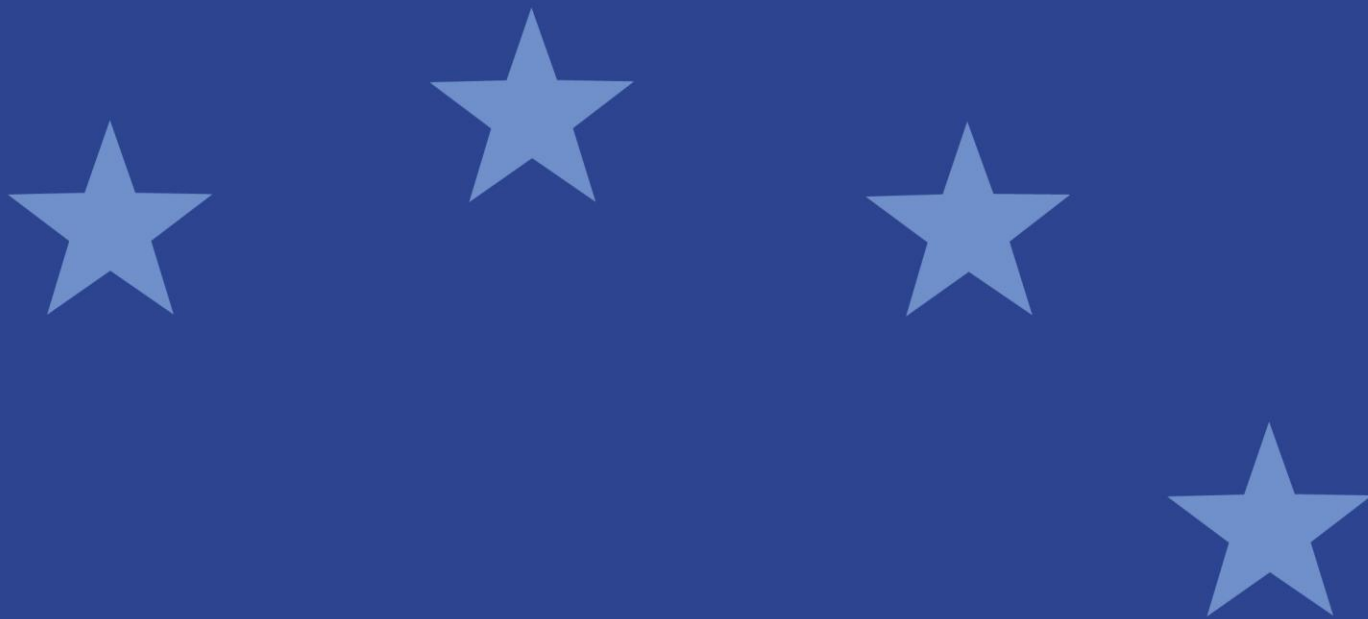




European Securities and
Markets Authority

ESMA Risk Dashboard

No. 4, 2013



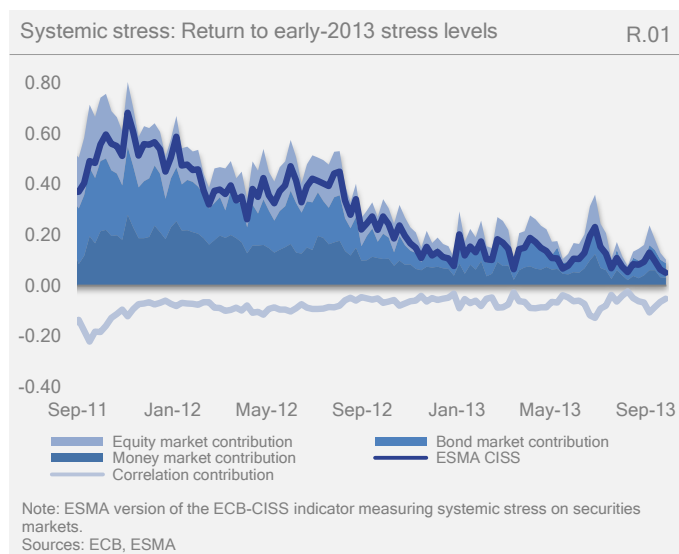
ESMA Risk Dashboard, No. 4, 2013

ESMA Economics and Financial Stability Unit

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ESMA Risk Dashboard



Main risks: Sources R.02	
Economic environment	Change since 2Q13
Macroeconomic conditions	➔
Interest-rate environment	↗
Sovereign debt risks	➔
Reassessment risk	↗
Securities markets conditions	
Tensions in EU sovereign debt markets	➔
Market clustering	➔
Funding risk	➔
Valuation risk	↗
Market functioning	↗
Note: Assessment of main risk sources under ESMA's remit: change since the last assessment. Upward arrows indicate an increase in the contribution to risks, downward arrows indicate a decrease in the contribution to risks.	

