European Securities and Markets Authority

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Measuring and assessing stability risks in financial markets

ESRB Shadow Banking Workshop - Frankfurt

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[Introduction]

Ladies and Gentlemen,

I am delighted to have been invited by the ESRB to its first conference on shadow banking and to have this occasion to present you with my views on this issue, the progress we have made in the EU and the future of this debate.

We have come a long way since the original commitment of the G20 leaders in 2011 to strengthen the regulation and oversight of the shadow banking system and endorse the Financial Stability Board (FSB) initial eleven recommendations. Since then, international policy makers have been engaged in a global project to monitor and measure shadow banking, and to adapt the regulatory framework to better address the risks. At the EU level we have taken a number of key measures through regulation, data collection or risk analysis. On the one hand, we have addressed shadow banking indirectly through the sectorial regulation of banks, insurance and asset management, such as the harmonised framework applying to alternative fund activity. On the other hand, we are promoting specific rules to improve the transparency of securities financing transactions (SFTs) or to increase the resilience of Money Market Funds (MMFs). Nearly every new piece of regulation includes the collection of data, thus progressively bridging the gaps that were identified or, in other word, dispelling the shadows.

At the same time we cannot afford to be complacent with past achievements. After all, shadow banking is alive and kicking, with 3.2 trillion euros in total assets in its narrowest definition. While shadow banking in this strict sense has been constant in the past years, activities more remotely associated with the banking system have been growing substantially. It is especially the case of the asset management sector which grew in the EU by around 40% in 4 years, up to 19 trillion euros of assets under management. About half of these assets under management concern managers with a discretionary mandate to execute transactions on behalf of the client, which can be a pension fund, insurance company or other institutional client. The other half is managed by investment funds which are raising growing concerns for financial stability.

As a securities authority, we at ESMA take this development very seriously. Asset managers, investment funds, securities markets, CRAs or financial infrastructures are in our immediate remit, and their activities can have an impact on financial stability. Thinking of ways we can address these risks adequately is one of the objectives of ESMA. And I am delighted that – together with the ESRB and its shadow banking expert group – we have an opportunity to spearhead this important conceptual process.

Of course, the interest of ESMA in stability issues is part of a broader development of securities regulators increasing their attention for stability issues in the non-banking sector. While understandably securities regulators have historically focussed on investor protection issues, the financial crisis has made clear that stability issues can strongly affect the functioning of the non-banking sector. This is for example evidenced with the role of OTC derivatives and securitizations in the financial crisis.

Risks to financial stability will form the first part of my intervention today, with a focus on the asset management industry. Afterwards, I will present the actions taken to address these risks and the progress made in the EU. I especially want to highlight the unprecedented collection of regulatory data for financial stability purposes with respect to non-bank financial entities. Finally I will show that these actions ultimately serve the economy by maximizing the potential benefits of market-based funding.

I know that I may be the outlier regulator of the day and, despite all sympathies, I won't be able to spare the audience from a number of abbreviations of EU legal text – which are proved anathema for economists, but make us regulators and supervisors proud and happy.

[Addressing growing concerns for financial stability]

Banking undoubtedly remains the core concern for all of us when it comes to financial stability. It is only natural that, after all the work on implementing the Basel framework and devising macro-prudential tools, our attention is now shifting to the non-bank financial sector. Asset management is one of the non-bank activities that is attracting particular attention these days. In particular, the current low-yield environment has created unprecedented challenges for asset managers. While this has helped to address issues in some parts of our financial system, there are growing concerns that the alleged search-for-yield behaviour, coupled with ample market liquidity, leads to mispriced risk and overvaluation of some asset classes. Eventually significant sales by asset managers could depress asset valuations, thereby transmitting stress to other institutions which may in turn be forced to sell assets. Cascading effects from fire sales can ultimately amplify deterioration of market confidence and deepen a crisis.

