will be accepted and ESGI implemented accordingly.

Ostensibly, the combination of the previously described challenges and strategy are the basic reasons behind investment managers' resistance to implementing ESGI. That is to say, IMs who have a successful strategy in place presumably find that the cons outweigh the pros of implementing ESGI. Given the steadfast persistence of the attempts to overcome this resistance, however, the author believes that an explanation is needed that provides a more complete account of ESGI resistance among IMs vis a vis its empirically based benefits and the existing and future demand for its use.

In recognition of this need, the author called upon sociological theory for insights into the possibility that there are deeper motivations and thought processes driving resistance to ESGI. The following five examples offer just that:

1. Cultural cognition theory posits that as scientific knowledge and numeracy increases, ie, the 'smarter' one is, among those with a world view that, "ties authority to conspicuous social rankings and eschews collective interference with the decisions of individuals possessing such authority", ie, the more one espouses the benefits of a hierarchical social order, the more likely one is to question the information with which they are presented. As IMs generally fall into this character category, it is reasonable to expect them to instinctively doubt the benefits of ESGI.
2. Motivated avoidance theory posits that when faced with a complex and troubling issue, some individuals' instinct is to give up and not learn more about it, i.e., they do not endeavour to come to an informed conclusion based on non-biased information. Thus, their resistance arises from their lack of knowledge being ‘informed’ by the disagreement surrounding the issue and any potentially conflicting information they are exposed to in their everyday life, such as, respectively, opposing positions in one's firm regarding the pros and cons of ESGI and news stories disseminated by the media regarding the risks associated with not managing ESG performance. With the risks of ESG in doubt, the relevance of ESGI is questioned.

3. Some hold that large sums of money are being made in the form of grants, subsidies, and donations from entities that accept the reality of the environmental, social, and governance risks facing society. Again, with these risks in doubt, the relevance of ESGI is rendered moot.

4. Under the heading of fear, when some individuals are presented with threatening information their instinct is to deny the truth of the information and/or its applicability to them. Similarly, humans are notorious - among economists - for underestimating the risks associated with likely events and overestimating the risks of unlikely events. Thus, in both cases, the threat of imminent danger is denied. The danger in this case being that resistance to ESGI is unfounded.

5. Building upon the sociological concepts of confirmation bias, wherein one “give[s] greater heed to evidence and arguments that bolster [their] beliefs” and disconfirmation bias, wherein one “expend[s] disproportionate energy trying to debunk or refute views and arguments [they] find unconvencial,” is the rationalisation explanation. That is, when presented with information that questions deeply held beliefs and/or that one's way of life could be fundamentally threatening to society, they reject the validity of the source of the information. Thus, the information itself cannot be correct.

These five explanations provide useful information regarding underlining subconscious biases that add to the previously stated challenges and help to better explain why attempts to overcome resistance to ESGI have seen limited success. To wit, they reveal that accepting ESGI’s effectiveness may represent a threat to the basic human instinct of identity preservation.

An aspect of identity being preserved, through denial, is one’s level of intelligence and self-worth as manifested in career performance. That is, if an IM admits that ESGI is an effective investing strategy, they will also conclude that their returns could have been greater. Such an admission, after years of claiming to have been doing the best for their employer, clients, etc., could be very uncomfortable and possibly embarrassing. Mental health professionals refer to this type of internal conflict as cognitive dissonance, i.e., the discomfort felt as a result of attempts to simultaneously maintain two conflicting cognitions.

In this case, ‘I have done my best’ and ‘I dismissed, without sufficient reason, information that would have improved my performance.’ This discomfort often leads to decision-making that serves to moderate emotions that fuel anxiety. Denial of the effectiveness of ESGI would avoid the anxiety associated with accepting its effectiveness and, thus, preserve one’s sense of career accomplishment.

Another aspect of identity being preserved is one’s self-image as a ‘good person.’ That is, admitting ESGI’s effectiveness will force an IM to realise that businesses that do not manage ESG performance are significantly contributing to the environmental and social issues facing society. With this realisation may come another, i.e., as a consequence of not adopting ESGI, they may have made an outsized contribution to these issues. As such, they may have, albeit unwittingly, further jeopardised the health and future wellbeing of their family members, friends, themselves, and indeed the rest of the world, a notion certainly capable of inducing a fair bit of anxiety. Analogous to the previous example then, denial of the effectiveness of ESGI would preserve one’s self-image as a ‘good person.’

