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Market-based finance: what systemic risks associated with asset management and other market-based finance activities?

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Objectives of the session

This roundtable discussed the possible systemic risks and vulnerabilities associated with asset management and other market-based finance activities such as money market funds and securities financing transactions, whether current or proposed policy measures were sufficient to appropriately mitigate these risks and additional measures that may be needed.

Executive Summary

Financial stability risks associated with asset management activities

Market-based finance, which provided banks with diverse sources of finance and helped to reduce reliance on bank funding, had grown in importance.

Within market-based finance, asset management was playing an increasing role in the functioning of the financial system and for investors; there had been strong growth in particular in the bond fund market. Generally, investment managers reduced systemic risks because they were making informed choices, unlike many retail investors, but the risks entailed by the development of investment funds needed to be understood. The FSB had identified four areas of potential vulnerability in asset management activities: misalignment between fund assets, asset liquidity and redemption features; the use of leverage within funds; the operational risks and challenges associated with transferring investment mandates in distressed circumstances; and securities-lending activities. Recommendations had been made by the FSB and IOSCO for mitigating liquidity mismatch and leverage risks which would be published in June for public consultation, after which IOSCO would develop a follow-up framework.

It was quite clear now that systemic risk in the field of asset management was not related to size, per se, a panellist stated. Moreover activities, as well as liquidity and leverage issues were now the main focus of systemic risk assessments, rather than the designation of possibly systemic entities. This was because asset managers did not use their own balance sheets, but acted as agents. There was no issue with substitutability in the asset management sector, as clients who invested in funds had a choice of alternative funds and mandates in the marketplace.

Liquidity mismatch

Liquidity mismatch was a key concern and appropriate disclosures were important for asset managers and the authorities as well as for investors. Robust stress testing was also needed. Fund liquidity depended on a number of factors. One was the liquidity of underlying assets, which had become more fragile, notably in the corporate bonds market. Other factors included the subscription-redemption flow of funds, the cash that was available in the fund to face redemptions, the price at which fund assets were valued and the time taken by the settlement of asset sales.

There were also herding issues that went with the delegation of portfolio management and the incentives that this created.

The UCITS and AIFMD directives in Europe provided liquidity measures. There was however still scope for improvement in the tools available for managing liquidity risk in funds with e.g. appropriate redemption terms better aligned with the liquidity of underlying assets and liquidity buffers, a regulator considered. There might also be scope for improvement of the tools that could be used to manage significant redemption pressures, such as gates, side-pockets and suspensions of redemptions. These latter tools were being debated as some believed that their use could create panic in the market and contagion risks; moreover, there was discussion as to whether the system as a whole was well served by such tools being at the discretion of boards of funds, rather than decided by regulators. Temporary credit solutions could also be proposed as an alternative to redemption in some cases, a panellist suggested. Tools such as swing pricing and redemption fees were moreover needed to reduce first-mover advantages and dampen run risks.

Leverage

With respect to leverage, the FSB was in favour of the provision of consistent and accessible data on the use of leverage in funds which required an appropriate set of measurements to be developed. Leverage was an important issue in the fund sector, as it could amplify liquidity and herding risks in particular. Rules in the EU and US imposed limits on cash borrowing by mutual funds, but quite significant leverage could still be built in some cases through derivatives, an official stated; such hidden leverage existed in some bond funds for example.

In Europe there was already an extensive reporting mechanism provided by the AIFMD that included leverage, as well as the possibility for ESMA and the ESRB to intervene if critical leverage risks developed at market-level. Reporting on leverage was however not available for UCITS. Some speakers regretted this because although such funds could not borrow money, leverage could still be built for example through the use of synthetic products. Other speakers argued that the leverage cap for UCITS concerned the overall leverage exposure of funds and not only borrowings. Improved data would help to determine this more precisely.