Main risks: Categories R.03			
Risk category	Systemic risk	Change since 2Q13	Outlook for 4Q13
Liquidity risk	●	➔	➔
Market risk	●	↗	↗
Contagion risk	●	➔	➔
Credit risk	●	➔	➔
Note: Assessment of main risk categories for markets under ESMA's remit since last quarter and outlook for following quarter. Systemic risk assessment based on categorisation of ESMA Systemic Risk Heat Map, green=low, yellow=moderate, orange=high, red=very high. Systemic Risk Heat Map measures current risk intensity. Upward arrows indicate a risk increase, downward arrows indicate a risk decrease.			

Systemic risk in EU securities markets remained at levels similar to those witnessed in 1H13 – high yet below those observed in more acute phases of the crisis. Market risk increased, as yield curves in advanced economies steepened, giving rise to valuation concerns. This triggered price changes and a reallocation of capital, with revaluation risks expected to continue going forward. Market concern over the US budget situation emerged as the reporting period of this edition of the Risk Dashboard drew to a close, and may be expected to endure as budget negotiations are set to continue after the compromise bill of 17 Oct. In the EU, aggregate risk levels did not increase further even as the focus on underlying risk factors shifted from an unwinding of pre-crisis imbalances towards uncertainties related to policy implementation. Risk levels settled back to early-2013 levels, having ticked-up mid-1H13 in reaction to idiosyncratic events in some more vulnerable Member States (MS). Liquidity, credit and contagion risks remained broadly stable at an elevated level and are expected to remain so over the short-run.

Systemic stress: Following an end-2Q13 spike, systemic stress in EU securities markets remained below levels prevailing during more acute phases of the crisis, with volatility considerable, however. Meanwhile, the volatility of some risk metrics increased, reflecting heightened vigilance of market participants. This was particularly evident with respect to frequently updated expectations regarding monetary policy stances, uncertainty around other policy measures and macro-economic developments, including at the global, EU and country levels.

Economic environment

Macroeconomic conditions: Macroeconomic conditions in the EU generally remained subdued, with performances again diverging as continued negative or almost zero growth in some countries contrasted with good performances in others. Regarding credit risk, two counteracting forces were observable. On the one hand, the further clean-up of private-sector balance sheets and the strengthening of policy frameworks to ensure solvency of sovereigns and banks tended to reduce credit risk. On the other hand, credit risks of banks and sovereigns remained significant, in particular in those countries that were affected by falling real estate prices or worsening macroeconomic conditions.

Interest-rate environment: Within a low interest rate environment, yield curves in major currencies steepened somewhat. Among various global macroeconomic developments, questions about the future levels of liquidity support by central banks garnered particular attention. While rates remained at very low levels overall, discreet nominal increases from such levels result in large percentage moves, with correspondingly significant effects on prices.

Sovereign debt risks: The EU sovereign debt situation continued to affect securities markets, albeit immediate threats due to the deterioration of fiscal or banking sector conditions in various MS appeared to have eased. Uncertainties related to elections and crisis measures in some vulnerable MS, which affected securities markets

Main risks: Summary assessment		R.04
Risk category	Summary	
Liquidity risk	Liquidity risk remained at the high levels witnessed during 1H13, if lower than during more acute phases of the crisis. In particular, balance-sheet driven liquidity support measures remained in place. Underlying recent developments, variability over time continued and heterogeneity across market segments and regions remained elevated. While recent reactions by policy makers and market participants have broadly reduced liquidity risks, fragmentation persists. Indeed, shifts in yield curves could create more segmentation across the maturity spectrum.	
Market risk	Market risk increased to high levels during 3Q13. Market reconfigurations, driven by changes in expectations, revealed risks underlying the prevailing low interest rate environment: yield curves steepened, corporate yields ticked up, and global capital flows reversed. In advanced economies, yields widened at the long end of the curve. Accompanying this was a sell-off in EM from end-2Q13. Related valuation concerns continued throughout 3Q13, if most prevalent in EM and the US. In the short-run, EU financial market conditions would likely benefit from such capital flow reversals.	
Contagion risk	The level of contagion risk in sovereign debt markets remained broadly stable, concentrating in the most vulnerable group of MS. The potential for systemic events remained substantial. Nevertheless, the financial system stabilised somewhat as markets reflected a risk differentiation increasingly driven by market-specific factors. Thus, co-movement of markets was more cohesive while differences across markets were more in line with fundamentals.	
Credit risk	At the EU level, sovereign and corporate credit risk did not further deteriorate during 3Q13. Credit risk declined slightly in countries that experienced better than expected macroeconomic developments. Where asset prices or macroeconomic conditions were deteriorating, however, risk increased. Deleveraging, lengthening of maturity profiles and implementation of sovereign and banking crisis related frameworks somewhat mitigated credit risk. Where macroeconomic expectations improve, however, this could be a mixed blessing. While better growth prospects should raise income and employment, they also could affect yield curves and locally raise credit risk, notably in vulnerable MS.	
Note: Qualitative summary of assessment of main risk categories to markets under ESMA's remit.		

