DoubleLine Joins IMF in Fretting About Dollar Loans Outside U.S.

2019-12-04 16:10:12.299 GMT

By Vivien Lou Chen

(Bloomberg) -- DoubleLine Capital, the $147 billion money manager, agrees with the International Monetary Fund that U.S. dollar loans made by foreign banks are creating a risk for the global financial system.

Banks based outside the U.S. can't get enough dollars to satisfy demand for loans denominated in the American currency. Unlike their U.S. counterparts, they don't have a stable base of dollar deposits so they use foreign-currency swaps, which the IMF says are expensive and occasionally unreliable, to meet borrowers' needs as a last resort.

The trouble, according to DoubleLine, is that hiccups in this complicated arrangement -- say, increased volatility that causes sources of dollar funding to dry up -- could harm the global economy. Under normal circumstances, swaps let FX traders quickly convert non-U.S. currencies into dollars via derivatives. But mid-September's turmoil in the U.S. repo market shows how rapidly conditions can worsen.

"Increased dollar lending activity by non-U.S. banks may not be the catalyst of the next downturn, but it will be definitely be the accelerant," said Bill Campbell, a portfolio manager at Los Angeles-based DoubleLine. "We're watching it."

Dollar Dominance

The greenback remains the world's preferred currency to invest and receive funds abroad. While dollar shortages aren't new, non-U.S. banks may be growing more vulnerable to disruptions, the IMF said in its Global Financial Stability Report from October. The Washington-based IMF says foreign banks held $12.4 trillion of dollar assets in mid-2018, up from $9.7 trillion in 2012.

In an analysis of 26 advanced and emerging economies, the IMF found the cross-currency funding gap, or difference between dollar-denominated assets and liabilities, widening to $1.4 trillion in recent years from around $1 trillion in 2008. That measure is a proxy for the amount of financing non-American banks must fill with FX swaps, according to a report written by Adolfo Barajas, an economist in the division that analyzes global stability, and others.

As European banks pulled back on their roles as dollar intermediaries over the past decade, counterparts in Japan and Canada stepped in to fill the gap in borrowing and lending greenbacks on a global scale, based on the IMF report. The concern is these institutions may become a crucial transmission mechanism for shocks that originate in major funding markets for dollars -- similar to the run-up of the 2008 financial crisis.

"While funding conditions for non-U.S. global banks are not troublesome on their own right now, they can change rapidly," Barajas said in an interview. The 2008 crisis was a rare event, but "it can't be ruled out from possibly happening again."

During the crisis, U.S. firms became reluctant to lend dollars to foreign counterparts. To keep the global financial system from collapsing, the Federal Reserve provided more than $500 billion in emergency funds to overseas central banks, which then lent that money to institutions.

Repo Chaos

The cost of dollar funding for non-American banks can change rapidly because it's sensitive to monetary conditions in the U.S. and abroad. September's repo turmoil showed the speed with which a spillover could occur between dollar funding and currency markets. Within a day of the sudden surge in the overnight rate on Treasury repurchase agreements that began Sept. 16, the cost to borrow greenbacks while lending euros for a week almost doubled.

For DoubleLine's Campbell, "the analysis of currency mismatches and asset/liability funding mismatches is an integral part of our investment process as we evaluate these risks on a country-by-country and security-by-security basis."

At issue is what might happen when foreign banks get caught in a liquidity squeeze, and their sources of dollar funding dry up quickly, he added.

"When we go through the next downturn, a lot of activities are going to be exposed as being problematic," he said. "The risk is that it could contribute to an even bigger fall in economic activity."

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