Conduct

A regulator considered that the main risk in the fund industry nowadays was from conduct, rather than liquidity or leverage. Inappropriate conduct could damage investor confidence and have systemic consequences. The issue at present was that with the present market conditions funds were moving into riskier assets in order to obtain better investor returns and could be tempted to look for ways to generate more fees. The rules on custody had been greatly strengthened, which was important in this perspective since custodians played an important role in checking the way funds were managed, but other measures may still be needed.

Update on the EU Money-Market Funds (MMFs) regulation proposal

Significant moves were being made towards developing a regulatory framework for MMFs in Europe, following the report adopted by the EU Parliament in April 2015. Satisfactory progress was also being made in other jurisdictions according to the FSB.

The concerns that were raised regarding MMFs were related to liquidity, run risk and contagion. An industry speaker stressed that even in October 2008 outflows from prime MMFs, which invested both in corporate and government debt, had only reached 13%; moreover most of the outflows had gone into other government MMFs. Ensuring that the potential issues raised by MMFs were addressed was supported by the industry. Three main types of measures were included in the current EU proposal: required weekly liquidity levels of 30%, the possibility for fund boards to impose fees and gates and the limitation or ban of sponsor support.

A regulator was supportive of an EU MMF framework but regretted that the approach proposed was quite rigid; this may be an issue if market conditions changed, as co-decision would be needed to change the rules. General principles relating to liquidity, building on the acquis of the UCITS and AIFMD directives would have been preferable to the detailed rules proposed. Supervision of MMFs was another issue, as MMFs did not exist in all EU countries; a reinforced supervision would be needed including the countries from which investment originated, as these could be hit by issues affecting these funds.

Vulnerabilities associated with other market-based finance activities

The FSB had a broad monitoring framework for shadow banking, with a specific focus on activities involving credit intermediation, leverage, maturity mismatch and imperfect credit-risk transfer, which raised stability risks. Asset management activities were the largest component of this latter segment in which there had not been significant growth over the past few years.

The starting point for defining how shadow banking risks should be regulated and supervised was to better understand the underlying drivers of their development which included search for yield, regulatory circumvention, complementarities with the rest of the financial system and the growth of large institutional investors that demanded assets.

In order to identify and address these risks, an efficient interplay between micro- and macro-prudential authorities and business conduct authorities was needed. Moreover transparency regarding the products that clients were investing in and the tools that investment managers were utilising was essential. Transparency on a fund level was not sufficient though, because regulators needed to be able to understand the risks across the entire sector.

A number of policies had been set out for the areas where there had been clear regulatory shortcomings before the crisis, which included MMFs and securitisation. The interdependencies between the shadow banking sector and the banking system had reduced and would be further addressed by Basel III rules. Securities financing and repo activities were another area of focus of the FSB, as they fostered pro-cyclicality and leverage; minimum haircut floors had been proposed in order to limit the development of leverage.

Substitute products that were manufactured outside the UCITS/AIFM world, such as notes were another issue to be addressed in Europe, a regulator suggested. Some of these products which resembled UCITS did not offer the same level of protection, but would be circulating quite freely with the implementation of PRIIPS in 2017.

In the insurance sector the situation was different, an official noted. The sector as a whole had not shifted towards riskier assets, but had become more exposed to risk, due in part to the low interest rate environment and to changes in market dynamics. Higher cross-asset correlations had also been observed with the rest of the financial system, diminishing the potential role of insurers as shock absorbers.

Detailed Summary

1. Financial stability risks associated with asset management activities

Main focus of the on-going assessments

A regulator explained that market-based finance had grown in importance and would continue to do so in the future. This had been a positive development because market-based finance provided banks with diverse sources of finance and helped to reduce reliance on bank funding. As market-based finance assumed a greater role in the financing of economies, it was important that the authorities understood the potential vulnerabilities of that part of the financial system. Risks from market-based finance arose mainly from maturity mismatching and leverage and had not always been well understood or measured. The authorities would be increasingly concerned about the continuity of that source of finance, given its importance for the overall health and functioning of economies.