Market functioning: Risk summary		R.05
Risk	Summary	
Benchmarks	Concerns over the resilience of interest rate benchmarks continued throughout the reporting period, as further banks withdrew from some of the relevant panels. ESMA, the Commission, EBA, ECB and national and international authorities work together to improve the governance and resilience of benchmark systems.	
Market infrastructures	Operational stability of market trading venues and systems outside the EU was tested on several occasions during 3Q13. These included data feed interruptions leading to broad trading halts of certain stocks or the erroneous execution of derivative trades by the trading system of a large investment bank. Elsewhere, the resilience of CCPs to systemic shocks merits vigilance as the share of derivatives contracts cleared through CCPs is expected to increase under EMIR.	
Collateral	Key determinants, such as demand, supply, rehypothecation, and changes in asset quality and their potential to impinge on financial stability are being monitored closely. Immediate risks to collateral availability appear limited, however.	
Shadow banking	Amid subdued securitisation issuance, shadow banking continued its gradual contraction, with leverage ratios in the non-bank financial sector staying below pre-crisis levels. Exposure of MMFs, Hedge Funds (HF) and other fund types to credit and funding risk remains a concern. Systemic risks from high degrees of interconnectedness, credit risk concentration, and liquidity flows remain under surveillance.	
Note: Qualitative summary of assessment of main risks to the functioning of markets under ESMA's remit.		

during 2Q13, continued to be relevant in 3Q13. As the reporting period drew to a close, tensions arose around US budget negotiations, raising market uncertainty over the ability of the US to avert technical default. While the immediate situation was defused by the 17 Oct compromise bill, budget negotiations are set to continue subject to new deadlines in 1Q14, and markets can be expected to remain alert to developments in this area.

Reassessment risk: While some crisis-related tensions eased in 3Q13, a variety of other stress factors influenced EU securities markets within the reporting period. Notably, 3Q13 saw a reassessment of market risks, which triggered an asset rotation from emerging markets (EM) to developed markets. Correlations between equity and bond markets strengthened as, at prevailing valuations, both appear sensitive to changes in yield curve expectations.

Securities markets conditions

Tensions in EU sovereign debt markets: Sovereign bond yields remained broadly in line with levels witnessed in 1H13, with cross-country dispersion broadly stable. Bond yield volatility flattened out, after uncertainties which affected securities markets during 2Q13 continued to ease during 3Q13. Irrespective of the broad decline in bond yields for MS, yields of the most vulnerable sovereigns fluctuated with the news flow on structural progress and banking sector reforms in these countries and the economic and political uncertainties surrounding them. Wider spillover effects were rather limited, however.

Market clustering: Clustering remains relevant for EA securities markets as is evident from the stronger correlations of yields *within* groups of countries, and weaker correlations *between* groups. During 3Q13, the composition of clusters became more persistent, with contagion risk largest among the most vulnerable sovereigns.

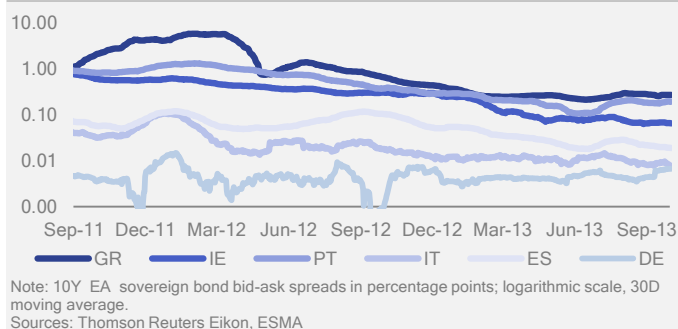
Funding risk: Funding risk eased somewhat during 3Q13, as corporate and sovereign access to equity and debt markets improved. Notwithstanding enhanced market access, issuance activity of debt securities decreased for most market segments, especially in the case of shorter-term paper. Despite ongoing bank deleveraging, future funding risk of banks remained elevated as a substantial fraction of debt outstanding remains to be rolled over in coming quarters.

