5. RESILIENCE OF THE EU NON-BANKING SECTOR IN THE GLOBAL CONTEXT

Market liquidity and volatility: what trends and impacts?

KEY ISSUES | *The objective of this session was to discuss the current status and future trends of liquidity and volatility in EU capital markets, the main drivers and possible solutions for ensuring sufficiently resilient market liquidity.*

Current status of market liquidity and volatility

In recent years many regulatory initiatives had impacted the way institutions and financial markets worked. One issue of concern and under research was the change in market liquidity. The typical indicators of market liquidity had revealed no significant problem; liquidity conditions had returned to pre crisis levels.

However quantity-based indicators were showing some changes; the depth of the market was decreasing. Issuance numbers were high but turnover had declined in a number of segments including some that were very liquid. There was also liquidity bifurcation, as well as more frequent short-term liquidity jumps, and it was becoming increasingly difficult to trade large quantities quickly in the market. Prices had not adjusted accordingly yet.

There was also increased volatility that was affecting the most liquid markets, particularly US Treasuries. That had been illustrated by the "flash rally" in the US market and the "Bund tantrum" in the German market.

Main drivers of market liquidity trends

Regulation was thought to be merely one of many drivers of change in the liquidity of fixed income markets.

The first major driver was the widening gap between supply and demand for liquidity services. That was due to a reduction of market-making capacity, and this was where regulation was possibly having an impact. At the same time regulation was making market-makers more resilient and the appetite for risk-taking in that activity had changed in many institutions. Second was the development of electronic trading, which had positive aspects for liquidity but also possible negative effects with the development of algo-trading in particular. The third was the development of non conventional monetary measures and asset purchase programmes, which could have both positive short-term and negative medium term implications for liquidity.

The main source of the liquidity issue was a macro problem, a speaker considered: there was a global issue of excess saving and under investment, which policy-makers needed to respond to. Low interest rates were a response of central banks to under investment. In Germany for example there was too much investment in bonds, which were affected by low interest rates, and not enough in longer term riskier assets such as equities and infrastructure projects. Prudential banking regulation may amplify effects (for example the NSFR), but was not the main source of the problem.

The market needed to adapt to this new environment. Market participants were in the process of adjusting to these changes; and authorities were advised not to stand in the way of that adjustment. Adjustments could take place through pricing, changes in business models or behaviours (e.g. risk management practices). Market participants were in an uncomfortable position because they were mid transformation and many changes were happening. It had to be hoped that those conditions would not last forever; and it was thought that once those conditions began to change, many of the concerns currently expressed regarding regulation would dissipate.

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>>> The effects of regulatory changes needed to continue to be monitored, and market participants needed assistance in their adjustments to the changing marketplace.

Possible solutions and way forward to be considered

Encouraging more investment in a longer term perspective and mobilising excess savings back into investments would make a great deal of difference. Short term interest rates would then start to normalise and this would progressively allow moving out from unconventional monetary policies, but this was still a remote objective. Investors who have a long-term business model such as insurance companies or pension funds should be encouraged to invest for the long term and in riskier assets. Making changes in Solvency II for example to allow more equity investment could be beneficial. Tax incentives or regulatory changes that would encourage investors to move to longer term and riskier assets would also help to address the current liquidity issues at the source.

However, more confidence was needed in the future development of the economy in order to address the imbalance between saving and investment. At present corporates preferred to buy-back their own shares and pay dividends to shareholders rather than reinvesting profits. Politicians and regulators had to come together to change the incentives for long term business and investment.

Technology and electronic trading platforms could help to stabilise the provision of liquidity services together with the development of new liquidity providers, although it was not yet clear if these new players would remain present in the market in periods of stress. Market-makers were also adjusting their business models. Further product standardisation would help to improve liquidity and facilitate electronic trading. The side-effects associated with the rise of electronic trading however needed to be taken care of. The development of high frequency trading which was felt to be a persistent trend which would eventually encompass broader markets over time was a particular issue as it was changing the way fixed income markets were functioning. It was however acknowledged that regulating high frequency trading was difficult. Market participants would have to accept a world with episodes of heightened volatility.