Within market-based finance, asset management played an increasing role in the functioning of the financial system and provided important benefits to investors. Moreover asset management was an important counterpart to much of market-based finance.

In spring 2015, the FSB decided to undertake work to identify potential sources of vulnerability in asset management activities. This had led to identifying four areas of potential vulnerability. The first was the misalignment between funds' assets, asset liquidity and redemption features. The second was associated with the use of leverage within funds. The third was the operational risks and challenges associated with transferring investment mandates in distressed circumstances. The last was associated with securities-lending activities.

Liquidity mismatch and leverage risks were the main focus of the work that the FSB had undertaken with IOSCO. The recommendations made were not yet public, but they had been agreed and were undergoing a final round of comments within the FSB and its membership. A document would be published in June for public consultation. Close examination and feedback was welcomed. The FSB's work in this area would end in 2016, and IOSCO would then be in charge of developing a follow-up framework on the liquidity and leverage-risk issues.

In terms of product scope, some recommendations were very much directed at open-ended funds, for which incentives for run risks were stronger, but many other recommendations applied across the asset management space.

An official added that the IMF was collaborating with the FSB on these issues. A detailed analysis of risks, both empirical and conceptual, related to plain vanilla mutual funds had been conducted in 2015. These funds had been growing considerably, and the growth of bond funds was a new development. Although this had many benefits notably from a financial stability perspective, it needed to be understood what risks, if any, this form of fast-growing financial intermediation might entail.

Potential systemic risks associated with asset management activities

An asset manager stated that the question that needed to be addressed was whether there was potential systemic risk in asset management. It had been quite interesting to see that some drivers of systemic risk had been eliminated by regulators in their assessments, for example size, per se. Activities, as well as liquidity and leverage issues, were now the main focus of the assessments of potential systemic risks in the asset management sector - rather than the designation of possibly systemic asset management entities. This was because asset managers did not use their own balance sheets, but acted as agents. There was no issue with substitutability in the asset management sector, as clients who invested in funds had a choice of different funds and mandates in the marketplace that they could use. This variety of options also allowed innovation to develop.

Another asset manager commented that, generally, investment managers tended to reduce (rather than increase) systemic risks, because they made informed decisions, unlike less-informed investors who made many knee-jerk decisions. If a few investors were selling through their investment managers, the market would adjust.

Liquidity risks

Liquidity mismatch was a key concern for asset managers, as well as for the authorities, a regulator explained, and an emphasis needed to be placed on liquidity-risk management. Disclosures around liquidity mismatches were also important for investors to be able to make decisions, so this would be an area covered in the recommendations. There was scope for improvement in the tools available for managing liquidity risk in funds, both on an ex ante and an ex post basis. In order to reduce material liquidity mismatches, one could change redemption terms, align them with the liquidity of the assets, or have liquidity buffers. There were tools to reduce first-mover advantages that were important to dampen run risks, such as swing pricing and redemption fees. There was a role also for robust stress-testing. There might also be scope for improvement regarding the use of intervention tools to manage significant redemption pressures. There was a discussion as to whether the system as a whole was being well-served by those type of tools simply being at the discretion of boards of funds, rather than market regulators being responsible for deciding in which circumstances it was appropriate to activate some of those ex post redemption tools.

A regulator noted that in terms of liquidity measures in Europe, the UCITS and the AIFMD Directives (Alternative Investment Fund Managers Directive) were quite satisfactory. The AIFMD in particular clearly provided that managers had to ensure that their funds had a liquidity profile consistent with the type of investors subscribing to them. In terms of tools for managing significant redemptions, gates, side pockets and suspensions of redemption could be used, but many market regulators were doubtful of the effectiveness of such measures. In markets, information ran very quickly and these tools could communicate a sense of panic and make the situation worse. If some funds were starting to suspend redemptions, this could spread to others and create a form of contagion. There needed to be a mechanism that should allow to ringfence the transmission of risk, should something happen that affected a particular asset class or category of funds.