Valuation risk: The low interest rate environment continued to influence behavioural patterns in financial markets and the risk of a sudden revaluation of market risk increased. Specifically, the low interest rate environment provided incentives for excessive risk-taking by investors, for example by rechanneling funds into more risky asset classes or seeking higher leverage. Future market reactions to global changes in yields could precipitate such risks.

Market functioning: Key structural issues, which may become relevant to the stability of EU financial markets, relate to benchmarks, market infrastructures, collateral, and shadow banking. For a summary risk assessment see textbox R.05.

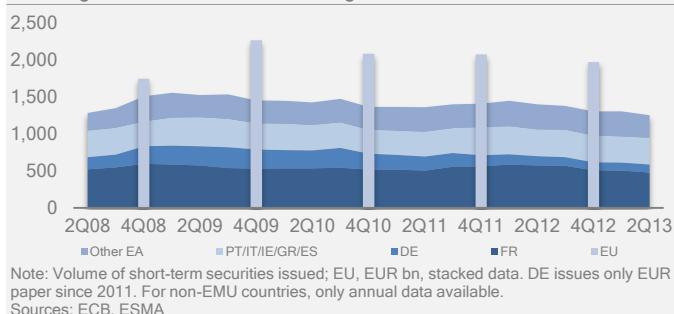
Liquidity risk

Sovereign bond bid-ask spreads: Broadly at 1H13 levels R.06



Liquidity risk remained at the high levels witnessed during 1H13, if lower than during more acute phases of the crisis. In particular, balance-sheet driven liquidity support measures remained in place. Underlying recent developments, variability over time continued and heterogeneity across market segments and regions remained elevated. While recent reactions by policy makers and market participants have broadly reduced liquidity risks, fragmentation persists. Indeed, shifts in yield curves could create more segmentation across the maturity spectrum.

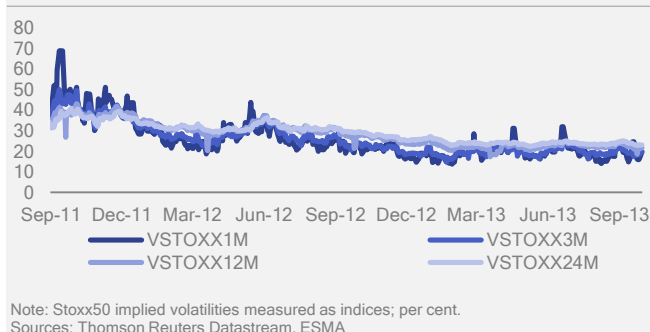
Sovereign short-term issuance: Marginal decline R.07



Sovereign bond bid-ask spreads: Bid-ask spreads of EA sovereign 10Y bonds broadly remained at 1H13 levels. For more vulnerable sovereigns, spreads ticked up early in the quarter and, with the exception of one, stayed at these levels for the remainder of the quarter. For one large core sovereign, spreads ticked up toward the end of the quarter. Overall, liquidity conditions remained differentiated across markets, reflecting country-specific differences. Sensitivity to developments in more vulnerable sovereigns remained elevated.

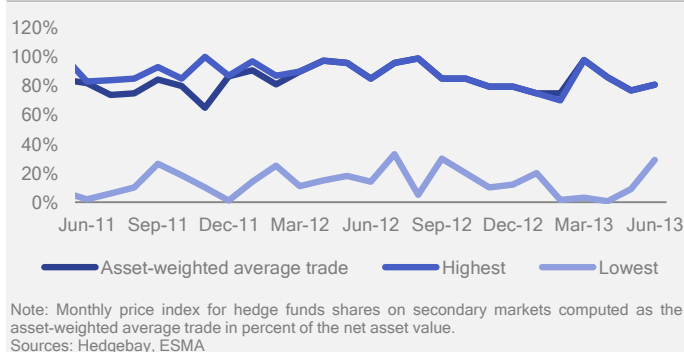
Sovereign short-term issuance: In 2Q13, the outstanding volume of short-term securities resumed the declining trend established early-2012, having paused in 1Q13. Issuance was broadly stable by sovereigns in the largest economies as well as by those most vulnerable. Notwithstanding continued fiscal deficits and rising debt in the EA, the continued reduction in short-term issuance would indicate that debt managers are able to use the low interest rate environment to extend maturity profiles. This is also consistent with an easing of funding conditions. The prevailing issuance of short-term paper remained elevated by comparison with the pre-crisis period, however.