CONCLUSION: SUGGESTIONS FOR A NEW APPROACH

As the combination of the obstacles previously articulated virtually eliminates the power of an empirically based argument to overcome resistance to ESGI, the following suggestions seek to appeal to IMs’ competitive nature, rather than attempting to show IMs the error of their position and the environmental, social, and economic benefits of ESGI. Thus, the author believes that this may be more effective in getting IMs to implement ESGI.

1. Similar to the XPrize, a competition could be issued to achieve alpha through the use of ESGI. Similarly, more prizes like the Moskowitz Prize for Socially Responsible Investing could be made available to students.

2. ESGI coursework could be added to the curriculum of business classes and more ESG-focused extra-curricular opportunities such as the PRI Young Scholars Finance Academy could be offered. Similarly, more ESGI training, such as that provided by Responsible Investment Academy and Robert F. Kennedy (RFK) Compass could be made available. In addition, a Responsible Investor professional accreditation could be added as a sub-designation to a Certified Financial Analyst (CFA) or the Cisi Masters in Wealth Management.

3. Mainstream, finance-focused media outlets could dedicate coverage to investment managers that are generating superior, risk-adjusted returns using ESGI.

4. A publicly available directory of sustainably managed investment products could be built to inform and drive retail investor demand for financial products and services using ESGI.

5. Investment management firms could align compensation structures and performance appraisals with the use of ESGI.

6. Eligibility for banking and investment subsidies could be restricted to firms that manage a predetermined minimum percentage of their AuM using ESGI.

7. Standard reports issued by indexes and exchanges could be benchmarked against a comparable index of assets determined as sustainably managed then distributed through social media applications and financial news outlets. The former links to ‘connect now!’

This article has explained what ESG and ESGI are and presented empirically based evidence for advantages of both. It has also presented the challenges associated with implementing the latter and described why the efforts of its advocates to get IMs to implement ESGI have seen limited success. In addition, with the aid of sociological theory, suggestions have been offered to help induce IMs to implement ESGI so as to increase the percentage of global AuM which employ an SRI investing strategy. Given the ESG-related challenges facing society, it is the author’s hope that this article will induce IMs to (re)consider implementing ESGI, the suggestions be acted upon, and that further use of the sociological insights provided will be made by ESGI advocates in their efforts to get IMs to leverage investors’ capital resources and influence to invest in and advocate for sustainably run companies.

References cited in this paper are listed at cisi.org/rofmjune2014
MACROPRUDENTIAL POLICY: POTENTIAL IMPLICATIONS FOR INVESTORS

Colin Ellis, Visiting Research Fellow, University of Birmingham
c.ellis@bham.ac.uk

ABSTRACT

Since the financial crisis broke in 2007, policymakers around the world have sought to design and implement new tools to prevent future crises and limit spillover effects to the wider economy. These new ‘macroprudential’ instruments are still being developed in many cases, but have already had a discernable impact on financial markets. In coming years, macroprudential policy (MPP) is likely to exert significant influence on future investment decisions and returns. This article sets out the core toolkit of macroprudential policy, and discusses potential implications for investors.

INTRODUCTION

Policymakers have sought new ways to influence economies since the recent financial crises and subsequent recessions in advanced economies. Central banks have resorted to a variety of less conventional monetary policy measures to support growth, with questionable success (Sinclair and Ellis, 2012). And concerns about the potential macroeconomic costs of systemic risks (Ellis, 2011) have led to a set of new regulations and tools, broadly defined as ‘macroprudential policy’ (hereafter MPP).

LITERATURE REVIEW

Before the recent crisis, academic literature on MPP was limited, although Clement (2010) establishes that the term was used by policymakers in the 1970s. Borio (2009) notes that, prior to the crisis, ‘macroprudential’ matters were generally thought to relate to links between regulation and supervision and the macroeconomy, while BIS (1986) describes MPP as supporting the safety of the financial system as a whole. McCauley et al (1999) focus on addressing risks from increases in leverage.

