



# **Securities Markets Risks & Vulnerabilities**

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# Disclaimer

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# Content

Introduction

Main trends and potential vulnerabilities

Potential sources of systemic risk

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- Last year good reception, identified potential risks (search for yield - leverage, CCPs too important to fail, etc.)
- Some risks explored in more depth (e.g. cyber, crowdfunding)
- Data gaps started to being addressed (e.g. CER Data initiative, AMERC, corporate bond markets)
- Several themes have been picked up by IOSCO policy (e.g. cyber, crowdfunding)

# Introduction

- Importance of securities markets growing, so are the risks
- Other global organizations have recognized this and are expecting ongoing work by IOSCO
- More data on trends, but big data gaps frustrate analysis on main risks

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Introduction

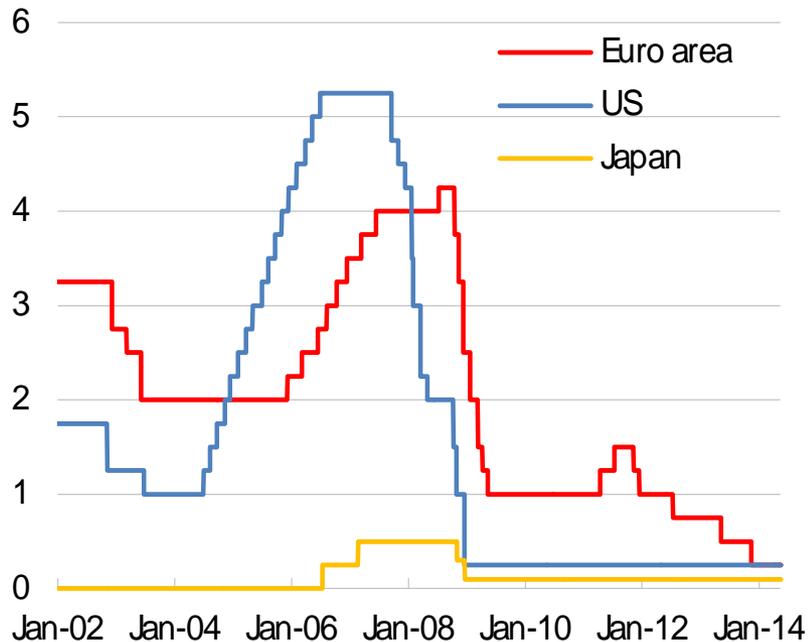
Main trends and potential vulnerabilities

Potential sources of systemic risk

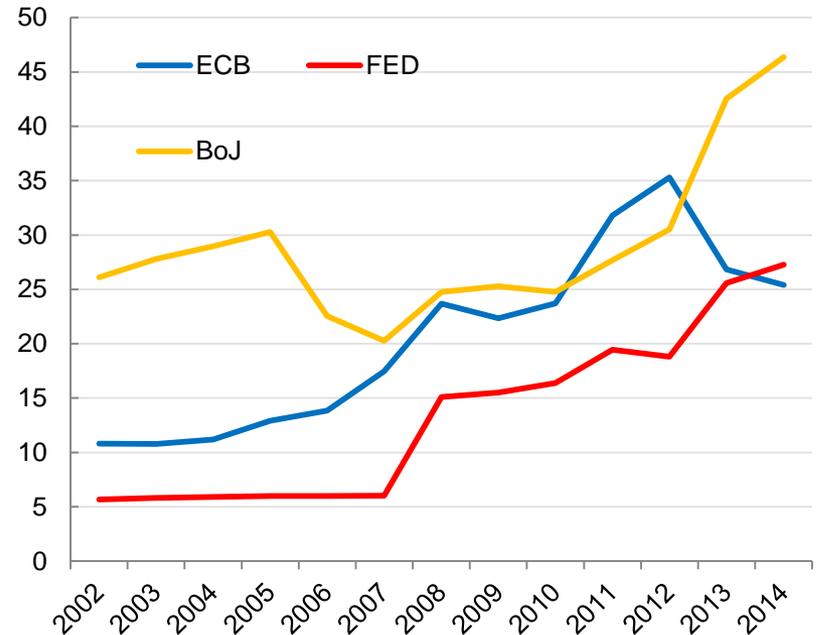
# Main trends and potential vulnerabilities

