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IOSCO Launches Second Securities Markets Risk Outlook

The International Organization of Securities Commissions (IOSCO) today published the IOSCO Securities Markets Risk Outlook 2014-2015. The Outlook is a forward-looking report focusing on identifying potential risks in securities markets.

The Outlook has been prepared during a transformative period for global financial markets. As the initial impact of the 2008 financial crisis recedes, securities markets are an increasingly important financing channel for the economy. At the same time, innovation is re-entering the markets, while accommodative monetary policies continue to bolster securities markets. Consequently, the identification and analysis of the build-up of systemic risk in securities markets is of growing significance.

The analysis in this Outlook has benefited from the growing availability of data on securities markets, although data gaps still exist. It also has drawn on the comprehensive inputs from experts in the markets, the academic world and the regulatory community. The Outlook builds on the work of other global organisations, such as the Financial Stability Board and the International Monetary Fund, and its analysis complements their work on risk identification.

The Outlook is divided into two parts. Part I describes selected global trends and potential vulnerabilities in securities market, including the following:

- The importance of securities markets is growing.
Asset price valuation is increasing, while volatility remain low. A change in the monetary stance will create winners and losers while markets are adjusting to the new reality.

Derivative markets are still growing and clearing is increasing.

Some real estate markets and real estate investment trusts could still be vulnerable.

Capital flows into emerging markets have grown and are affecting securities prices.

Part II identifies the potential systemic risks in or related to securities markets. Many of the potential risks described below were identified in the 2013-2014 Risk Outlook and are expanded upon in this year’s iteration. These potential systemic risks are:

1. **The Search for Yield and the Return of Leverage in the Financial System**:
   The current low interest rate environment has set off a search for yield, leading to a resurgence of high-yield products. Leverage also has rebounded after initial signs of credit-related deleveraging by households and corporates in the wake of the financial crisis. While increasing leverage can signal returning confidence in the financial system, it could become a source of potential risk when interest rates increase. This is of particular concern in the case of leveraged, complex and often opaque products and constructions such as CDO squared.

2. **Search for Yield and Volatility Affecting Emerging Markets**
   Capital inflows into emerging markets have recovered from the effect of the US Fed’s suggestion in 2013 of tapering. But non-bank credit provision accounts for a growing portion of cross border flows to emerging markets. The volatility of these flows could create a point of risk entry -- for example, if triggered by the unwinding of accommodative monetary policy in the developed world.

3. **Risks in Central Clearing**
   The systemic importance of Central Counterparties (CCPs) has grown, as highlighted in last year’s Risk Outlook. CCPs have developed business models and risk management procedures
that have proved robust so far. But as their business becomes more complex, and as market volatility eventually returns to higher levels, these models and procedures come into question because of:

- The inherent pro-cyclicality of margin calls and the widespread use of similar risk management models;
- The varying levels of capitalisation of CCPs to withstand:
  - the failure of clearing members of CCPs; and the structure of default waterfalls;
  - the impact of non-default losses on the operational viability of a clearer.
- The acceptance of collateral of varying quality, which are risk related to the investment policies of the CCPs

4. **The Increased Use of Collateral and Risk Transfer**

   Last year’s Risk Outlook described the risks associated with collateral management in a stressed funding environment. This year’s edition underscores the importance of understanding where and how risk transfer takes place in order to assess how risks may be pooling in the financial system. Re-hypothecation and collateral transformation practices are sometimes off-balance sheet. This lack of disclosure makes it hard to assess these activities and can contribute to risk in the financial system.

5. **Governance and Culture of Financial Firms**

   Corporate governance failures have been cited for contributing to the financial crisis and, more recently, to the Libor scandals. Risks related to corporate governance may build-up in the financial system, signalling the need for regulators to better understand how corporate incentives and internal structures contribute to generating those risks.
Background to the Report:

Following the outbreak of the current financial crisis, IOSCO adopted a new strategic direction that emphasized the need for securities regulators to identify, monitor and manage systemic risks. To that end, IOSCO established a research function comprised of a Research Department at the General Secretariat and the CER. Various potential systemic risks identified and analysed by research are being addressed by IOSCO’s global policies. Appropriately regulated securities markets are essential to the sound functioning of the global economy and its recovery.

NOTES TO THE EDITORS

1. IOSCO is the leading international policy forum for securities regulators and is recognized as the global standard setter for securities regulation. The organization's membership regulates more than 95% of the world's securities markets in more than 115 jurisdictions and it continues to expand.

2. The IOSCO Board is the governing and standard-setting body of the International Organization of Securities Commissions (IOSCO), and is made up of 32 securities regulators Mr Greg Medcraft, chairman of the Australian Securities and Investments Commission, is the chair of the IOSCO Board. The members of the IOSCO Board are the securities regulatory authorities of Argentina, Australia, Belgium, Brazil, China, France, Germany, Hong Kong, India, Italy, Japan, Korea, Malaysia, Mexico, Morocco, the Netherlands, Nigeria, Ontario, Pakistan, Peru, Portugal, Quebec, Romania, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Trinidad and Tobago, United Kingdom and the United States.

3. The Growth and Emerging Markets Committee is the largest Committee within IOSCO, representing 75 per cent of the IOSCO membership. Mr. Ranjit Ajit Singh, Chairman, Securities Commission, Malaysia, and Vice Chair of the IOSCO Board, is the Chair of the GEM. The Committee endeavors to promote the development and greater efficiency of emerging securities and futures markets by establishing principles and minimum standards, providing training programs and technical assistance for members and facilitating the exchange of information and transfer of technology and expertise.

4. IOSCO aims through its permanent structures:

- to cooperate in developing, implementing and promoting adherence to internationally recognized and consistent standards of regulation, oversight and enforcement in order to protect investors, maintain fair, efficient and transparent markets, and seek to address systemic risks;
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• to enhance investor protection and promote investor confidence in the integrity of securities markets, through strengthened information exchange and cooperation in enforcement against misconduct and in supervision of markets and market intermediaries; and

• to exchange information at both global and regional levels on their respective experiences in order to assist the development of markets, strengthen market infrastructure and implement appropriate regulation.

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