Volatility of equities: Broadly stable R.08



Volatility of equities: Implied volatilities of equity markets broadly remained at levels observed in 1H13. In an historical context, variability remained mildly elevated, even if slightly lower than in 2Q13, and concentrated in the shorter-end of the spectrum. Implied volatilities remained low by comparison with more acute phases of the crisis, especially for the short-term. This suggests a greater consensus was forming around market expectations regarding equity valuation.

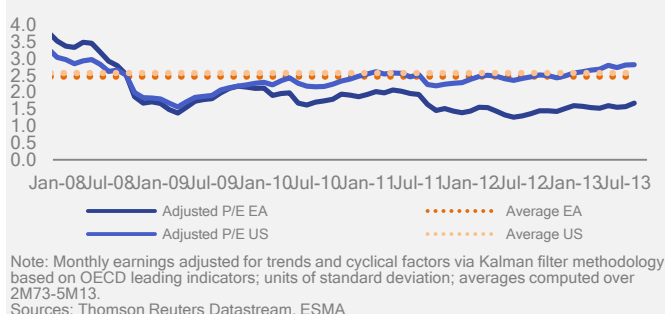
Hedge fund shares' liquidity premia: Remained elevated R.09



Hedge fund shares' liquidity premia: The liquidity premium required by investors to acquire shares of hedge funds on the secondary market increased to mid-2012 levels, having compressed briefly in March 2013. This may signal renewed caution entering investors' expectations of hedge funds' future performance. Factors affecting the liquidity of investment into hedge funds include broader market trends and macroeconomic risks.

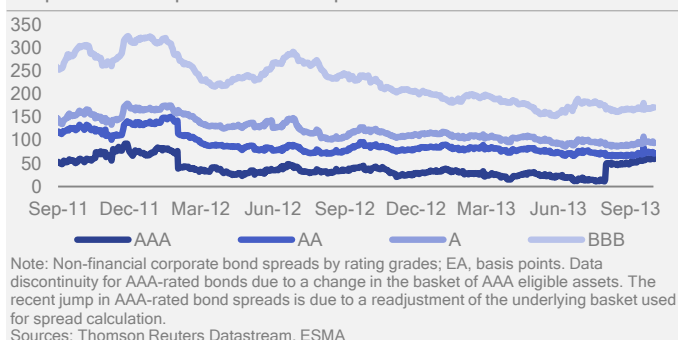
Market risk

EU and US equities adjusted PE-ratios: Divergence remained R.10



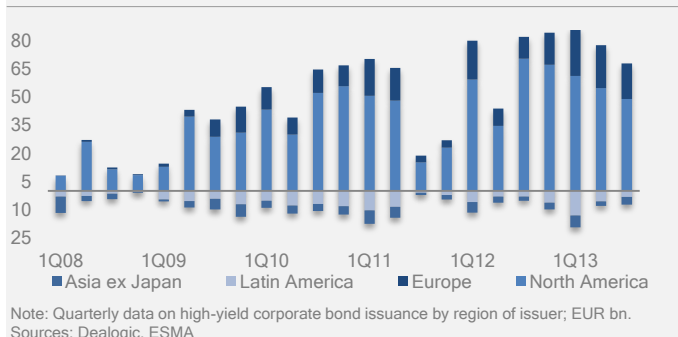
Market risk increased to high levels during 3Q13. Market reconfigurations, driven by changes in expectations, revealed risks underlying the prevailing low interest rate environment: yield curves steepened, corporate yields ticked up, and global capital flows reversed. In advanced economies, yields widened at the long end of the curve. Accompanying this was a sell-off in EM from end-2Q13. Related valuation concerns continued throughout 3Q13, if most prevalent in EM and the US. In the short-run, EU financial market conditions would likely benefit from such capital flow reversals.

Corporate bond spreads: Ticked-up R.11



Equity price-earnings ratios: EA price-earnings (PE) ratios, below their long-term average, increased slightly during 3Q13. They hovered around levels witnessed since 2009, thus not signalling risk of overheating. This measure is based on a EA stock index, hence potentially masking important heterogeneity in markets across the EA. On the other hand, the US PE ratio continued to rise so that the gap between the two regions remained stable.