Since 2007, research on MPP has become more widespread, and is only briefly summarised here. Initially the aim of MPP was unclear: BiS (1986) describes MPP as supporting the safety of the financial system, while Caruana (2010) focuses on reducing interlinkages between institutions and the procyclicality of the financial system. Meanwhile, Landau (2009) suggests that MPP should act to prevent asset bubbles; but in contrast Geanakoplos (2010) proposes that policymakers should respond instead to build-ups in bank credit and leverage during expansionary periods. Nier (2011) summarises the emerging consensus that MPP should focus on mitigating systemic risk.

One particular strand of the literature relates to identifying banking crises. Claessens and Kose (2013) provide an in-depth review of past crises, while Laeven and Valencia (2012) compile a comprehensive database. Several papers have examined potential leading indicators of financial distress that could guide policymakers, including those from balance sheets (Carson and Ingves, 2003) and financial markets (Illing and Liu, 2006, and Tarashev and Zhu, 2008). De Nicolò and Lucchini (2009) jointly model macroeconomic variables and financial risk indicators using a factor-augmented vector autoregression (FAVAR) approach; Ellis et al (2014) demonstrate how FAVARs can capture evolving economic dynamics and transmission mechanisms. However, a key criticism of this strand of literature is that past crises were not typically preceded by poor economic conditions or other indicators (Alfaro and Drehmann, 2009). To date, the ability to predict crises – and avoid false positives – remains unproven.

Hannoun (2010) and Bank of England (2011) offer generic discussions of potential MPP tools. More specific research has often focused on banks’ capital, with papers examining the role of short-term debt in determining banks’ vulnerability (Brunnermeier, 2009), the risk-mitigating role of contingent instruments (Sundaresan and Wang, 2010), and differences in the impact of price-based versus quantity-based tools (Perotti and Suarez, 2011). There is often disagreement. For instance, Shin (2010) discusses how countercyclical capital buffers (CCBs) can mitigate risk concentration; but in contrast Claessens et al (2013) suggest that CCBs are suboptimal, and argue that caps on debt-to-income and loan-to-value (LTV) ratios are more effective tools, having reduced vulnerabilities in emerging markets. Several papers have also addressed the challenge of incorporating MPP within macroeconomic models; for instance, Angeloni and Falai (2009) incorporate banks in a standard dynamic stochastic general equilibrium (DSGE) framework. However, the relative complexity of such approaches, and indeed wider concerns about DSGE models, means that they are not yet in common use. Finally, the International Monetary Fund (2013) provides a good recent summary of MPP, noting in particular that strong enforcement of policies must be complemented by appropriate monetary, fiscal and other financial policies.

CRISIS PREVENTION

Most macroprudential tools relate to either crisis prevention, or crisis management. The former seek to limit the incidence of financial crises. While regulatory efforts such as Solvency II have sought to harmonise capital adequacy metrics within the insurance industry, most of the recent focus has been on banks.

Banks suffer from a maturity mismatch – they lend over long horizons, but are funded with short-term money, such as deposits and wholesale market funds. Funding can therefore be withdrawn very quickly if trust in an institution is lost, even if the value of its assets is robust. Banks also suffer an uncertainty mismatch: the present and future value of liabilities are known with some certainty, but the return on assets will depend on credit risk and asset prices.

Banks cope with uncertain returns – and particularly unexpected losses – via capital buffers. Bank capital has the critical ability to absorb losses, so that the institution remains a going concern. Ordinary share capital and retained earnings are basic forms of capital, while other types include preference shares and hybrid securities. However, market participants focused on simple measures of capital during the crisis, reflecting uncertainty around the loss-absorbency of other types of capital.

The scale of some banks’ losses during the financial crisis raised concerns about the adequacy of capital buffers. One of the first MPP acts was to require banks to hold more and better quality capital – to increase loss-absorbing buffers – but this was phased in (Figure 1) to give banks time to adjust.
Higher capital requirements are an implicit acknowledgement that regulators underestimated risks prior to the crisis. This is partly because inherent uncertainties in banks’ risk models were often ignored, and they failed to capture the intrinsic risks that actually crystallised (Haldane, 2009). More stringent and public stress tests, designed in part to counter this, are now an important part of policymakers’ toolkits.

