

## 1. The Search for Yield – return of leverage

- The search for yield is leading to a return of leverage:
  - *Pension funds and other institutional investors* turn to hedge funds and leveraged products, such as CDO's, CMBS etc.
  - *Retail investors* into leveraged mortgage REITs etc.
- In the case of reversal of interest rates leverage can steepen losses and destabilise the financial system if not properly managed.
- CDO's are complex and the last crisis showed that even the most sophisticated investors did not understand the risks involved. The trend is sizeable and could harm the financial system and the economy as a whole if not properly monitored.
- The trend of pension funds taking on leverage indirectly through hedge funds can also be a risk. We have seen that pension funds with the worst funding position are most tempted to use this route. While investing in hedge funds is not necessarily a bad thing, pension fund risk management practices and due diligence need to be thorough and properly overseen. If things go wrong and funds were to be faced with big losses of savings of millions of people, this can harm public trust in pension funds and hedge funds.
- Retail investors tend to be trend followers with their investments and also go into leveraged real estate and mortgage investment funds, such as mortgage REITs in the US.
- In the case of a reversal of interest rates the value will fall rapidly. Investors might not be aware of these risks.
- Apart from the eventual losses a fire sale could lead to market destabilisation, as mortgage REITs will have to sell-off their MBS's (they hold a large percentage of MBS). This can spill-over to the mortgage rates and reduce economic activity in this field.

## **2. The Search for Yield – volatility to emerging markets**

- The *Search for yield* is being felt in emerging markets and has led to capital inflows in past years.
- After FEDs announcement of tapering there was a reversal of flows and volatility, especially through the bond markets channel.
- Most emerging economies have used the years of buoyance by building stronger economic and financial foundations.
- They have diversified their markets expanding the investor and product base, and made markets more accessible and flexible (FX).
- This helps absorbing shocks but will not entirely avoid a reduction in economic growth. We have seen this already in the IMF's WEO published last week.
- Further reforms, including of securities market structures, will thus be necessary and IOSCO will play a pro-active role here. Miss Arunma Oteyemi, chair of the Africa-Middle-East Committee and Bert Chanetsa, vice-chairman of the Growth and Emerging Markets Committee will explain this in more detail later during the meeting.

### 3. Collateral in a stressed funding environment

- The collateral space is filled with huge uncertainties, lack of transparency and risks of pro-cyclicality that are systemic.
- Banks do increasingly depend on collateral for their funding.
- Demand will grow cumulatively by additional collateral calls emanating from the derivatives package (margin requirements for non-cleared; additional collateral for CCPs; higher capital charges for banks for non-cleared derivatives and increased bank capital requirements.
- Supply has decreased as Central bank lending has absorbed collateral and institutional investors appear to lend out less.
- The question is whether collateral be there where it will be most needed.
- And if the velocity will pick up and help here.
- Market responses we have found include *re-use* and *collateral optimisation and collateral transformation.*
- As these activities are not always disclosed, it is hard to keep track and to know where the risks are transferred to and pooling.
- The collateral space has benefited from a period of low volatility. What if a big event happens and volatility picks up. Haircuts will rise and additional posting of collateral will be needed. This will increase pro-cyclicality in the system and can cause fire sales.
- Disclosure of risk management measures like concentration information and asset encumbrance ratios, etc. is needed.
- Today we are unable to assess the impact of the changes and challenges of the collateral space.

#### 4. Derivatives Markets and CCPs

- CCPs are becoming too important to fail as they pool huge amounts of risk, have become increasingly interconnected with the banking system, and manage enormous amounts of collateral. We agree with the vision of Paul Tucker expressed last week, with whom by the way we have had intensive discussions, that this is the most important risk to the financial system if not adequately managed and supervised.
- A failure of a CCP would be catastrophic for the financial system as they are so interconnected.
- An event, such as a downgrade of the debt of a big firm or country, can cause pro-cyclical effects when CCPs pose margin calls and demand higher haircuts. There are serious fears if there would be enough collateral available in such events.
- OTC derivatives markets have grown since the crisis by almost 10% to \$ 633 trillion outstanding. Total clearing has increased with 213% to \$ 173 trillion.
- We notice that varying types of collateral are accepted not all types highly liquid. In relation, we fear competition on collateral as they are costs to CCPs who are profit maximizing institutions. In addition, we haven't got enough insight in the quality of risk management and models. This, again, is a cost center for CCPs.
- CCPs are also are interconnected with the banking system. Not only are many major banks members of CCPs, but initial margin collateral collected, particularly cash collateral, in some cases may be deposited back into the bank.
- While CPSS-IOSCO recently has published principles for financial markets infrastructure, supervision will have to be expanded and intensified.