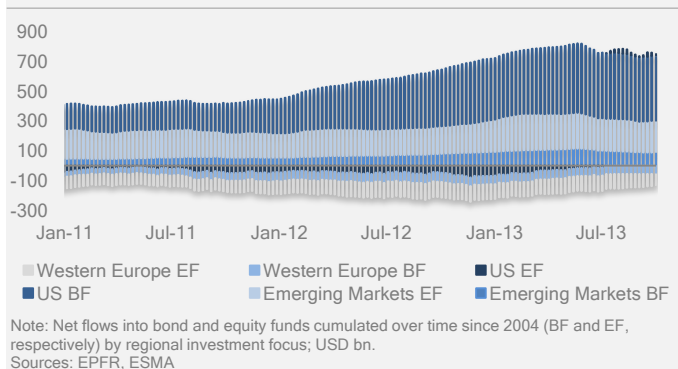
High-yield corporate bond issuance: Remained high R.12



Corporate bond spreads: Bond spreads of investment-grade non-financial corporations in the EA broadly remained at 1H13 levels, somewhat elevated (except for AAA rated bonds) compared to the pre-2007 period, but well below those of peak-crisis periods. Spreads exhibited slightly elevated volatility during 3Q13, especially for lower rated bonds. As search-for-yield behaviour would suppress spreads, the moderate spread increase during 3Q13 could be interpreted as a normalisation of risk valuations. Recent fluctuations suggest that bond markets retained a heightened vigilance toward changes in the macroeconomic environment, frequently updating their expectations, and perceived credit risk.

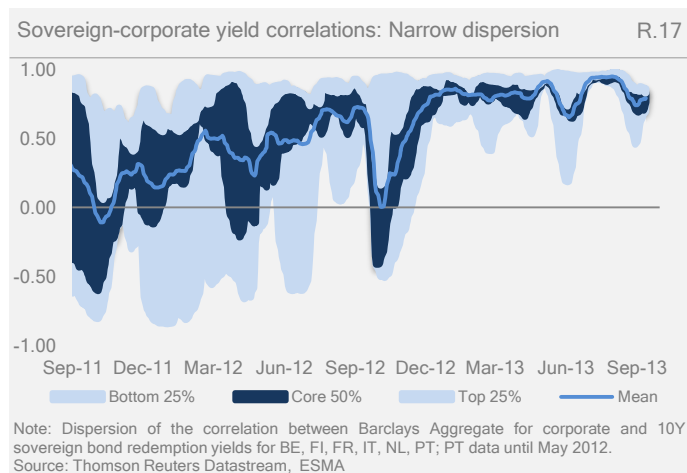
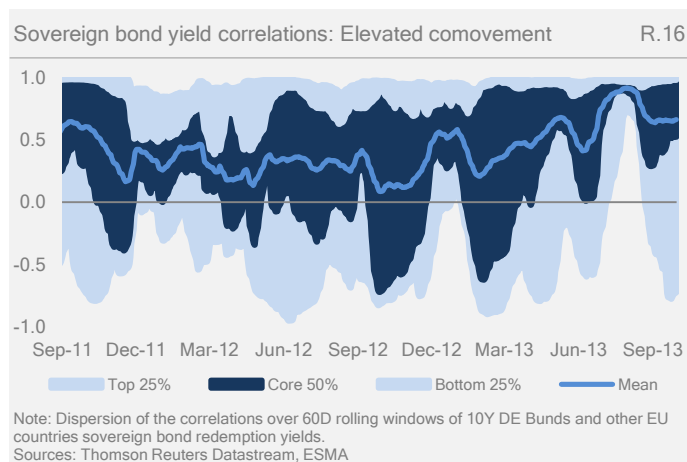
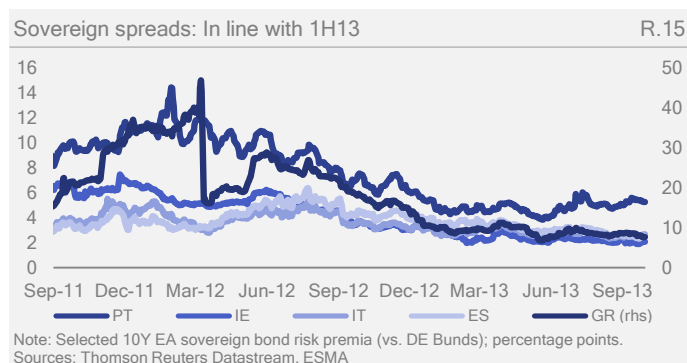
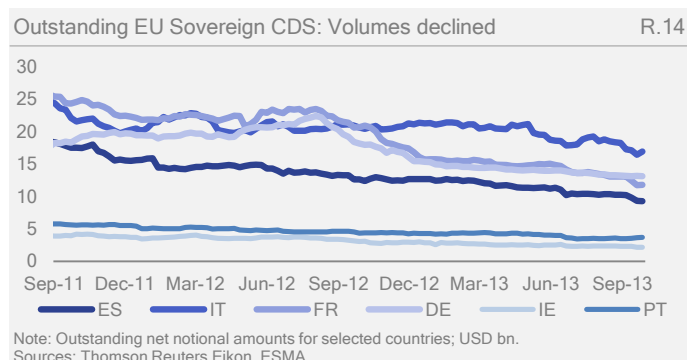
High-yield corporate bond issuance: In 3Q13, high-yield corporate bond issuance declined somewhat in North America, the EU and Japan, but remained rather strong in Latin America. The continued decline in the EU is in line with the general negative trend observed also in issuance of other debt securities. Again, the aggregate figures disguise heterogeneity among EU countries.