Single measures of solvency may also be misleading, especially given uncertainties around risks. As such, some regulators have also introduced leverage ratios as alternative measures of capital adequacy. This essentially measures capital against total assets, without any risk weighting. One consequence is that banks that engage in relatively safe activities are penalised.

Failures of large multinational institutions are more likely to engender widespread economic externalities than smaller ones. As such, sistemically important financial institutions (SIFIs) typically face higher capital requirements than smaller banks, with global SIFIs facing the highest requirements. However, given no cross-border agreement on resolution of global SIFIs when they fail, the default position is still for the home regulator and government to lead. Furthermore, concerns about regulatory arbitrage persist, with global co-ordination in banking regulation falling short of what is likely to be needed in a crisis, prompting fears of a ‘race to the bottom’ (Houston et al, 2012). This poses significant fiscal risks for countries where the banking sector is disproportionately large, as seen in Iceland and Ireland. Furthermore, many systemic transmission mechanisms persist: efforts to promote central counterparty (CCP) clearing for derivatives and securities, thereby limiting network effects, have had limited impact so far.

Most of these developments are essentially static in nature. But MPP can also be countercyclical, restraining booms and cushioning busts. In many countries, banks must now hold CCBs, while clear signals from policymakers could improve private agents’ financial decisions in a more dynamic fashion (Giese et al, 2013). Sectoral capital requirements for specific markets or even limits on lending – for instance via caps on LTV ratios – could also vary as conditions evolve. Finally, closer links between macroprudential and microprudential regulation – the latter focusing on individual institutions rather than the financial system as a whole – could also result in higher capital requirements for individual banks. However, the slow implementation of regulatory capital changes limits their responsiveness to financial dynamics.

CRISIS MANAGEMENT

Crisis management tools seek to limit the impact on the wider economy when institutions do fail. The development of these tools implicitly recognises that policy will never eliminate the risk of large or systemic institutions failing.

First, many banks now require ‘living wills’ detailing how the institution should be managed if it fails. These process maps are still very opaque, but should ostensibly help regulators. The imposition of ‘ring fences’ within banking groups – essentially, trying to separate the utility aspects of banking from more speculative activities – should also help, by protecting the ordinary business of the bank from shocks arising elsewhere on the balance sheet (ICB, 2011).

Second, new resolution regimes often empower regulators to intervene early and break banks into ‘good’ and ‘bad’ parts. Typically, the bad bank with the underperforming assets is then run by the state, with the aim of recouping as much money as possible while insulated from liquidity concerns. Meanwhile, the ‘good’ bank starts afresh with a clean balance sheet. In practice, it is difficult to quantify prospective losses within poor credit and asset portfolios, and aggressive write-downs in asset values could result in the good bank requiring new capital.

New securities also ensure that bank creditors suffer losses alongside equity holders. In particular, some hybrid securities known as ‘contingent capital’ (or CoCos) will convert from high-yielding debt into loss-absorbing equity, where the trigger for conversion will often be prior to the bank’s point of non-viability.

If these ‘capital-like’ instruments are insufficient, then losses can also be imposed on other junior securities, senior debt holders, and uninsured depositors. This ‘bail-in’ approach ensures that creditors suffer losses instead of fiscal authorities injecting money. The Cypriot banking crisis resolution in March 2013 followed this principle, and the EU’s Banking Recovery and Resolution Directive is very much in this vein.

These crisis management tools aim to provide effective mechanisms for resolving failing banks while minimising taxpayers’ costs and sustaining the normal functioning of the banking sector. However, financial market conditions are likely to deteriorate markedly in any period of significant stress; and here the traditional role of the central bank remains.

LIQUIDITY PROVISION AND MARKET-MAKING

When shocks to the demand or supply of money crystallise, banks can face funding shortfalls even if their overall solvency is not threatened. However, in the absence of such short-term funding, a bank’s solvency may then be called into question, especially if it has to liquidate assets at substantial discounts in so-called ‘fire sales’. Potential panic could also lead to a run on the bank, and liquidity crises can swiftly become solvency crises.

