Disclaimer

The views and opinions presented in this presentation are of the presenter only and do not necessarily reflect the views and opinions of IOSCO or its individual members.
Content

Introduction

Main trends and potential vulnerabilities

Potential sources of systemic risk
Content

Introduction

Main trends and potential vulnerabilities

Potential sources of systemic risk
Introduction

• 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
Content

Introduction

Main trends and potential vulnerabilities

Potential sources of systemic risk
Main trends and potential vulnerabilities

1. Monetary policy is impacting securities markets...

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

Source: BIS
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

4. 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
Content

Introduction

Main trends and potential vulnerabilities

Potential sources of systemic risk
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