Work was moreover being conducted by the FSB and IOSCO looking at strengthening liquidity management practices in the asset management industry. A consultative document would be released in June/July. Asset managers were also in the process of reviewing the way they approached the liquidity risk management of individual funds. One solution was to raise cash buffers but that would reduce returns for investors. Another possible action was making sure that there was no mismatch between the perception that clients had of the liquidity terms of investment funds and the liquidity profile of the underlying assets in the fund portfolios. Other measures were to consider backup credit lines for the event of large redemptions after significant bouts of volatility, stress testing and redemption tools (e.g. redemptions in kind). Each of the measures considered had arguable benefits and drawbacks; the key was finding the right balance and adapting risk management to the current altered market conditions. ●

CCP resilience, recovery and resolution: key elements of a possible EU framework

KEY ISSUES | *The objective of this roundtable was to discuss the key elements of an EU regulatory framework for the recovery and resolution of CCPs, the level of flexibility or predictability that should be built into the framework, how the availability of appropriate financial resources could be ensured and the possible issues raised by the global dimension of many CCPs.*

Key elements of a CCP Recovery and Resolution (R&R) framework

CCPs had been identified by the G20 as the appropriate financial market infrastructure for concentrating counterparty risk with the implementation of the clearing obligation. There was now a need to provide a framework on how recovery and resolution of CCPs was expected to work. The systemic risks associated with >>>

>>> these infrastructures were indeed very high and the impact of a potential failure on the economy could be immense. Moreover, this needed to be a global approach given the international dimension of many CCPs and legal certainty had to be ensured for all stakeholders in the system.

Regulators had withheld action, pending further work in the FSB and guidance from the September 2016 G20 meeting. The European Commission was planning a subsequent legislative approach near the end of the year.

Definitions had to be agreed first because there were different interpretations across jurisdictions.

Resolution meant finding a way to preserve critical business functions with a financial reconstruction in order to allow the systemic functions of a CCP to continue. Public support was not an option.

The protection of the financial system and its constituents in the event of a CCP stress required a toolbox, something which needed to be clearly stated in the rules. It was suggested that recovery tools should be favoured at first instance given the objective of continuity. They also needed sufficient transparency regarding the recovery plan and there should be clarity and alignment of the incentives of shareholders and clearing members in order to ensure an appropriate resolution of the failure. Prudential and market supervisors moreover should be required to work together in order to avoid conflicts regarding clearing members in particular. The suggestion was also made that a solution needed to be worked out for non-default losses i.e. those that were unrelated to a clearing member's default, as there was still uncertainty as to who should bear the losses in such a case; it should be shareholders, a panellist suggested, but equity might also have been wiped out.

Ensuring that appropriate risk governance was in place was another important issue. Members wanted a forum to enable them to put forward their views, from a membership liability perspective, on clearinghouse rules and risk management frameworks, as they provided a large part of the capital. There were rules under EMIR, but some felt that they were not always appropriately applied in the CCPs' risk committee. Representatives from clearing members and clients sat on CCP risk committees but they just supplied market expertise, and were not supposed to speak in their organizations' interests. Many clearinghouses did not take their member feedback seriously enough but some CCPs are engaged regularly with their members and are very much user-orientated, some speakers considered.

Another issue was defining who the decision-makers were and how they interacted with the other stakeholders in a recovery and resolution process.

The nature and the role of the resolution authority in particular needed clarification. One speaker suggested that the resolution authority should be the local authority supervising the CCP on a day-to-day basis because it was the only one able to understand how the CCP worked and to anticipate how markets would react. Another speaker however suggested that there should in any event be a clear division of roles and responsibilities in that case, and in the cases where a CCP was supervised by a college, such as European cross-border CCPs, resolution should be conducted by a resolution college that would be narrower in order to facilitate coordination.