What had not been duly taken into account in Europe and in other jurisdictions, was the impact of these tools on the overall market, the regulator believed. The decision to use such measures was left with the asset managers, but if there was another situation like the Lehman crisis then the ability to intervene across the market might be needed, because it would be a whole sector that was affected, not necessarily a particular fund. This dimension of co-operation among regulators and a possibility to adopt collective measures was still missing from the debate and from the measures so far implemented in Europe.

An official emphasised that the IMF had analysed the issues related to the first-mover advantages likely to exist in most collective investment vehicles. There were different situations. It could be because investors did not want to be the last in the queue if others were exiting a fund, or the fund might be selling more liquid assets first which might create pricing issues. The incentive problems when portfolio management was delegated had also been examined, as this could lead to herding behaviour among managers and might also be destabilising.

The evolution of market liquidity in the bond market, and in particular in the corporate-bond market had also been thoroughly examined by the IMF. It had been found that, although the levels of market liquidity were not low, liquidity had become more fragile. This seemed to be driven in part by changes in market structure, the retrenchment of banks and a more homogenous buy-side. Larger holdings by open-end mutual funds in particular were associated empirically with more severe liquidity declines during stress periods. For example, for bonds that had been more heavily held by mutual funds before the crisis or the 2012 taper tantrum, liquidity tended to decline more during the event. The type and magnitude of these new risks were only beginning to be understood, and would need to be looked into further.

An asset manager noted that a report on liquidity had been issued in April 2016 by EFAMA, the European Fund and Asset Management Association and AMIC, the Asset Management and Investors Council, showing that many provisions to mitigate liquidity risk already existed, as well as a toolbox to mitigate liquidity risk. ‘Mutual fund’ was a better term than ‘collective investment’ from a risk management perspective, because there should be some mutualisation between in- and out-flows within funds and within the fund industry. The concept of mutual fund introduced the idea that there was some mutual sharing of risk including liquidity risk, as well as performance, whereas a collective investment scheme conveyed mainly the idea that people were pooling interest in order to manage a risk-reward strategy together.

Liquidity risk for an investment fund was not exactly the same as for the market, the asset manager stressed. It was important to analyse market liquidity, since the liquidity of a fund depended on the liquidity of the underlying investments, but the subscription-redemption flow, within the investment strategy of the fund, as well as liquidity buckets and buffers also needed to be considered; in other words, how much cash was in the fund to face redemptions. Maintaining liquidity and being able to face redemptions was an important requirement for funds and was part of risk management. Another question that needed to be asked was whether the fund was valued at market price and able to sell its assets, and whether a sale would take place for settlement in T+1 or T+2 in most cases. The question related in particular to non-liquid assets which were to be identified. It was something that should be worked on, but not all funds had illiquid assets in their portfolio.

There was another question to be considered from the investors’ side which was the reason for which investors wanted to redeem fund shares, the asset manager added i.e. whether they wanted their money back, or because they wanted to exit the exposure the fund gave them. If they simply wanted their money back, credit could play a role in that case. Standard Lombard credit (i.e. a fixed rate loan that could be guaranteed by the fund shares) was an appropriate way to create liquidity when the investor was willing to maintain the exposure but needed cash at a given time for a given period. It was important to say that this existed, especially when speaking of less liquid funds, because there were solutions other than redemptions. Finally, there was a link between liquidity, price and valuation. Valuation was what the asset management industry was good at, because they went in most cases for -daily valuation.

Leverage risks

The members of the FSB were in favour of consistent and accessible data on the use of leverage in funds, a regulator considered; a consistent set of measurements should be developed and disclosed, providing for the possibility of this information being aggregated and tracked.