Investment fund flows: Part-reversal R.13



Investment fund flows: Net inflows into investment funds generally displayed high volatility during 3Q13. This peaked at the beginning of the reporting period, marked by a shift in yield curves in advanced economies as well as a sell-off in Asia. The latter included a decline in stock prices across Asia and the devaluation of some Asian G20 currencies, reflecting asset reallocation across markets. Somewhat improved prospects for the US and some European economies further increased the relative attractiveness of developed markets over EM investments. In particular, US and Western European equity and bond funds experienced higher inflows compared to the previous period. Cumulative net flows into US equity funds turned positive for the first time since mid-2004.

Contagion risk



The level of contagion risk in sovereign debt markets remained broadly stable, concentrating in the most vulnerable group of MS. The potential for systemic events remained substantial. Nevertheless, the financial system stabilised somewhat as markets reflected a risk differentiation increasingly driven by market-specific factors. Thus, co-movement of markets was more cohesive while differences across markets were more in line with fundamentals.

Outstanding EU sovereign CDS: Net notional outstanding CDS volumes continued to decrease slowly or stabilise for most EA countries. For one larger and more vulnerable sovereign volumes exhibited noticeably more volatility, ticking up briefly at the beginning of the period. Volumes are linked to both size of the underlying market and vulnerability of the sovereign. Against a background of still increasing sovereign indebtedness and absent significant supply constraints, this development indicates broadly reduced demand for CDS protection and may reflect a continued easing of the acuteness of the crisis.

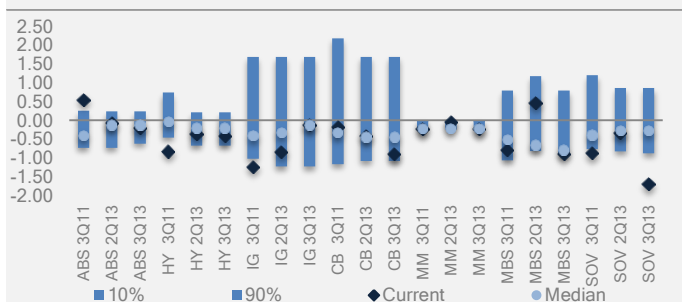
Sovereign spreads: Spreads of vulnerable EA sovereigns' 10Y bonds to Bunds generally remained within the range observed in 1H13. Indeed, several trended back toward the lows of 1Q13. One vulnerable sovereign, however, resumed an upward trajectory established in 2Q13. This development partly reflected continued political uncertainty. Within this broad levelling-off of spreads at levels not witnessed since early-2011, investors thus remained vigilant vis-à-vis risks in vulnerable MS. That being said, the spreads for most vulnerable sovereigns at the longer end of the curve have moved more closely together when compared to early-2011.

Sovereign bond yield correlation: Correlations of Bunds with other EU 10Y sovereign bonds broadly remained above the – by crisis standards – relatively high levels seen in 2Q13, approaching unity before receding somewhat later in the quarter. The dispersion was driven by the most vulnerable sovereigns. This continued co-movement of EA sovereign yields at levels not seen since end-2010 suggests that expectations regarding EA sovereigns are to a greater extent aligned than during more acute phases of the crisis. Notwithstanding the high sensitivity of the most vulnerable sovereigns, with markets continuing to differentiate across markets, system resilience may have enhanced.

Sovereign-corporate yield correlation: On average, correlations between the yields on selected 10Y benchmark EA sovereign bonds and respective corporate bonds followed the trend witnessed among sovereigns in 3Q13. Having approached unity, they deteriorated somewhat during the quarter, though remaining at the relatively high levels seen throughout 1H13. By comparison with correlations among sovereigns alone, co-movement within this measure was somewhat stronger, with outliers largely driving the dispersion on both sides of the mean.

