Portfolio Investment: A Driving Structural Factor behind Recent Financial Turmoil

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One of the structural changes in global fund flows and the financial industry since the global financial crisis in 2008 (hereinafter referred to as the GFC) is the significant increase in portfolio investments. The proportion of other investments, such as loans in cross-border capital flows, has decreased, while the proportion of portfolio investments, including equities and debt securities, has risen, particularly in equities investments.[1] These changes have been observed across the financial industry, with the growth of global regulated funds representing the global capital market surpassing that of global bank assets. Even within the banking industry, this structural shift has occurred, with a decrease in the share of loans and an increase in the share of securities in the total assets of commercial banks in the U.S. While these changes are not exceptional in Korea, the degree to which they have occurred may differ.

1 The ratio of portfolio investments to other investments worldwide rose from 119.3% before the GFC (2002-2006) to 174.3% after the GFC (2017-2021) on the liabilities of international investment position basis. During the same period, South Korea's ratio increased sharply from 226.2% to 415.7%.

The expansion of portfolio investments as a structural change has two major implications in terms of systemic risk.[2] Firstly, since the GFC, financial institutions and systems have become vulnerable to market risks.[3] Relatively speaking, this is because portfolio investments are highly exposed to market risk, unlike loans, which are greatly exposed to credit risk. Under this structural change, even if credit risks are not significant, falling financial asset prices are likely to cause losses and liquidity risks for individual financial institutions. Market risk is very sensitive to financial asset prices and can quickly spread to liquidity risk compared to credit risk. The multiple cases of financial turmoil arising since 2020 indicate that this risk is high. They include the Korean Equity Linked Securities (ELS) crisis in March 2020, the collapse of U.S. Archegos Capital Management in March 2021, UK pension loss in September 2022, and the collapse of Silicon Valley Bank (SVB) in March 2023.

These cases led to severe financial instability through two channels. Firstly, falling stock prices lead to margin calls (liquidity shortage) in derivative financial products, which causes the financial market to panic as financial companies sell off their assets to secure liquidity. This was seen in the Korean ELS crisis and the bankruptcy of Archegos in the U.S. Secondly, falling government bond prices result in a drop in collateral value, leading to margin calls, realized and unrealized losses of holdings, followed by liquidity shortage, which causes panic in the financial market or bankruptcy. This includes the bankruptcy of the SVB, as well as significant losses from liability-driven investments as in the UK pension. The problem is that these market risks do not end with temporary financial instability but can lead to systemic risks. The recent global financial instability triggered by soaring interest rates and falling stock prices is signaling this risk. However, recent cases differ from the GFC in terms of the nature of the crisis. The recent cases stem from market risks, while the GFC was caused by credit risks.

Finally, the increase in portfolio investments as a structural change has also raised the possibility of financial instability through cross-border capital flows. This is because, first of all, since the GFC, cross-border portfolio investments, which are highly sensitive to market prices such as stock prices and interest rates, have increased significantly compared to other investments. Portfolio investments have the characteristic of frequent and rapid fund flows compared to

2 A risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy. (IMF, FSB and BIS)

3 Market risk refers to the risk of loss of assets held by financial firms due to changes in market prices such as interest rates, stock prices, and exchange rates, while credit risk refers to the risk of loss due to the counterparty's default on contracts.

other investments. Additionally, after the GFC, the sensitivity of portfolio investments to financial instability has increased. According to Jeong et al. (2018)[4], the sensitivity of foreign portfolio investments to financial stress in emerging countries has increased compared to before the GFC, while the sensitivity of foreign other investments has decreased. This implies that the impact of portfolio investment on financial instability after the GFC has been structurally greater than before the GFC.

Moreover, with regards to cross-border capital inflows, the expansion of portfolio investment indicates that emerging countries, where large amounts of global funds have flowed in, are at an increased risk of facing a shortage of foreign currency liquidity due to market risks. The problem is that even emerging economies with strong fundamentals could be easily exposed to this risk. In the event of a liquidity shortage caused by market risks in major countries, financial companies and funds in these countries are likely to withdraw investment funds from emerging countries to secure liquidity. The concern is that large-scale funds could be withdrawn from countries with relatively well-developed financial markets such as Korea.

In conclusion, Korea needs to address the potential risks posed by the structural changes in domestic and global portfolio investments. To achieve this, the authorities should prioritize strengthening their supervision of market risks. While the Korean banking sector has a relatively low exposure to market risks in that the proportion of securities investment is low and the maturity of bonds is relatively short compared to the U.S., the rapid growth of the non-banking sector and capital market means that Korea's overall exposure to market risks cannot be overlooked. Therefore, it is necessary to enhance surveillance and supervision of market risks across the financial system to prevent their spread into systemic risks.

Furthermore, it is crucial to strengthen supervision of foreign currency liquidity. Korea's external financial stability has greatly improved with $750 billion in net foreign financial assets as of December 2022. However, there is still a risk that global funds could flee Korea, where the liquidity of the financial market is high, in the event of external shocks. In addition, as Korea's overseas portfolio investment has increased sharply[5], it is essential to prepare for financial instability arising from overseas assets held by Korea, as well as from foreign funds due to market risks. KIEP

4 Jeong et al. 2018."Constructing a Financial Stress Index and Changes of Financial Stress Determinants after the Global Financial Crisis." *Policy Analysis* 18-22. Korea Institute for International Economic Policy. (In Korean)

5 The ratio of portfolio investments to other investments on the Korea's assets of international investment position basis rose sharply from 64.5% before the GFC (2002-2006) to 226.9% after the GFC (2017-2021).