More recently, “hidden leverage” had been investigated, an official emphasised. Leverage was an important issue. The previously mentioned issues regarding first-mover advantage and herding behaviour existed for funds that had no leverage, but they were amplified by leverage. Although regulations in Europe and the US foresaw limits on cash borrowing by mutual funds, large leverage levels could still be achieved through derivatives. Regulations typically required funds to disclose only a limited amount of information on the derivatives they used, and assessments had shown that in many cases amongst bond funds, the levels of embedded leverage were quite high.

Another regulator stressed that in Europe the AIFMD provided very detailed reporting requirements, which included leverage as well as the possibility of intervention on leverage at a European level. In case of particularly critical leverage situations, regulators could report to ESMA, who in consultation with the European Systemic Risk Board would be able to intervene. Unfortunately, this amount of information was not available for other funds, in particular for UCITS. Before AIFMD had been developed, there had been concern regarding the retailisation of hedge funds or the use of synthetic products able to create some sort of leverage risk in UCITS. Such funds existed in the market, but it was unknown how many there were. This issue had been discussed from time to time within ESMA, and it was fair to say that there were UCITS which could be leveraged more than what was allowed under the UCITS Directive.

An asset manager stated that the UCITS Directive was quite clear regarding leverage, and hopefully no UCITS fund manager was breaching the law, because the directive limited leverage exposure and not only borrowings. UCITS could not have a leverage exposure more than double compared to its capital. Under AIFMD, the AIFs that did not use significant leverage were limited to three times. There was therefore an overall view on leverage exposure and strict limitations. The question was however about the implementation of these rules and checking the data, the Chair noted. Development of knowledge, understanding, transparency and real-time data could solve a huge number of problems.

Conduct risk

A regulator emphasised that markets were evolving quickly. The biggest risk in the fund industry nowadays came from conduct, not from run risk or liquidity. Conduct was an issue that needed to be kept in the radar, because damage to investors would lead to a loss of confidence, which could in turn create systemic risk. ESMA had done some work on this issue. A great deal of money was now pooled in the fund industry. Given the situation in the markets, funds had moved towards riskier assets in order to be able to generate return for investors. In certain cases, some may be tempted to play with fees, for example funds that were marketed as active but were purely passive and following benchmarks. Some might also be tempted to employ aggressive trading techniques in order to increase churning. The rules on custody which had also been very much strengthened, needed to be taken into account in this perspective, since the role of the custodian was to double check the behaviour of the managers.

An asset manager noted that funds were investment products, and the issue was really to make sure that investors went into these products understanding the risks that they faced, which was also a question of conduct.

2. Money-Market Funds (MMFs)

Update on the on-going regulatory process in Europe

An asset manager stated that the industry supported an appropriate MMF regulation that would help to ensure that the potential issues raised by those funds were addressed and that any further problems could be avoided. Significant moves were being made towards this objective. The work by the Parliament and the report that came out in April 2015 was a positive step forward. Some further elements had come out of the Dutch Presidency that were being discussed at present. Another asset manager added that the FSB and IOSCO were looking at the issue from a global perspective, so it was important to produce and deliver on this.

Key issues related to MMFs and proposed regulatory measures

An asset manager explained that the concerns that had been raised regarding MMFs related to liquidity, run risk and contagion. When looking at liquidity, even in the worst week of October 2008, there had been only 13% of outflows from the prime MMFs (that invest both in corporate and Government debt) and most of the outflow had gone into government MMFs (that invest mostly in government debt). As investors liked the product, their main concern was the holdings that they had in bank names and other names that they were not happy with.

The current reform process required a weekly liquidity level of 30%. This was higher than the self-imposed requirement of the Institutional Money Market Funds Association (IMMFA) of 20%, but this were just a minimum. The good investment managers knew their clients and their client flows, so had ensured that any of the hiccups that had taken place between 2011 and 2013 had been smoothly handled by maintaining sufficient liquidity levels.

