

**JOINT COMMITTEE REPORT ON
RISKS AND VULNERABILITIES IN THE EU FINANCIAL SYSTEM
AUGUST 2015**

Executive summary	1
1 Introduction	2
2 Risks concerning the low profitability of financial entities in a low yield environment	2
2.1 Impact of low yields on profitability and asset valuations	3
2.2 Business models challenges	5
3 Risks related to market-based funding and market-based credit intermediation	7

EXECUTIVE SUMMARY

The severity and character of the risks to the EU financial system have persisted since the March 2015 JC report. Risks resulting from low interest rates and search for yield remain unchanged. Risk around reductions in market liquidity and their implications for asset managers persist. The fragile economic recovery continues to adversely affect the profitability of the financial sector. Market uncertainty related to the financial situation of Greece led to the introduction of capital controls, high market volatility and renewed risks to the cohesion of the euro area. An agreement between Greece and the other euro area countries to negotiate a comprehensive financial assistance programme and the provision of temporary funds, however, mitigated immediate risks.

Amongst others, search for yield increased asset prices and compressed yields, **rendering investors' positions vulnerable to a potential market reassessment of risk. The profitability of banks remained under pressure** with high stocks of legacy assets and non-performing loans and reduced volumes in some business segments adding further strain. Life **insurers faced the threat of tightening margins** between investment returns and guaranteed rates and maintaining adequate levels of profitability remains a core challenge.

Reduced corporate bond market liquidity exposed **asset managers to valuation risks**, also due to increased investments in illiquid assets. Related concerns about asset managers' liquidity risks may indirectly **impede plans** to promote economic growth through **capital markets** channelling funds managed by institutional investors to the real economy, in particular SMEs.

To manage those risks and enhance capabilities to provide credit, supervisors need to **scrutinise efforts to clean up balance sheets** and **the sustainability of financial entities' business models**. A clear picture of institutions' earnings potentials, funding mixes and strategies is crucial. Promotion of **rigorous valuation** of assets and liabilities and transparency in the **disclosure of valuation risk** is essential to discourage mis-valuation tendencies. Regulators should continue, step up and complement recent measures and plans to **support market-based funding** by, for example, **devising appropriate and harmonised regulation for non-bank loan origination models** as well as **supporting adequate, transparent and harmonised marketing of investment products**. Regulators should also strive to ensure that undertakings engage in consistent, comparable and high quality communication with their customers and investors.

1 INTRODUCTION

Since the March 2015 Joint Committee Report on Risk and Vulnerabilities the risks facing the EU financial system remained similar in nature. Currently the main risks challenging financial stability in the EU are:

- the low interest rate environment and its impact on the profitability and business model sustainability of financial institutions;
- the continued search for yield by financial institutions and the associated mispricing of assets;
- reductions in market liquidity and implications for asset managers;
- political and economic risks due to uncertainty around the resolution of problems related to Greece's financial situation. Partial materialisation of risk already led to capital controls, high market volatility and risks to the cohesion of the euro area.

As highlighted in previous reports, if the tightening in credit spreads observed throughout the first half of 2015 is not in line with future economic developments, **a re-emergence of concerns about sovereign debt sustainability** reflecting high public sector indebtedness, large fiscal deficit and insufficient fiscal consolidation in some countries **could trigger a change in market sentiment**. Such concerns apply particularly in the euro area, also in reaction to potential adverse developments regarding the long-term trajectory of the **Greek financial position** (Cf. Box 1). Another potential trigger could be **increasing international risks**, e.g. following **heightened market volatility in China**, the **events in Ukraine**, fluctuations in commodity prices or divergence of monetary policy conditions between major jurisdictions. Adverse spill-over effects from China, or other emerging market economies facing reduced growth, could provide further challenges to the EU economy.

2 RISKS CONCERNING THE LOW PROFITABILITY OF FINANCIAL ENTITIES IN A LOW YIELD ENVIRONMENT

Amid concerns that inflation would remain too low for a prolonged period, EU central banks **implemented a number of monetary policy measures** aimed at providing further stimulus to the economy. These measures included historically low central bank interest rates and, in some instances, asset purchase programmes. In March 2015 the ECB's expanded asset purchase programme (APP) was launched, encompassing a set of euro-denominated investment-grade public sector securities and integrating the purchase programmes for asset-backed securities and covered bonds launched in autumn 2014.¹

Those measures, aimed at fulfilling central banks' price stability mandates and addressing the risks of a prolonged period of low inflation, should have a positive effect on inflation and growth, and consequently on medium-to-long-term business prospects of EU financial institutions. **Regarding banks, monetary policy measures provided additional funding**, for example via the ECB's targeted longer-term refinancing operations (TLTROs) and a reduction in long-term government bond yields, which are the basis for the pricing of a large variety of assets and loan contracts. Both effects supported banks' essential financial intermediation function for the real economy. The **insurance sector would possibly also benefit through** increased sales in the medium-to-long-term, as growth in written premiums can be affected by GDP growth. Moreover, as QE programs have had a positive effect on asset prices, some insurers, and especially non-life insurers, might have been able to take advantage of improved asset valuation and investment return over the short run.

¹ ECB (2015), Financial Stability Report (FSR), May 2015, pp.19-21; <http://www.ecb.europa.eu/pub/fsr/html/index.en.html>

Notwithstanding its financial stability benefits, a prolonged accommodative monetary policy stance has, owing to e.g. search for yield, **side-effects** in form of risks for the **profitability and business models of financial institutions** and for the **valuation of assets** in securities markets. Weak macroeconomic conditions further add to the substantive challenge of protracted low profitability in the EU banking and insurance sectors.