The typical response is to establish a ‘lender of last resort’ (LORL) that can provide discretionary liquidity to financial institutions against good collateral (Bagehot, 1873). Given their role at the heart of the banking and payments systems and ability to ‘create’ money, the LORL is typically the central bank. These can even offer unlimited funding to a large number of banks, as in the European Central Bank’s long-term refinancing operations (LTROs).

Concerns remain about central banks injecting liquidity to support institutions, as this backstop could encourage banks to take excessive risks, engendering moral hazard. (A similar argument can be made about government-funded bailouts.) Typically, the costs of not supporting solvent institutions are thought to be greater than the costs of intervening; but distinguishing between solvent and insolvent institutions can be difficult within short time-frames (Goodhart, 1999). Hopefully, higher capital buffers should make this distinction easier.
A second development will be the further shift of activities from the increasingly regulated banking sector to the less fettered shadow banking sector. This reflects a continued desire by banks to shrink and de-risk their balance sheets, and by businesses to diversify their funding sources. European companies are still highly dependent on bank funding, compared with US businesses, and policymakers are likely to encourage efforts to increase businesses’ direct access to financial markets (or indirect access via securitisation). The ultimate implication of activities shifting to the shadow banking sector is that the inherent risks associated with them will no longer be visible in the banking sector, but will still be present in the wider economy. As such, if investors want to maintain exposures to the same implicit risks (and returns) that bank investments offered prior to the financial crisis, then they will need to change and/or broaden their portfolio allocations accordingly.

The shift of these activities outside of the banking sector is consistent with MPP not preventing bubbles or large swings in asset prices. However, it also suggests that MPP may struggle to curtail increases in whole-economy leverage, unless new tools are also applied to regulate the shadow banking sector.

Given the limited access of many borrowers to non-bank finance, the shift in the provision of finance will also result in increased credit rationing. This will pose challenges for monetary and fiscal policymakers, and will widen inequality among households. But rationing will also drive a further wedge between the performance of firms with good market access and those without it; the external finance premium for smaller and riskier firms is likely to rise. In principle, this could lead to higher returns for providers of alternative finance, such as private equity and venture capital (VC) firms. However, the performance of VC funds, in particular, has been poor for many years (British Private Equity & Venture Capital Association, 2013), which should temper any optimism.

Stricter regulatory enforcement regimes are also likely, which could increase the incidence of broader corporate default. Apart from an increased likelihood of banks being allowed to fail as implicit state support declines, regulators are also less likely to allow widespread forbearance on bad debts. Under regulatory stress-testing frameworks, banks are typically forced to recognise losses up front, thereby limiting the scope for sequential write-downs. In turn, that could result in underlying borrowers facing greater financial distress; companies will be less able to negotiate an extension or non-payment period for a troubled loan. This may be partly offset by political pressures, where governments want to keep credit flowing for other reasons.

IMPLICATIONS FOR INVESTORS

The wide range of new MPP tools has the potential to significantly affect the financial landscape. However, it is clear that MPP will not eliminate asset bubbles or unusual swings in financial market prices. In the absence of wider external capital controls limiting cross-border and currency flows, the potential for financial market prices to diverge from fundamentals is likely to remain little changed from prior to the crisis. One caveat here relates to leverage-fuelled asset prices. While MPP will not aim to control asset prices, policymakers are still likely to try to limit increases in leverage. As such, those asset prices that are closely related to developments in credit markets – in particular, residential and commercial property prices – may experience declines in value, over the long term, relative to the prices of other assets. But equity investors should not expect to see reduced volatility in stock markets as a consequence of MPPs.
For bank investors themselves, the implications are likely to be more direct. Ordinarily, more capital and less leverage will lower the return on equity that a bank can deliver, for a given return on assets. For this reason, bank equity prices are unlikely to return to their previous relative standing against non-bank companies (Figure 3).