The resolution authority came in at the resolution stage and the EU Parliament had recommended that there should be oversight by public authorities when end-investor money was involved. It was suggested by several speakers that the resolution authority also needed to be involved in the recovery stage, given that recovery would be a fast process and the authority needed to be well-informed of the situation. Moreover there was merit in an early intervention while resources were still remaining, in cases where a recovery was destined for failure, although this was difficult to predict and it could be unhelpful to intervene prematurely in some cases.

Flexibility vs predictability of the CCP R&R framework

Some panellists were in favour of limiting flexibility in the R&R process and ensuring a presumptive path as the most predictable way possible.

Predictability in resolution was very important because at that point all stakeholders would need clarity on where the process was heading, what resources would be used and how the continuity of the CCP could be managed. Clearing members were favourable to predictability, a panellist stressed, because they needed to know upfront what were their financial exposure and liabilities and to be able to plan operations, given that there would be multiple issues to face in the event of a CCP failure i.e. closing bilateral exposures, bidding on auctions in several markets, etc... Shareholders and asset holders also wanted to know what would happen and what they would be liable for. Moreover predictability was important for incentive reasons, because the market would internalise the risks of failure thereby diminishing the risk of failure. Finally, resolution involved interfering with property rights and if resolution authorities did not follow a contractual order in loss >>>

>>> allocation for flexibility reasons, they might face legal proceedings and the threat of successful compensation claims under the 'no creditor worse off' safeguard.

Other panellists were in favour of more flexibility. It was indeed very difficult to know what to expect in advance because all defaults were different and in severe crises a rulebook could only be used to a certain extent, before specific thinking was needed. Transparency regarding the waterfall and the obligations of the different stakeholders was however essential.

A balance had to be struck between flexibility and legal certainty, a speaker emphasised. There were various reasons why flexibility was important. The toolbox of measures needed to reflect the differences among CCPs and had to be broad enough to adapt to different liquidity situations in the market and different crisis scenarios. At the same time there had to be legal certainty for supervisors; in addition investors and asset holders needed to know what would happen. Also, there should be no conflict between the actions of prudential and market supervisors, that otherwise might prevent clearing members from participating in the resolution process.

One speaker understood the benefits of a fixed order of loss allocation in resolution in particular but stressed the importance of having appropriate incentives in order to prevent manageable situations from becoming crises. A key to success was in incentivising the clearing members who were crucial for the resolution of the CCP to behave in an appropriate way and to participate in the auction process, if one was needed. This required the incentives to be carefully thought through. For example, if a resolution strategy led to clearing members regaining control of a CCP that had been demutualised, through the provision of equity to members that absorbed losses in resolution, this could influence their behaviour earlier on in the process. Another issue was having the appropriate capital and leverage ratios that would allow members to bid on the defaulting member's portfolio. Predictability and transparency about the order of loss allocation could be beneficial in this case provided the incentives were well-aligned.

Ensuring the availability of appropriate financial resources

Where the question of predictability really arose was regarding financial resources. If the two largest net debtors defaulted, there had to be sufficient aggregate financial safeguards to cover the losses. The resolution discussion had reached an awkward position because CCPs were required to implement comprehensive loss allocation rules, meaning that the losses would have to be absorbed by the market right down to the end of the waterfall, with less attractive tools as they moved further down.

The question was where the resources would come from and to what extent they needed to be pre-funded Implementing a resolution fund and TLAC was challenging because they were difficult to scale and involved additional costs. A speaker felt that asking CCPs to pre-fund resources on top of defaulter margins and Cover 2 requirements (the EMIR requirement that total financial resources should cover the default of the two largest members) would challenge their business models and go against incentivising central clearing. An option for ensuring that adequate resources would be available for resolution without requiring additional pre-funding might be to reserve parts of the waterfall for potential use by the resolution authority. They could incorporate a final cash call in the recovery plan or in tools such as variation margin gains haircutting or partial tear-ups of trades, subject to discussion with the resolution authority. It was also suggested that the clearing members should receive equity in return for contributions to the resolution cash call. However, another speaker considered that this approach would lead to re-mutualising the CCP and needed further thought; if equity was wiped out, it should be in favour of new money. Another issue was that these tools impacted end-users and this would be a situation left to management discretion; it would therefore be preferable to put that under resolution, a panellist suggested.

