Financial Fragility in 'Mature' Markets

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With rising non-financial corporate debt and evidence of elevated borrowing levels among non-bank financial companies, the fragility resulting from excess leverage has returned to haunt developed country financial markets. The fact that the collapse of a little-known family office firm like Archegos Capital Management inflicted huge losses on leading banks suggests that the failure of a rogue, overleveraged speculator can have systemic effects of the kind that unravelled in 2008.

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At the end of March 2021, when the world was worn out having spent more than a year battling the ongoing pandemic, news broke out that Wall Street traders were searching for the source of a fire sale of tech, media and other stocks to the tune of around $19 billion. That burst of selling had resulted in the collapse of prices of the stocks of companies like ViacomCBS, Baidu and Tencent Music, wiping out some $33 billion in share values.

It now turns out that the sale was led by a bunch of bankers serving as prime brokers for Archegos Capital Management, a "family office" firm managed by Bill Hwang, a trader with a past record of having run foul of regulators, but with the reputation of being a "money-making genius." Barely a year after Hwang had to settle with the regulators on charges of insider trading, investment banks were ready to do business with him, looking to earn large fee and interest incomes through instruments called "total return swaps." As part of this swap contract, the investor (here, Archegos) is charged a fee in return for payments based on the performance of the underlying securities, which in this case were large volumes of stocks in companies chosen by Archegos. The shares were bought and held by the banks, which were to be compensated for any loss they may suffer because of a fall in the value of the stocks concerned. Profits were paid out to the investor after deducting charges. The arrangement allowed the investing firm to make leveraged bets. So long as it could persuade the banks serving as prime brokers, it could hold large stakes in multiple companies without having to disclose ownership since the shares are not directly owned by it. The secretive frame of the "family office" that is supposed to provide a range of wealth management services to high net-worth individuals, also helped.

Hwang dealt with multiple banks, investing in these total return swaps, and allowing Archegos to ramp up indirect share ownership with a small amount of investment of its own. According to market rumours, less than a dozen banks were exposed through credit totalling $50 billion to Archegos, which actually invested its own money in anywhere between one out of nine to one out of 20 of the stocks it was hoping to gain from (Kinder and Lewis 2021). Unfortunately for Hwang (and the banks), his bets went sour and the prices of stocks held by the banks on his behalf fell steeply over prolonged periods, necessitating Archegos to make margin call payments to keep the contracts going. With multiple bets it placed turning against Archegos, the firm being hugely overleveraged could not comply, and sought to initiate an orderly unwinding of its holdings in negotiations with its prime brokers. Some of them lost heart and decided to unload the shares in the market instead, leading to the price crash, demands on the bankrupt Archegos to compensate the banks for the losses incurred through the sales and, finally, the firm's insolvency. As of now, the banks are stuck with the losses and the likelihood of recovery is near nil.

The real issue here from the point of view of systemic risk is not the behaviour of Archegos and Hwang. The latter could be dismissed as a rogue speculator with an oversized ego, who saw himself as a trading genius. The issue is how the investment banks concerned were willing to expose themselves so hugely to a single investor, resulting in a situation where they have had to accept large losses: $5.4 billion for Credit Suisse, $2.9 billion for Nomura, $911 million for Morgan Stanley, $861 million for UBS, and smaller sums for sundry others. The claim that each of them was unaware of the exposure of the other and the total exposure of Archegos is a poor defence for the failure of diligence. The incident also raises the question as to why lessons learnt on speculative exposures mediated

by toxic instruments in the 2008 crisis had not, even more than 10 years later, led to regulations and rules that could pre-empt transactions of this kind that can damage balance sheets to an extent where the risk is systemic. Regulators too were clearly sleeping on the job.

Leverage and Risk

These questions are especially relevant given the evidence of substantial increases in leverage in the years since the financial crisis. The May 2021 edition of the International Monetary Fund's *Global Financial Stability Report* states that, during the pandemic, the ratio of household debt to the gross domestic product (GDP) in mature markets rose from 72.1% in the fourth quarter of 2019 to 78% in the third quarter of 2020, and debt of the non-financial corporate sector from 90.5% of the GDP to an elevated 102.3%.

This spike over a period which covered six months of the pandemic need not in itself be a cause for excess concern. Part of the increase in the debt to GDP ratio was the result of the GDP contraction triggered by the pandemic and the responses to it. If the denominator falls steeply, the leverage ratio would rise sharply, even if the actual increase in borrowing is not overly large. That would imply that as economies recover, some of the increase in debt to GDP ratios would be reversed, making the condition appear less worrisome.

But the elevated leverage ratios do give cause for concern, because their increase is from levels that were already high. Not all have forgotten that underlying the global financial crisis of 2008 was the rapid accumulation of corporate and household debt in the years that preceded it. Household debt in mature markets rose from 63% of the GDP in the first quarter of 2001 to 84% by mid-2009, and non-financial corporate debt from 76% in early 2001 to 89% in early 2009. That credit bubble on which economic growth rode during those heady years went bust and precipitated the great recession.

That did set off a process of deleveraging in the household sector in the advanced economies with the household debt to GDP falling to 72% in 2019. The trend, however, was different in the case of non-financial corporate debt, which having declined from 89% in the first quarter of 2009 to 84% in the third quarter of 2011, nudged upwards to 91% in the second half of 2019. The spike to more than 102% in the early phases of the pandemic came on top of this elevated figure, raising concerns about its sustainability.

The tendency towards increased leverage despite the experience with the global financial crisis reflects more than the unreformed attitude of the world's dominant financial players, including the banks that are too big to fail. It can also be traced to the long-run shift in the monetary policy stance of developed country central banks, which, encouraged by low inflation, have stayed with a combination of large liquidity injection and low interest rates. That was the principal ingredient of the post-2008 recovery packages and is an important feature of the response to the ongoing pandemic, though this time there has been much greater reliance on large fiscal interventions. The persistence of high and rising leverage is partly the result of this supply-side push.

The easy availability of cheap money has meant that leverage even within the financial sector (as opposed to the non-financial sector) of the advanced economies has also increased. This is where the big and unrecognised risks possibly lie. The May 2021 edition of the *Financial Stability Report* (pp 41–42) prepared by the United States Federal Reserve notes that

> several indicators of leverage intermediated by dealers on behalf of hedge funds, such as hedge funds' margin and securities borrowing in prime brokerage accounts, suggest that hedge fund leverage associated with equity market activities is at high levels.

The report goes on to state that

> A few recent episodes have highlighted the opacity of risky exposures and the need for greater transparency at hedge funds and other leveraged financial entities that can transmit stress to the financial system. For example, some hedge funds with substantial short positions sustained losses during the meme stock episode in January 2021, when intense social media activity contributed to fluctuations in the prices of some specific stocks.

The reference here obviously being to the spike in share values of firms like GameStop driven by retail investors collaborating on social media sites to push up stock prices and inflict losses on hedge funds with short positions. The report also refers to the Archegos Capital Management episode, which "highlights the potential for material distress at NBFIs to affect the broader financial system." What it fails to emphasise is that these risks arise and intensify because the system is awash with cheap liquidity and is still populated by poorly regulated big banks that choose to exploit the lax regulatory environment to engage in risky practices at a scale that threaten systemic stability.

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