

**Financial stability issues arising from current risk
premia configurations and dynamics**

(Provisional version)

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Financial stability issues arising from current risk premia configurations and dynamics

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One of the major financial stability issues, we currently need to focus upon, relates to risk premia dynamics. Recent market turbulences have indeed, once more, shown that such dynamics can change quickly. True, the well known long term interest rates conundrum, highlighted by M. Greenspan, might appear less crucial an issue in 2006 than in 2004/2005. But several other market configurations appear puzzling.

***First**, long term interest rates remain relatively low at this stage of the cycle. However, the jury is still out regarding the question, whether low term premia will be permanent. **Second**, credit markets remain buoyant, with very aggressive pricing. Low credit spreads often only match average historical rates of default without providing additional risk premium. A benign scenario can obviously account for such a configuration, but this is only one scenario among many other more risky ones. **Third**, the contrast with high equity risk premia is puzzling. In the past, at the specific time when excesses from previous bubbles had to be wiped out without too much damage to economic growth, the decrease in credit spreads in the face of high equity risk premia might have served financial stability. But, currently and for the longer term, these advantages seem less clear. Higher credit risk premia might indeed bode better for future financial stability. **Fourth**, recent market tensions have highlighted some vulnerabilities. This should lead us i) to remain cautious in our assessment of potential future short term market dynamics and ii) put on top of our agenda an enhancement of the resilience in face of longer term vulnerabilities.*

Risk premia move constantly because of changes in fundamental factors as well as in risk appetite. This often smoothly contributes to financial stability. However some characteristics of the present environment could make such adjustments challenging in the future.

***First**, less accommodative global liquidity makes financial market dynamics more complex to predict. **Second**, bank lending standards might be looser than in a steady state. If credit standards are finally tightened more strongly, this would benefit financial stability in the medium term. But the transition includes challenges for borrowers which have relied on cheap credit in recent years. **Third**, cyclical lows on financial market volatility might be behind us. **Fourth**, financial institutions risk management often relies on fragile diversification related assumptions. This makes sense in a stable environment, when correlations do not change quickly. However, diversification might not protect as expected in time of stress. And a quick unwinding of positions is not always possible. **Fifth**, model risk remains a field where improvements are needed in order to strengthen financial stability over a full financial cycle.*

^{NB} All data are as of 17/07/06

The main market related risks, in a context of less ample global liquidity, include changes in risk aversion and risk premia, with the potential for a breakdown in traditional correlations. If significant portfolio reallocation flows take place, market liquidity issues have the potential to transform vulnerabilities into financial instability. These risks might not be perfectly captured by some risk models currently used by financial institutions (including stress-tests).

The main financial system related risks include the scenario in which financial institutions would not decrease sufficiently their search for yield in the future, in an environment where higher expected returns could be subject to increased risks.

We can certainly envisage an ideal exit scenario in term of financial stability. However, risk premia are not controlled by any single institution and are subject to complex and uncertain dynamics. In fact, financial market dynamics might be more challenging in the future than in recent years.

Financial institutions should therefore continuously enhance their resiliency in face of the variety of potential scenarii. The various conditions which can prevail during a full economic and financial cycle need to be seriously taken into account. This means that financial institutions should continue to ensure to avail of sharp risk management practices, emphasising the cases when risks (unfortunately) materialise over the short term, even for those risks which are often relegated to long term scenarii. They should also increase their sensitivity to the potential difficulty of a quick unwinding of some positions in difficult market conditions.

The risks, that we highlighted, certainly warrant i), at the micro level, a monitoring of financial institutions risk management and ii), at the macro level, of the dynamics behind potential crowded trades. It is the role of central banks and all public authorities, individually and in co-operation, to foster a risk cycle management oriented attitude, which allows combining the advantages of real and financial innovation with financial stability and sustainable growth.