## 1. Monetary policy is impacting securities markets...

Official interest rates



Balance sheets of central banks in % GDP

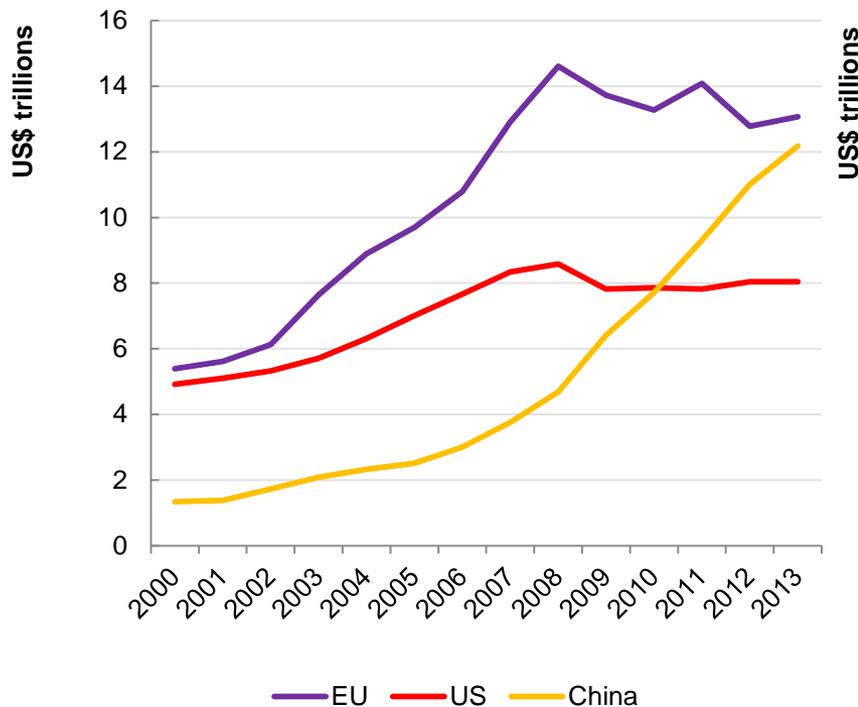


Source: Bloomberg and Thomson Datastream

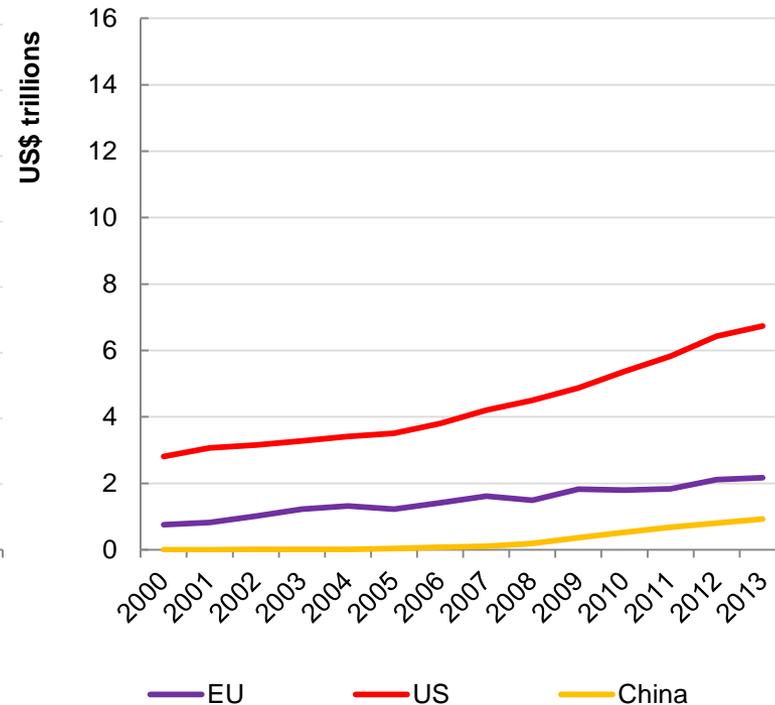
# Main trends and potential vulnerabilities

## 2. Importance of securities markets is growing

Bank credit to non-financial corporations, outstanding



Corporate bonds, non-financial corporations, outstanding



# Main trends and potential vulnerabilities

## 3. Asset price valuation is increasing...

Liquidity in markets drive prices of securities:

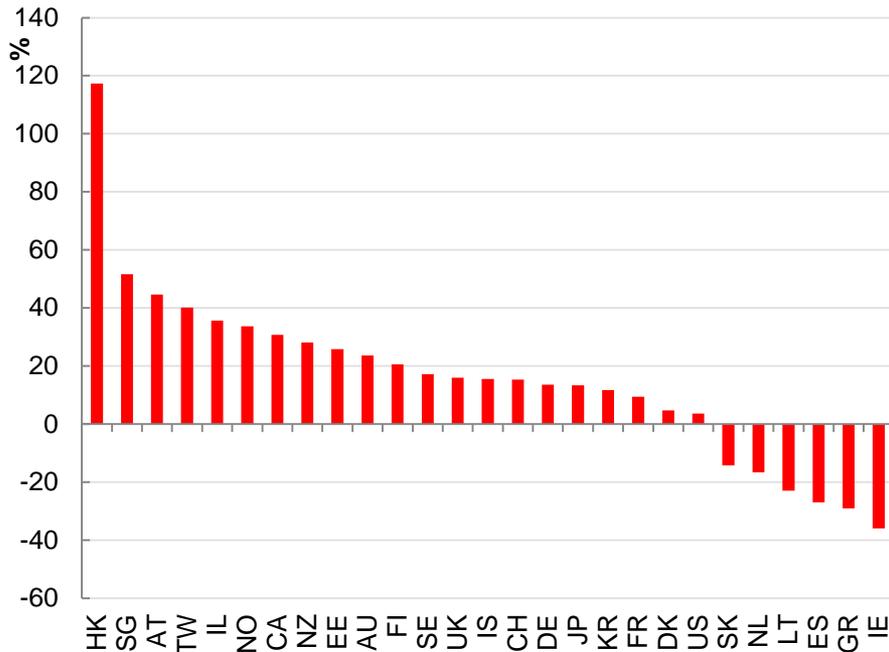
- Equity markets: statistical measures show upward trend of valuation is main markets, especially those with QE: US (+2 SD); Europe (=), HK (- 1 SD), AU (-0.5 SD).
- Corporate bond markets: US spreads with Treasuries decreasing and at very low historical levels

# Main trends and potential vulnerabilities

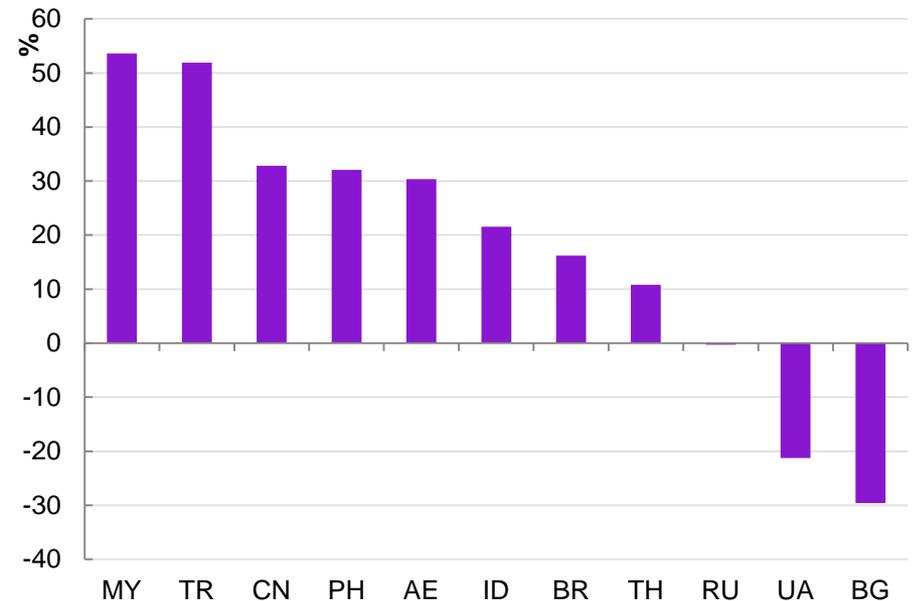
- Some real estate markets and real estate investment trusts could be vulnerable...