Fees and gates to back up the liquidity requirements also formed part of the regulatory proposal. There was the concern that suddenly imposing such restrictions would create some panic, but having this ability would serve as a belt-and-braces approach. It would give boards of directors additional tools with which to deal with stressed market conditions and ensure fair treatment for all investors. Rather than just acting in a knee-jerk manner, everyone would be treated fairly in order to ensure there was not a first-mover advantage.

The question of limiting sponsor support had also come up in the EU regulatory discussion and was effectively the method for limiting contagion into the other parts of the market, specifically the banking market. If there were significant controls or a total ban on sponsor support, it would eliminate the perception that MMFs were guaranteed products and the possibility that banks could be brought down by having to put funds into their MMFs. It would also make absolutely clear that this was an investment product just like any other security, and that there was an element of risk.

A regulator hoped that the MMF package would be agreed, as Europe needed such a framework that existed in other parts of the world, but regretted that the regulatory approach proposed was so rigid and that regulators would not have much possibility to intervene. This would hinder the ability to cope with fast-changing market conditions. The MMF regulation proposal indeed introduced very detailed rules on the composition of portfolios and the type of assets that could be invested in, and also introduced constraining measures such as the possibility to impose additional redemption fees if a certain percentage was crossed. To change the regulation in the future, co-decision would be needed. Recalling the Lamfalussy approach around general principles, besides the introduction of constant net asset value (CNAV), variable net asset value (VNAV) and now low-volatility net asset value (LVNAV) MMFs, the Level 1 should have included general principles on the need to perform liquidity stress-testing, etc, which was already part of the acquis through the AIFMD and the Level 2 measures on the UCITS package.

Moreover, the MMF framework was pushing a model of funds that did not exist in a number of EU countries, as had been shown in the two peer reviews that had been conducted at ESMA level. Supervision would need to be considered as well. If there were funds that were only managed in a certain number of jurisdictions, but that could spread risk because they received investments from other parts of Europe, a reinforced supervision would be needed with the participation, via colleges or some sort of mutualisation, of the countries that could be hit by the possible negative outcomes of these funds. Nobody was willing to revert to a home-host organisation, but when there were specific activities that were concentrated in certain financial centres supervision needed to be adapted.

This situation summarised the dilemma of how much granularity was wanted, the Chair commented. On the one hand, a single rulebook was desirable, but may also raise some issues. And if principles alone were relied on, they would certainly be translated in different ways in national laws.

A regulator added that regarding MMFs, the FSB was waiting to see what would come out from the ongoing legislative processes in Europe and other jurisdictions. IOSCO had been asked to monitor the implementation of the recommendations. On the whole, the FSB was pleased with the direction taken in the largest markets in this area.

3. Vulnerabilities associated with other market-based finance activities

Monitoring the shadow banking sector

A regulator explained that, regarding the broader shadow banking sector, the FSB had a monitoring framework in place which cast the net very widely, and narrowed things down to those activities involving credit intermediation, leverage, maturity mismatch and imperfect credit-risk transfer. Experience had shown that this was where the potential resided for stability risks to arise.

There had been a very extensive information-sharing exercise between FSB member jurisdictions and a number of other jurisdictions in 2015 regarding shadow banking activities. The volumes were large, but over the past few years there had not been a significant growth worldwide in the narrow measure of shadow banking comprising activities that posed the risks mentioned above, although it was growing quite rapidly in emerging market economies. This narrow measure could be broken down into five recurring economic functions, even though they were carried out by entities of very different legal character. The largest component were functions happening within collective investment vehicles or asset management vehicles that posed banking-type risks with some kind of a mismatch between the underlying liquidity of assets and their redemption features.

An official suggested that in order to identify and address emerging risks, a very good interaction was needed between micro- and macro-prudential authorities and business conduct authorities, in order to complement the work of each of the authorities. This was not easy to do. The Chair noted that good quality data that could be quickly available was also needed. An asset manager felt that regarding data, transparency was the cure-all. If clients knew what they were investing in and if regulators knew quickly enough what their investment managers were utilising as tools, risk mitigation would be much easier.