Whether an exposure to a CCP was capped or uncapped was also a critical issue for clearing members, who were asked by their regulators to measure risk ex ante if they were joining a clearing house that had the potential for uncapped liability. This was the case for some CCPs, where members had to cover remaining losses that exceeded the guarantee fund for the CCP to continue its operations. In many other CCPs however there was a cap on a single default, for which the guarantee fund could be used. What happened in this case if the breakdown was more systemic and if more than one clearing member defaulted was however unclear, because clearinghouse approval was necessary for a member to withdraw and members were subject to a continued replenishment obligation of the guarantee fund over a period of time. Having the market provide large cash calls at a bad time was procyclical. Therefore the best way to arrange financial resources, in terms of market stability, was to have a capped structure as the standard, a speaker stated.

International Coordination

The delay of European legislation until the end of the year to allow international standards to >>>

>>> develop was applauded. The prospects for success were far greater when everybody reached a degree of consensus around international standards at the start, and were held to them, rather than engaging in lengthy equivalence processes.

They however faced the challenge that laws were made nationally and decisions were made by local authorities, while the financial system was global, markets were interconnected and many CCPs had a global dimension and shared the same clearing members. Outcomes had to be delivered that worked for all jurisdictions when they faced a stress event, but they did not yet have an appropriate answer for that, a speaker believed. Barriers had been created between financial systems because it had not been possible to reach reliance and trust. Although the framework should work for both the home and host countries of a cross-border CCP, the issue was not to protect a specific country but the whole financial system, another speaker emphasised, this was a global issue. Another challenge was that business could move from one CCP to another and potentially concentrate in the weakest point in terms of regulation, and this would threaten stability.

Establishing a minimum set of common standards at the international level, such as those defined by the FSB and CPMI-IOSCO, was a necessary starting point for addressing these different issues. There remained however the issue that laws were local and would be applied by local authorities, a speaker stressed.

Moreover prudential and market supervisors needed to be brought together in the event of a CCP resolution in order to avoid contradictions between them. This required knowing where the possible barriers were, e.g. regarding clearing members that may be located in different jurisdictions, and pre-planning in order to have enough legal certainty. ●

Insurance: what systemic risks in the insurance sector?

KEY ISSUES | *This session was intended to clarify where we standed regarding the definition of NTNI and HLA and more generally the global framework dedicated to the systemic threats possibly posed by certain insurance groups. The panel also outlined possible adjustments required by the Global framework.*

Designing globally a better methodology for systemically important insurers

The IAIS was a technocratic body of supervisors, not a legislative body, and had no legal authority. Its role was to develop standards, which democratically elected bodies can then decide whether or not to adopt.

However, a 'glass ceiling' existed between the IAIS and the FSB: the FSB was pursuing its objectives without access notably to systemic risk management plans that were submitted to the IAIS, and a more detailed consideration would need to take place of what should be in these reports, to avoid systemic risk in the sector.

The Parliament had recently adopted an initiative report on the governance issue linked to global standard setting. Elected representatives of the population should be capable of explaining to voters where rules arose from; sometimes, this was not possible. This was very important provided that insurance regulation had significant potential impacts on growth and job creation. During the financial crisis, the G20 had played a major and positive role in finding a global solution; however, the G20 was also entirely undemocratic, and non-universal. Now there needed to be more consideration of how to increase cooperation and accountability.