Aggregate growth post crisis in the housing market

Developed markets



Emerging markets



Source: Global Property Guide

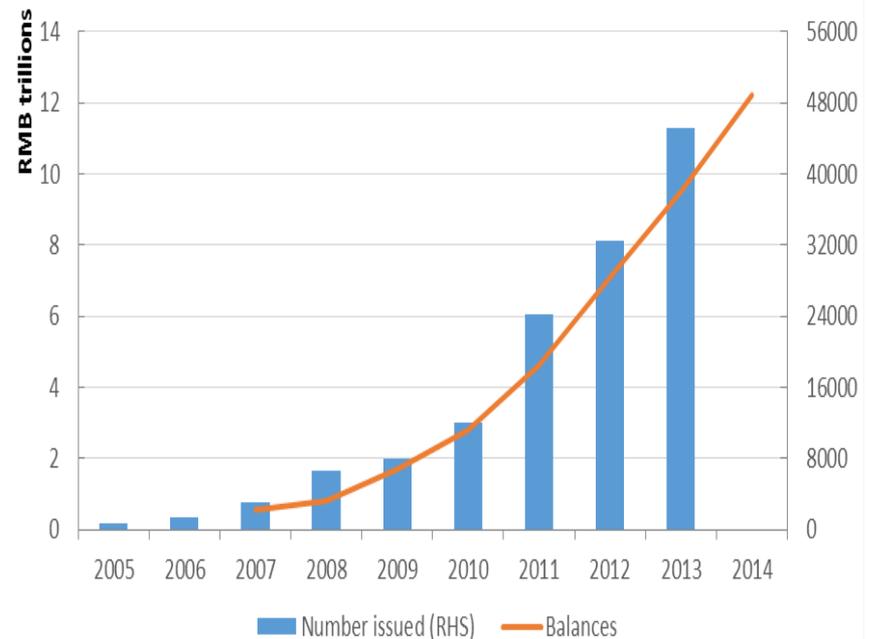
# Main trends and potential vulnerabilities

## 5. Chinese wealth management products are potentially vulnerable...

### Concerns

- Quality and transparency
- Size
- Rapid growth
- Lack of regulation
- Interrelation with the banking system