A regulator emphasised that understanding risks was key, but regulators needed to be able to understand risks across the entire sector. Transparency of a single given fund was good for investors but might not necessarily be sufficient for regulators, if they were not able to pull the entire picture together. The Chair agreed that the development of knowledge, understanding, transparency and real-time data could solve a huge number of problems.

Drivers underlying the development of the shadow banking sector

An official considered that for understanding shadow banking risks and how to supervise and regulate the sector, one starting point was to understand how and when shadow banking activities emerged. They took many different forms that should not be lumped together. Analysis had shown that the search for yield, regulatory circumvention and complementarities with the rest of the financial system were important drivers for fostering the growth of shadow banking. For example, more stringent bank-capital requirements usually triggered a stronger growth of shadow banking. In the post-crisis period, there had also been a negative correlation with term spreads, suggesting that search for yield had played a role. The growth of large institutional investors was also associated with the growth of shadow banking, because they demanded assets.

Moreover interesting parallels could be drawn across very different forms of shadow banking around the world, where similar dynamics could be seen. For example, in the US, interest rate regulation and ceilings on interest rates on deposits had become binding when inflation had started to rise in the early 1970s, which had led to the emergence of money-market mutual funds. In China, interest rate regulations had also put ceilings on deposits that had led, in the expansionary phase, to the emergence of wealth management products. Looking at it with this a broad approach was sometimes also helpful in identifying emerging risks.

Policies put in place

A number of policies were being set out in the areas where there had been clear shortcomings before the crisis, a regulator stressed. Money-market mutual funds' and their perceived susceptibility to runs had been one of these. Another had been the put-back risk to the banking system related to some activities that happened, in part, off the balance sheet and/or in other entities and to which banks remained committed. Securitisation and misaligned incentives had been a third, and financing a fourth. Recommendations were being developed in all of those areas, and MMF regulations and measures for dealing with the incentives problems in securitisation were well underway. As for the interdependencies between the shadow banking sector and the banking system, they had reduced, which was positive. Some of the most aggressive forms of shadow banking could not have happened without the banking system, and Basel III rules were due to address a number of these issues.

Securities financing and repo activity were another area of focus of the FSB; whilst these markets were crucially important for the functioning of the financial system, there was considerable scope for pro-cyclicality and leverage, and pro-cyclical developments in leverage. Everybody was happy when leverage expanded, but unhappy when it collapsed. This had happened in that market, and the FSB was seeking to introduce minimum haircut floors. The objective was not to dictate haircuts in those markets, but to put a limit on the development of leverage through securities financing transactions. This was being implemented as from 2018, and the FSB was in the process of putting together a global reporting framework, so that both the markets and the authorities would be able to track these developments.

Another issue that had to be dealt with in Europe, a regulator suggested, were the problems with substitute products that were manufactured outside the UCITS/AIFM world, and which would be circulating quite freely with the PRIIPS package (Packaged Retail and Insurance-based Investment Products) that would enter into force at the beginning of 2017. Functional regulation would be needed, because this should not be allowed. It was not necessarily a case of circumvention, because different regulatory avenues were being used, but there was not the same level of protection for UCITS which included many regulatory safeguards and other substitute products such as notes.

4. Risks in the insurance sector

An official mentioned that in a recent report, the IMF had looked at the insurance sector, where the situation was quite different. The insurance sector did not seem, in aggregate, to have shifted into riskier assets in major advanced economies, except for some weaker, smaller and less-capitalised firms, but the sector as a whole had become more exposed to risk. This was possibly due in part to the low interest rate environment, and also to changes in market dynamics.

Higher cross-asset correlations were being observed also in a persistent manner now, and this could affect, in the end, the riskiness of many players in the financial markets. If insurers were not only exposed to risks amongst themselves, but also to similar risks in the rest of the financial system, they could be relied on less to serve as a buffer or shock absorber if there was a shock, and they would be less likely to play their roles as financial intermediaries when others were also hit.