In 2013, the IAIS published its First Methodology to assess globally systemically important insurers which contained provision for review every three years. The first review took place and an updated methodology was published in November 2015 for public comment. The IAIS has been considering comments received and revisions to be made to the 2015 Updated Methodology. Comments have been supportive of the direction of travel, although some had wanted to go further.

The IAIS was focusing on the development of 'absolute reference values'; clarification of >>>

>>> what was going to happen within 'phase 3', the qualitative phase, and the reinsurance supplemental assessment; and the best way to make processes transparent for the benefit of firms. This new methodology would be published in the first half of this year, and would be applied to data that the IAIS had already started collecting, with a recommendation made to the financial stability body regarding designations in October.

Although there had been a lot of concern about nine groups being designated as internationally systemic, this should not detract from what the IAIS had done to work towards a common framework for the supervision of internationally active groups that recommends good practices, a common culture of supervision, and early warning systems, among other improvements. Given that the IAIS had no legal authority over any firm, no standard was legally enforceable; crisis management groups were already active, assessing liquidity and producing resolution plans. Initiating the development of the first ever capital standard in insurance was a significant achievement.

Systemic Risk and Reinsurance Groups

Reinsurance has been singled out for supplemental assessment in the latest IAIS G-SII designation methodology proposal, despite consensus that traditional reinsurance business is unlikely to be systemically risky. The rational provided by the IAIS is the concern that reinsurance might lead to institutional and/or geographical concentration risk. Many studies by IAIS, regulators, and rating agencies classify reinsurance as "unlikely to be systemically risky". Accordingly, reinsurance is neither a source nor an amplifier, but rather a mitigant of systemic risk. Concentration risk assessment is first and foremost quantitative in its nature and cannot be captured with a discretionary qualitative assessment. If there were concerns about large exposures – i.e. concentration risk, a solid quantitative assessment should primarily take place and not a totally discretionary qualitative assessment. At least one reinsurance institution prepared such a quantitative assessment and is making it available to the IAIS. The outcome of this assessment has proven to be quite impressive, having identified that reinsurance is far from systemic.

Concerns Raised by Insurers

The European Parliament had recently adopted an initiative report on the governance issue; it had appreciated the direction that it had been given, but had some concerns, as did the insurance sector.

One institution stated that it was generally accepted that, in banking, size was the basis of designation as systematically important, but this was not the case in insurance: diversification meant that large groups were not necessarily riskier. The notion of residual risk also needed to be borne in mind as an insurance company's role was to accept and manage risks i.e. the products might be hedged or not hedged, or diversified or non diversified. They were of the view that the designation framework focusing on a few institutions and activities overlooked the biggest risk: namely, low interest rates, which endangered long-term savings, social security and social stability and had a significant impact on the financial sector. This was not just a risk for insurance, but for society more broadly; it was a risk for long-term savings, social security and social stability, because people did not get a return on their savings, and it was very difficult to get guarantees. This had a very broad-based impact on the financial sector.

There was a difference between FSB and the United States in relation to designation: the Metlife case demonstrated the possibility of judicial reviews in the United States, but if an institution was designated as a GSII by the FSB, it had no right of appeal. FSOC derived its authority to designate U.S. non-bank financial institutions as U.S. non-bank SIFIs, from the Dodd-Frank Act, which also provided designated firms with a legal means to contest their designation. In this context, Metlife requested a judicial review of FSOC's decision and the judge rescinded its designation. FSOC has filed an appeal. Metlife welcomed this decision as a recognition of certain of its claims.

There was a need for increased transparency; one insurance representative noted that her institution delivered data, but did not know how its scores were calculated, or at what level an activity was deemed to be systemically risky. Firms should be told what their situation was, in order to allow them to manage their systemically risky activities. The IAIS could consider developing a more proportionate approach to policy measures, whereby as institutions became less important, the policy measures applied to them decreased proportionately. This needed to be articulated to avoid large cliff effects.