Numbers issued and outstanding

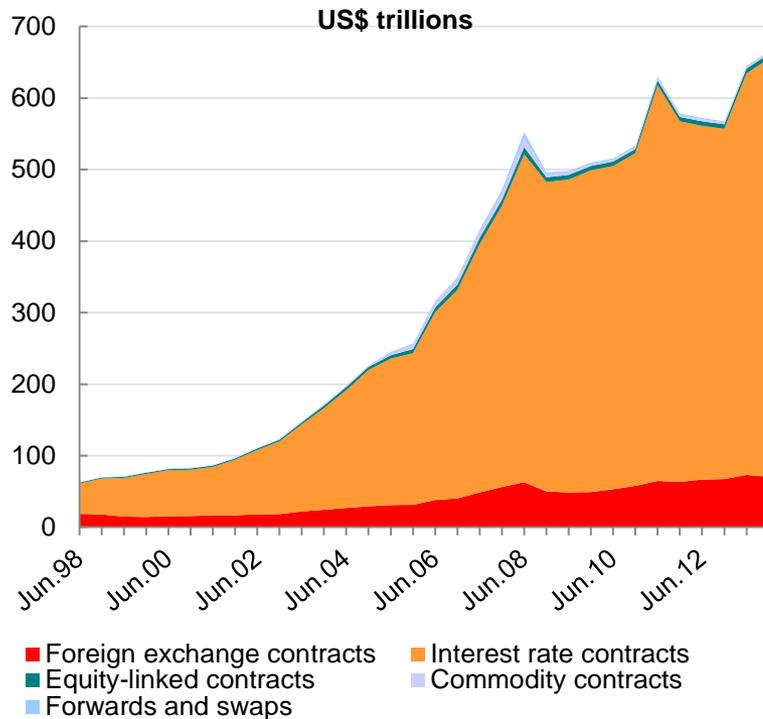


Source: Wind Information

# Main trends and potential vulnerabilities

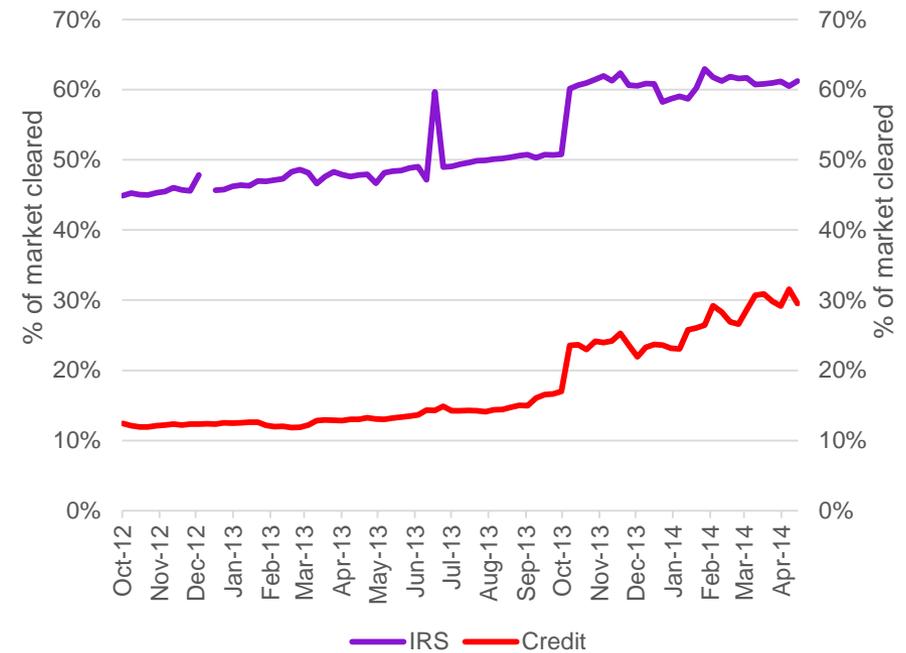
## 6. Derivatives markets are still growing and clearing is increasing...

Notional outstanding of OTC Derivatives markets



Source: BIS

Clearing of IRS and Credit Derivatives (US only)



Source: CFTC

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# Potential sources of systemic risk

1. The search for yield and the *return of leverage and complexity* in the financial system. Systemic risk can be building up. Markets can *destabilize* markets when interest rates go up.

## Increased risk taking

(Near) all time highs for: high yield bonds issuance; subordinated bonds; CoCo's; covenant-lite bonds; PIK bonds; leveraged loans

## Leverage

(Near) all time highs for: margin debt; LBO's

## Leverage and complexity

(Near) all time highs for: CDO's (incl. CLO's)

## Potential sources of systemic risk

2. *Capital flow volatility* in EM has calmed during the last year but remain a point of risk entry, especially in the case of interest rate adjustments in developed markets.
  - EM reliance on non-banks flows is higher than bank flows
  - Portfolio flows are small compared to FDI
  - Most EMs showed temporary volatility after the tapering announcement, but several suffered slowing GDP growth
  - Prices EM Equity below DM; prices EM bond converging with DM

In case of an interest rate adjustment/change monetary stance in DM:

- Monetary and fiscal positions (reserves, debt, trade balance etc.) matter
- Political instability and structural reforms make difference
- Macro-prudential policy measures in place in monetary sphere
- Little is known about measures and their effectiveness in securities markets space

## Potential sources of systemic risk

3. CCPs have developed business models and risk management procedures that seem robust. However, risks are:
  - the *inherent pro-cyclicality* of margin calls;
  - the widespread use of *similar risk management models*;
  - the *varying levels of capitalization and profitability* of CCPs to withstand a non-default event;
  - the failure of clearing members and the structure of default waterfalls;
  - risk related to:
    - the *investment policies of CCPs*;
    - the acceptance of collateral of varying quality;

## Potential sources of systemic risk

4. *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 the risk of the financial system.
  - Data gathering on collateral holdings is hampered by lack of disclosure, market intelligence is advancing slowly
  - It makes it hard to assess whether there will be shortage
  - It makes it hard to assess where the risks are pooling/moving
  - Especially in cases when volatility gets back into markets and correlations move...

## Potential sources of systemic risk

5. Corporate governance failures have been cited for contributing to the financial crisis and the more recent Libor scandals.

Concerns with:

- Board and managerial quality
- Shareholder involvement/activism or lack of
- Risk management and quality controls