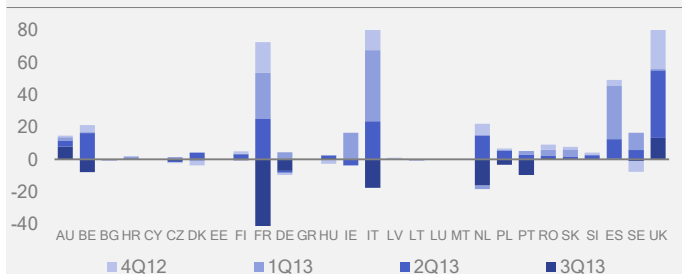
Credit risk

Sovereign debt issuance: Continued decline R.18



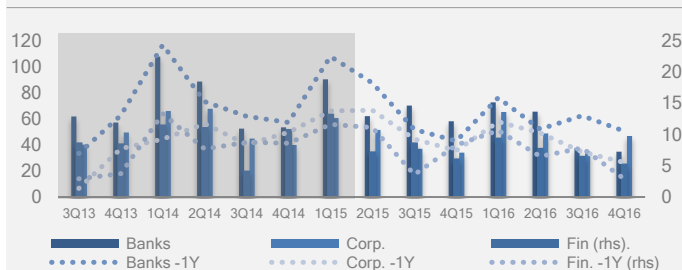
At the EU level, sovereign and corporate credit risk did not further deteriorate during 3Q13. Credit risk declined slightly in countries that experienced better than expected macroeconomic developments. Where asset prices or macroeconomic conditions were deteriorating, however, risk increased. Deleveraging, lengthening of maturity profiles and implementation of sovereign and banking crisis related frameworks somewhat mitigated credit risk. Where macroeconomic expectations improve, however, this could be a mixed blessing. While better growth prospects should raise income and employment, they also could affect yield curves and locally raise credit risk, notably in vulnerable MS.

Sovereign net debt issuance: Low activity R.19



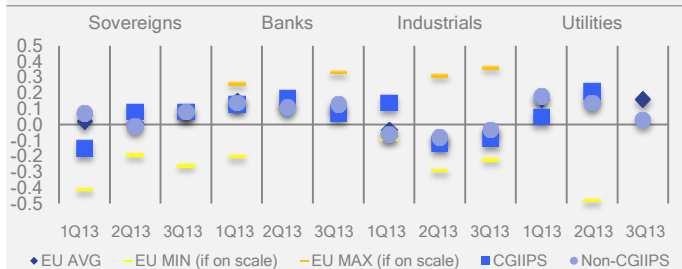
Debt securities issuance: Most market segments experienced a decline in issuance of securities with a maturity of more than 18 months. Thus, 3Q13 accentuated a trend that has persisted over the past four quarters. In particular, sovereign bond issuance declined more than in previous quarters. While investment grade and high yield corporate bond issuance revived somewhat, MBS issuance declined again after spiking up during 2Q13.

Debt redemption profiles: Somewhat shortening R.20



Debt redemption profiles: From 3Q13, EU private corporates needed to repay EUR 1,607bn of outstanding debt until the end of 2016; thereof, about EUR 837bn will have to be repaid by 1Q15. Redemptions by banks until 1Q15 amount to EUR 449bn; by non-bank financials to EUR 56bn; and by non-financial corporates to EUR 328bn. Repayment profiles of all sectors were shortened somewhat over the past year. Note that repayments to central banks are not included in bank redemptions, including longer-term refinancing operations (LTRO) provided by the ECB in December 2011 (EUR 489bn) and March 2012 (EUR 530bn). Since the beginning of this year, banks started to make use of their early repayment option. For 3Q13, the ECB reported early repayments of EUR 32bn (until Sept. 2013), bringing the remaining LTRO balance down to EUR 714bn, which remains substantial but leaves banks time to close the funding gap until March 2015.

Debt maturity: Increasing with low rates and deleveraging R.21



Debt maturity: Average maturities of outstanding debt increased in 3Q13 across nearly all sectors except for industrial corporates. Sovereigns that were able to access market-based financing could thus benefit from low interest rates and relatively flat yield curves. Still, some EU sovereigns continued to experience funding constraints, also affecting their ability to expand maturities. The general increase in average maturities of banks may be closely related to deleveraging in this industry: Average maturities of debt outstanding increased while net issuance of short-term debt declined to a greater extent than that of longer-term debt.



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