Non Traditional/Non Insurance

The IAIS had published a paper regarding the definition of NTNI activity in November, separate from its proposed updated Methodology; this affected a number of work-streams. Its purpose was to articulate why the IAIS considered certain activities NTNI, and to connect this to transmission channels. Numerous comments had been received, with the industry generally welcoming the fact that the IAIS was trying to better articulate why certain products were NTNI, but being concerned >>>

>>> that the IAIS was conflating macro prudential risk with micro risk, particularly in the case of variable annuities and the management of variable annuity risks with purchase of derivatives.

Most people agreed on the definition of non insurance activity, but the non traditional space was more difficult to define. One insurer had conducted work on this issue identified, which demonstrated that the notion of NT was not conceptually sound. Another agreed, noting that the 'NT' aspects of NTNI were most concerning in terms of systemic risk. They had identified that it was very difficult to achieve a binary, strict classification of which products were NT: in an overall assessment of how systemic a company was, it was necessary to look at what the drivers of the systemic risk were, and what features of an insurance product were most likely to contribute to systemic impacts. Qualitative assessment needed to be taken into account.

Single large institutions' failures are not the only source of market impact. Several medium institutions' reactions to market stress must also be considered, as identified in the 2016 IMF global financial stability report. One example of this form of stress is low interest rates, which is something that is not captured within the definition of NTNI or via the designation of companies; it is an issue that impacts small and medium sized companies also. To tackle this, it would be necessary to take into account different measures, including macro surveillance programmes, micro supervision, and cooperation between supervisors.

Alternative Approaches

If activities gave rise to systemic risk, they should be appropriately noted and regulated across the industry as a whole. This approach was much less likely to disturb competitive balance within markets and give certain firms advantages over others; at least one representative of the insurance industry was pleased that the assessment methodology was being reviewed and reconsidered, as the current methodology confused the concept of vulnerability with the concept of systemic impact. Within the industry, there were extensive risk management programmes, but the many of the assessment Methodology presently in use ignored these product and balance sheet risk management tools.

One insurer felt that if the IAIS and others persisted in assessing firms, they would need to not only look at the relevance of the firm compared to other insurance firms, but also as compared to financial markets as a whole. The comparison should be with some kind of objective benchmark of the sort of damage that a firm or an activity could do to the financial system. Separating vulnerability from impact of failure, considering risk management tools, and using objective benchmarks instead of relative analysis would produce a much more reasonable approach.

A representative of a different insurer replied that products could not be labelled as non traditional without understanding the individual product features, and the proposal should not introduce an entirely discretionary assessment. A representative of a supervisory authority commented that the ideal approach was one that combined quantitative proxies with more accurate qualitative information, while maintaining full transparency in relation to designation.

Expected Evolutions

The designation of individual large companies misses an additional equally important source of systemic relevance, which might come from small to medium sized firms' reaction to continued low interest rates coupled with asset price shocks, or through very large duration mismatches. These could affect a wide variety of firms. This activity based or sectoral source of systemic risk was different in nature, and therefore required different policy measures. To deal with the possibility of activities based or sectoral systemic risk, as opposed to that arising from individual companies, the IAIS was providing the appropriate 'building blocks'; one of these was ComFrame, which contained within it the ICS that the IAIS was developing.

Today, much of the focus in relation to systemic risk in the insurance space was on variable annuities, because managing these required dynamic derivative hedging; if markets were to stop, the owner of these would be 'stuck' with a lot of derivatives and liabilities that did not have any more cover. Companies should not be incentivised to not hedge to cover their risk, and as such, incentives to reduce interconnection needed to be put in place, with the systemic designation taking derivatives' interconnectedness into account in a thorough way.

The ICS represented an opportunity to improve the product based approach: it would be a better base for calculating the HLA, compared with the BCR, but would also allow for all supervisors to use the same metrics for measurement, and would avoid regulatory arbitrage between different jurisdictions. It would also allow product based classification to be abandoned to a certain extent, and would promote the development of better measurement of certain dimensions that were relevant to systemic risk analysis. ●

>>> 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. ●

Global coordination: how to improve the coordination of capital market regulation and capital market data?