What are the triggers through which asset managers might play a role in downward spirals in stressed markets?:

- Firstly, liquidity risk, especially for open-ended vehicles, can arise if investors wish to have shares redeemed, but the cash amount in the fund is not sufficient, and assets cannot be sold on short notice. In other words, there is a mismatch between the liquidity of fund assets and the liquidity for investors. This can create run risks for the fund in stressed market conditions and asset sales in response to redemptions can in turn spread stress to other portfolio market segments.
- Secondly, leverage, through borrowing or derivatives, is a potential driver of fire sales and may force funds to sell assets at depressed prices when facing higher haircuts or margin calls from creditors.
- Third, their sheer size – more than 9 trillion for investment funds – and active role in day-to-day trading could make them important elements in scenarios of herded trading.
- Finally, asset managers are interconnected with the rest of the financial system, through direct investments or through financial intermediation, such as securities financing transactions. Especially, the re-use of collateral creates a network of linkages between financial institutions across different markets segments, including banks and non-bank financial institutions. Distress at an asset manager may thus generate substantial risk for its counterparties, and have a broader impact on market liquidity and risk aversion.

[Regulations have improved financial stability]

After acknowledging these potential risks to financial stability, I would like to look back at what has been achieved on the regulatory side and how this has already improved the safety of financial markets. Let me give you some examples of major steps undertaken in the EU in response to the financial crisis, especially regarding asset management.

As I pointed out earlier on, liquidity risk can have very adverse consequences for funds and ultimately for financial stability. From a regulatory perspective, both the Undertakings for Collective Undertakings in Transferable Securities (UCITS) Directive and the Alternative Investment Fund Managers Directive (AIFMD) have various requirements in relation to liquidity management which are designed mitigate this risk. The UCITS requirements are the most prescriptive, reflecting the fact that UCITS are supposed to be liquid products that can be sold cross-border to retail clients on the basis of a passport. The UCITS Directive requires liquidity to be ensured for all investments by UCITS, and sets out specific rules for the eligibility of transferable securities, money market instruments and financial derivative instruments. Where appropriate they are also required to carry out stress tests as part of their risk management. With respect to the AIFMD, there are requirements on the fund manager to put in place liquidity management requirements and stress tests, especially if they manage open-ended or leveraged funds. The results of the stress tests must then be reported to national competent authorities. These results will be ultimately passed on to ESMA.

Leverage is another important issue addressed by regulation. UCITS are subject to strict rules on the extent to which they use financial derivative instruments to increase their exposure. Under the AIFMD there is no legal limit but managers must report this information to their national competent authorities. Moreover the Directive foresees the possibility for national competent authorities and ESMA to limit the leverage employed by a manager. In particular, ESMA can issue an advice to national competent authorities to limit the use of leverage by a manager in their jurisdiction. If a national competent authority takes action contrary to ESMA’s advice, ESMA can publish the fact that the authority is not compliant.

In the particularly sensitive area of MMFs, the ESRB and ESMA have provided support towards improved risk prevention. A regulation aiming at promoting variable NAV for MMFs is currently being negotiated in Brussels, and we are eager to see this important project succeed. Now that we have regulations in place, it is for supervisors to make it work.

Finally, it should be acknowledged that an important part of the asset management sector is indirectly governed by insurance and pension regulations. As indicated earlier, about half of the European asset management sector concerns so-called direct accounts, whereby asset managers receive a mandate to manage assets, in most cases an insurance company or pension fund. Taking the agent-model of asset management into account, the stability issues in this type of asset management activity are very similar to the stability issues in case these assets would be managed by the insurance company or pension fund itself, and are subject to the same insurance or pension fund regulations.

[Making this regulations work]

With the new regulations, securities regulators will benefit from unprecedented data collection that can be used for financial stability. Let me give you a glance of the challenges and opportunities these new regulatory datasets will entail:

- The implementation of EMIR and AIFMD respectively significantly increase the availability of harmonized data regarding OTC derivatives and alternative funds. Such information helps to identify potential “super spreaders” of financial contagion, namely the most interconnected market participants.
- MIFID II will broaden the range of instruments for which market participants will be required to store or report data to competent authorities. Especially, identifiers will enable regulators to detect the trader executing a specific transaction, the algorithm used, and the client on whose behalf the transaction is conducted.

