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2. FX benchmarking
Introduction

• In an environment of accommodative monetary policy globally
• Importance of securities markets growing, so are the risks
• Other global organizations have recognized this
• More data on trends, but big data gaps frustrate analysis on main risks
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2. FX benchmarking
Main trends and potential vulnerabilities

1. Monetary policy is impacting securities markets...

Source: Bloomberg and Thomson Datastream
Main trends and potential vulnerabilities

2. Loan provision to the real economy...

Bank credit to non-financial corporations, outstanding

Source: BIS
Main trends and potential vulnerabilities

3. Increasing importance of securities markets

Corporate bonds, non-financial corporations, outstanding

- EU
- US
- China

Equity markets, Global ISPO issuances

- Total Value of ISPO

Graphs showing trends and values over time.
Main trends and potential vulnerabilities

4. Innovation is happening...

P2P loan market, global new loan origination

P2P loan market, outstanding loans

Total: $US 9,000,000

Data as at Feb-2014

Data as at Feb-2014
Main trends and potential vulnerabilities

5. 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

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

Aggregate growth post crisis in the housing market

Source: Global Property Guide
Main trends and potential vulnerabilities

7. 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

Clearing of IRS and Credit Derivatives (US only)

Source: BIS

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
Content

1. Trends and risks

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2. FX benchmarking
FX Benchmarking

• Unlike Libor, FX benchmarks are based on transactional data
• Concerns about integrity of FX benchmark especially around fixing time
• Benchmarks used for a variety of purposes.
• The issues were:
  • Clients using an fx benchmark rate, cause trade concentration around the fix time
  • Dealers promising to execute at an unknown rate
  • “Manipulate” benchmark to receive positive outcome
FX Benchmarking

- Final FSB report published on 30\textsuperscript{th} Sept 2014 with 15 recommendations including:
  - Fixing window be expanded to five minutes
  - Increase data feeds to capture more of the FX market around fixing time
  - Support industry initiatives to develop infrastructures for fixing trades
  - Establish and enforce internal controls
  - Market-makers should not share information
  - And others…

- IOSCO led assessment against benchmarking principles concluded
  - Further work to do in implementing principles
  - Further review in 2015