KEY ISSUES | *This roundtable discussed the need for further regulatory coordination at the global level in the capital markets area and the possible solutions for improving the global coordination and cross-border implementation of capital markets regulations. The progress made at the international level in the standardisation and sharing of data needed for financial stability monitoring was also examined as well as the remaining issues.*

Regulatory coordination needed improving at the global level despite significant progress

Significant progress had been made regarding global cooperation since the crisis, but many issues remained to be addressed.

A regulator stressed that the communiqué from the 2009 Pittsburgh G20 meeting had been a remarkable statement. The spirit of cooperation read through virtually every paragraph, with encouragement to avoid balkanisation and protectionism. However, in the six and a half years since, the spirit of cooperation had been subsiding; regulators, notably in the US, had been operating somewhat unilaterally. A significant step forward had been achieved regarding equivalence determination in February 2016 in the area of CCPs, which was a positive sign. There was also a general agreement among regulators that more international cooperation was necessary. But countries had different histories and legal systems, which made harmonisation difficult. The backdrop of this situation was substandard growth in which the lack of coordination on global rules played a part. Maintaining a strong global financial services market was essential for economic growth.

Two main issues had to be addressed in order to achieve greater cross-border cooperation between Europe, the US and Asia. Political risk was a first issue: regulators were concerned that deference to other jurisdictions would expose them to a greater risk of being challenged by politicians if investors lost money. Loss of sovereignty was a second concern, with global standards often giving rise to defensive postures on the part of domestic regulators.

The issue, however, was that these problems would not go away in a world driven by a greater degree of populism. A cultural shift was needed, and regulators had a role to play in this, to remind the marketplace that investment in securities markets was essential to prosperity but that this would not go without risks. Market risks should not systematically lead to a political crisis or to investigations. Systemic risks and manipulation were a different issue and regulators were there to police these risks. Making sure that regulators could continue to work together and finding global ways of addressing market issues was also essential in a context where issues were increasingly being looked at in a similar way around the globe, some panellists emphasised. Further developing a culture of compromise among regulators was also necessary.

When considering which areas of regulation could benefit from more global cooperation, OTC derivatives were an obvious candidate, because of the global nature of the market. Repo markets >>>

>>> and the related reporting were another area worth considering.

IOSCO had produced a very detailed paper at the end of 2015, laying out three main approaches to regulatory co-operation (national treatment, recognition and passporting) that would be completed later in the year with a next-steps paper on cross-border regulation. IOSCO was also increasingly using a toolbox approach in its different initiatives, but this raised potential implementation issues. Toolboxes were a set of options but did not establish a standard. Moreover it was not yet clear how equivalence assessments could work with existing vested domestic interests.

Progress had been made with TRs to improve market data

Improving market data was essential since a lack of transparency on the counterparty credit exposures of large swap dealers had been at the heart of the financial crisis. Significant progress had been made towards making the derivatives market more transparent with the implementation of Trade Repositories (TRs).

TRs had emerged as a key tool for identifying and monitoring systemic risk through the collection and maintenance of derivatives data. They were supported by significant investments and were now receiving and reporting massive volumes of data on derivatives markets. Key questions however remained about whether TRs were achieving the G20 mandate for measuring systemic risks; the usefulness of the data was indeed limited by the fragmentation of TRs at the global level, the difficulty of sharing data across jurisdictions, as well as data standardisation and quality issues including formatting, completeness and accuracy. The implementation of TRs had been so far mostly domestic, with a focus on the surveillance and identification of risks in individual domestic markets - TR data was being successfully used in Europe by the ECB and the ESRB and also in Singapore and Hong-Kong for example - rather than on the monitoring of systemic risk on a global basis, as had originally been planned by the G20.