For ESMA, such data clearly improve our capacity to analyse risk to financial stability. We already publish regular analyses of risks in the asset management sector, such as for example a working paper on the systemic dimension of hedge fund illiquidity and prime brokerage. More recently we issued an analysis of the risks and opportunities arising from the development of funds specialised in loan origination. Finally, our recent proposals for central clearing are based on data collected regarding OTC derivatives in the EU.

But we need to do much more to improve our understanding of the data and our risk monitoring. We are only at an early point of understanding the complex channels of interaction between the banking sector and the non-bank activities. Our ad-hoc studies that we at ESMA have undertaken in cooperation with the ESRB on, for example, the CDS market and its network structure, or Securities Financing Transactions and the market for cash and non-cash collateral suggest that the transition from ad-hoc to on-going monitoring in matching these data will be challenging task.

As I mentioned earlier, it is also our responsibility to point to possible gaps in our data on securities markets. In that context, one area where we need to further progress is information on securities financing transactions. I, therefore, very much support the European Commission proposal regarding the reporting of these transactions to trade repositories.

[Mitigating risks is essential to maximise the potential benefits of market-based funding]

Finally, I would like to stress that the ultimate challenge for policymakers is to maximise the potential benefits of financial markets while minimizing systemic risks, i.e. to help limit risks to financial stability and market integrity in market-based financing and make it support sustainable economic growth.

That is the reason why we believe that more integration through the Capital Market Union is an appropriate response. Greater diversity in financing is needed in order to foster EU economic growth, as traditional sources of financing remain subdued especially for SMEs. A more diversified system with greater involvement of institutional or non-bank investors and higher shares of direct capital market financing is needed to fill the funding gap.

Such objective can only be achieved with a strengthened and harmonized supervision, based on comprehensive data, in-depth analysis and regulatory tools.

[Conclusion]

Ladies and gentlemen, let me conclude by underlining our commitment to promote financial stability. Regarding asset management especially, we need to continue working decisively on enhancing our understanding of the systemic implications of asset management activities in all its varieties, and their interconnectedness with the rest of the financial system. Moreover there can be no doubt that we need a macro-prudential framework for non-banks to complement the excellent work the ECB and ESRB are doing in the banking world. Going forward, I believe our joint efforts should be guided by four principles:

- **Thorough risk identification**. Non-banks are non-banks because they are not banks! We can draw on the important experience the ECB, the ESRB and the banking authorities have collected in the past years on macroprudential regulation.

But asset management, infrastructure and other non-bank activities are markets in their own right, with their specific business models and risk profiles. In order to be successful must get this analysis right.

- **Risk-adequate tools and instruments**. It logically follows that the policy responses we develop must be tailor-made to the specific risk profiles of each non-bank industry we look at. Again, the tools and instruments we develop must be suitable for individual industry risk structures. We cannot afford to get this wrong.
- **Institutional cooperation.** The market players we are dealing with are highly interconnected, and that interconnectedness has been well-documented by the excellent analytical work the ESRB had delivered in past years. This reality needs to be reflected in the way we as public authorities work together on this important topic. Central banks and market regulators and supervisors have unique insights, and we can only benefit from bringing all those to the table and follow a strong joint approach. The existence of the ESRB pays tribute to the unmistakeable expectation our policy makers have towards a joint spirit, and it is an excellent forum for us to develop this important policy area.
- **Strong initiative at developing an international approach**. Finally, we are not alone in the EU. The questions we are discussing today here in Frankfurt are very similar to those discussed elsewhere in the world. Benoît Coeuré (ECB) and Richard Berner (OFR) have vividly shown us how our concerns are shared by key policymakers around the world. Given the global nature of the markets and market participants we are dealing with, this is natural and necessary at the same time. We should aim for macroprudential advances that are aligned with those of our key partners - especially in the US - and the discussions we are having on this topic in the FSB, IOSCO and the IMF as well as bilateral coordination are key to achieving that objective.

Thank you for your attention.