At the same time, this might seem to imply that banks’ debt securities will become more attractive. Holding higher levels of capital will at the same time, this might seem to imply that banks’ debt securities will become more attractive. Holding higher levels of capital will reduce the risk of bank failure and creditor losses. And – if counter-cyclical MPP works – dampened credit cycles will also be positive for creditors, in the sense that losses on defaulted portfolios will be smaller.

However, there are important qualifications to this analysis. First, there is no guarantee that MPP will effectively dampen credit cycles, or indeed be applied consistently over time; as memories of the crisis fade, in particular, policymakers are likely to come under more pressure to regard past events as exceptional. Second, the underlying bias of bank managers towards risk-taking remains unchanged even in the event of distress, as noted by Myers (1977). As such, banks will tend to fix damaged capital ratios by shrinking assets and credit rationing rather than by raising new capital, which would be better for creditors.

Third, a key aim of MPP is to end – or at least limit – government-led bailouts. This means that the implicit state support for banks and SIFIs, in particular, should end if MPP is successful; and in the event of distress, bank bondholders may have significant losses imposed on them, particularly if a large portion of deposits is insured by the government (which ultimately controls bank resolutions). Exhibit 4 presents an illustrative example of two banks, where one is heavily deposit funded, and the other is more reliant on equity. If the total asset losses faced in the event of failure are the same, then bondholders of the deposit-funded institution could see higher write-downs, because the total loss is spread among a smaller pool of wholesale debt. From the point of view of bondholders, a high deposit ratio may be undesirable, even if deposits provide a stable funding base.

New MPPs could also have a perverse impact on banks’ risk management. In recent decades, many banks have increasingly devoted more resources to developing their own risk measurement and monitoring frameworks. But if regulators are increasingly prescriptive about risk measurement, the need for complex internal systems may diminish; for instance, if there is no scope for debating the risk weights associated with different lending categories, and the regulator’s word is final, then banks may have little need for complex internal capital models.

The regular US stress tests that the Federal Reserve conducts in its Comprehensive Capital Analysis and Review (CCAR; see Federal Reserve, 2014) are already moving in this direction. Each of the reporting banks currently conducts its own stress test, prior to the Federal Reserve conducting its centralised tests. However, the market focus is already skewed towards the Fed’s tests, rather than those of the banks, as these are the results that drive regulatory requirements and banks’ remedial actions. Although the banks will still have to conduct their own tests, the relevance and impact of these internal exercises are greatly diminished.

CONCLUSION

The range of macroprudential policies currently being developed and implemented will have a profound impact on financial markets and investors. While swings in asset prices are still likely, credit cycles may be dampened. Bank investors will face a new constellation of risks, with some activities shifting into the shadow banking sector, but bail-in regimes increasing the likelihood of credit losses in distress. Investors. While swings in asset prices are still likely, credit cycles may be dampened. Bank investors will face a new constellation of risks, with some activities shifting into the shadow banking sector, but bail-in regimes increasing the likelihood of credit losses in distress. In addition to the likely effects outlined above, however, there will undoubtedly also be unintended consequences arising from policy. Apart from the recent acceleration of the shadow banking sector, the application of MPPs is likely to lead to other changes in the financial landscape that are as yet unpredictable. In part, this is the necessary consequence of putting new rules into operation. However, it also implies that the final impact of macroprudential regulation is likely to remain unclear for some time.

References cited in this paper are listed at cisi.org/rofmjune2014

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Figure 4: Illustrative effects of bank losses on balance sheets
Source: Author’s calculations. For simplicity, losses are assumed to run through liabilities sequentially.

A academic indicator of investors’ appetite for bank debt will be the evolving market for CoCos and other hybrid securities. Against a recent backdrop of tight spreads and strong issuance in high-yield corporate markets, banks have increasingly been issuing these securities. However, a sudden deterioration in market conditions could significantly hit investor demand.

Policymakers are also likely to influence banks’ strategies. In the short term, many institutions are focusing on meeting the new ‘rules’, building up capital and reducing risk as swiftly as possible. Over the longer term, there is likely to be a strong focus on once again delivering a high return on equity, given the continued alignment of bank managers’ incentives with shareholders rather than creditors.

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