Capital market data required further harmonisation at the international level

Achieving full consistency of data was a daunting task; therefore an incremental approach had been chosen in order to progressively expand the group of players using standards and a harmonised dataset. Establishing a target for a global data architecture was however necessary, not to lose track of the longer term ambition to achieve more complete harmonisation; swaps data was the number one priority in this regard, some speakers emphasised.

Data standardisation was a win-win improvement for regulators and the financial industry. The importance of data was recognised both by regulators and the industry, notably for systemic risk measurement purposes. There were however huge costs associated with the collection and processing of data, most of which was performed by the industry, in a context of lower margins and higher regulatory costs. Further harmonisation was essential for improving the efficiency of these data-related processes.

It had been hoped initially that standards would first have been defined globally and then implemented domestically, but the implementation had been faster than expected and domestic jurisdictions had established rules before international standards were available. There was a real need to look at data harmonisation issues globally, in connection with organisations such as CPMI-IOSCO, before implementing some of the detailed level requirements at a national level, because data was difficult to improve ex-post. Ideally, a single standard-setting authority could be in charge of establishing standards at the global level, monitoring their adoption and the related rulemaking at the domestic level and ensuring compliance with them, a panellist suggested.

Progress was being made towards further standardisation, in particular through international efforts to establish standard identifiers such as the Legal Entity Identifier (LEI). The adoption of LEIs was very encouraging; more than 430,000 LEIs were registered in Europe and some institutions had about 30% of their counterparties already using one. However, the type of data hierarchy to be used with LEIs had to be defined, since an accounting hierarchy did not work for all parts of the industry, a panellist believed. Moreover, 20% of LEIs had already lapsed, and it was a challenge to keep pressure up to renew them each year; this required cooperation between regulators and the industry. A broader adoption of identifiers, such as securities identifiers, should also be planned in a second stage.

The importance of good quality data was emphasised

Sufficiently clean and good quality data was essential for analysing, sharing and using data collectively across jurisdictions.

Improving the quality of data was a main focus of ESMA in particular, both at the domestic and EU levels. Cleaning data so that it could be used effectively was however a difficult and time-consuming >>>

>>> task. It was important to draw common experiences from the implementation of EMIR, MiFID and SFTR reporting in this perspective, a speaker suggested. EMIR data was not easy to use, and there was the need to gather more information than had initially been defined, because the understanding of risks had evolved. Expectations had to be well managed in such a context, taking into account the tools that were available. Involving the users and providers of the data in the definition of objectives was also important in order to check the feasibility of data collection and analysis.

Another focus was the measurement of systemic risks. This required ensuring that sufficient data sources were available for assessing the interconnectedness between the banking sector and other parts of the financial sector and for monitoring financial stability in the capital markets, which was increasingly important with the CMU objective to diversify the financing of the EU economy. This was quite challenging because the capital markets had a hugely broad horizon. Trying to get reliable data from across the range of different market participants and activities was quite difficult; the attempts made so far had not been very successful. Supervisors needed to work collectively to assess risks in the overall financial system and how they were moving between its different components. In any case, spotting the next crisis was probably too ambitious, so supervisors had to make sure at least that the last crisis would not repeat itself, a panellist stated.

Data governance and access to data at the international level also had to be improved

The FSB target to remove all barriers to sharing data by the middle of 2017 was an important step towards the further harmonisation of derivatives data reporting. It was suggested that a data governance and access framework was urgently needed. This would ensure that data standards were maintained and updated, as markets and regulatory requirements evolved, whilst providing a formal structure for the appropriate sharing of and access to data across jurisdictions.

Data privacy and transference was an emerging issue to be considered in this regard, with ongoing data protection initiatives in Europe and Japan for example. There was concern about whether data would be handled in an appropriate manner if such rules developed further. Moreover, while some regulatory obstacles to the sharing of data had been removed (for example the indemnification provision in the US), others remained, such as Article 75 of EMIR relative to the recognition of TRs authorised in third-countries. ●