2.1 IMPACT OF LOW YIELDS ON PROFITABILITY AND ASSET VALUATIONS

In the banking sector, net interest income in a protracted low interest rate environment **remains under substantive pressure**, in spite of some recent improvements. Net interest margins on the flow of new lending are particularly affected. Low interest income impedes the ability to attain acceptable levels of return on equity (RoE), especially at banks already facing high levels of impaired loans. Still **high stocks of legacy asset portfolios and non-performing loans (NPL)** in a number of banks and countries, as well as **reduced volumes** in some business segments **add to profitability pressures** and affect RoE. In some situations, conduct-related charges and litigation costs are expected to further adversely affect future profitability.

An increasing gap between costs and operating income can be identified for EU banks during 2014 (Figure 1), with costs growing at an accelerated pace (Figure 2), raising concerns in an environment of low interest rates and interest margins. Although banks' profitability was slowly improving in 2014, mainly driven by declining impairments to financial instruments, it has not yet reached a sustainable level. EBA data indicates that current RoE levels are often not consistent with the cost of equity (CoE), and only around 35% of respondents to the EBA risk assessment questionnaire (RAQ) indicate that their current earnings cover their CoE.

For life insurers, the prolonged low yield environment puts pressure on earnings and profitability. In countries where life insurers provide **guaranteed returns, persistent low interest rates reduce the margin between investment returns and guaranteed rates**. Data² gathered in scope of the EIOPA stress test 2014 showed that the average internal rate of return of the covering assets is below the average level of the guarantees (approximated by the internal rate of return of technical provisions) in many countries (Figure 3). Given the still substantial stock of guaranteed return contracts in many member states, the duration of which often exceeds that of the covering assets, a renewed decline in long-term interest rates or a persistent low yield environment would further weaken insurance companies' balance sheets.

In the short term, as the QE and monetary policy is moving risk free rates downward, the valuation of insurers liabilities on a market consistent basis increases, **weakening their capital position**. Low yields might also provide incentives for search for yield, which would **increase the riskiness of the portfolio of insurers**, leaving insurers vulnerable to a potential re-assessment of risk (a risk reversal scenario). Such a re-assessment, in combination with low risk free rates poses a threat of a "double hit" to insurers as highlighted in the EIOPA insurance stress test 2014. As noted in the follow-up to the 2014 EIOPA stress test, **problems of sustainability** will in general **take time to materialise** and **depend on the current quality of the insurer's asset-liability management, the current capitalisation level and the potential for other risks to materialise** (e.g. caused by an excessive search for yield). However, it is clear that in a prolonged low yield scenario annual cash flows could turn negative for certain companies in 8 - 11 years' time, unless appropriate actions are taken.

While some upward movement in premium rates somewhat eased the burden on insurance companies, the overall return on assets (RoA) continues to be low. Moreover, **current low profitability** is combined with **commercial challenges** which **pressure** insurance companies to continue **offering competitive rates and**

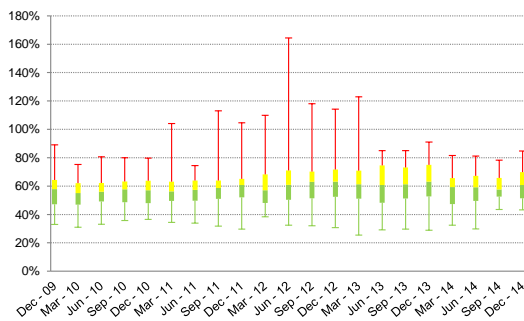
² Data collected referred to end-2013. The results discussed here relate to interest bearing assets with predictable cash flows.

products that appeal to policyholders as yields remain low. A prolonged period of poor results will eventually affect insurers' strategies and business models as already observed in form of increased M&A activity in 2014.

In the non-life sector, **profitability benefited from limited frequency and severity of natural catastrophes over 2014 and claims growth remained benign.** Hence, despite the challenging macroeconomic environment the combined ratio³ as a crucial measure of profitability is relatively stable around 95% for a median company in 2014 as well as 2013 in the sample of companies reporting to EIOPA. Pressure, however, still arises in highly-competitive business lines such as motor insurance.

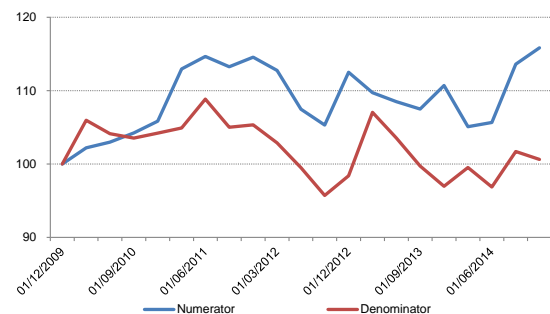
In securities markets accommodative monetary policy⁴ continued to contribute to **increases in asset prices** in markets directly affected by APP. The thereby generated search for lucrative investment opportunities implied the diffusion of price increases and compressed yields across maturity and risk spectra. Investors' risk appetite may have been supported by an upward correction in the present value of future expected revenues, as far as investors did not fully adjust expectations for future risk-free discount rates for possible changes in interest rate levels. Thus, **interest rate risk may add directly to valuation risk.** Valuation risk, in particular if not diversifiable, may in the longer run impact the business models of investment funds (IF) and, even stronger, of money market funds (MMF), which are already exposed to compressed and partially negative yields in money markets. Volatility observed in several market segments illustrates the presence of valuation risk (Figures 7-8).

Figure 1: EU banks' cost to income ratio - 5th and 95th percentiles, interquartile range and median



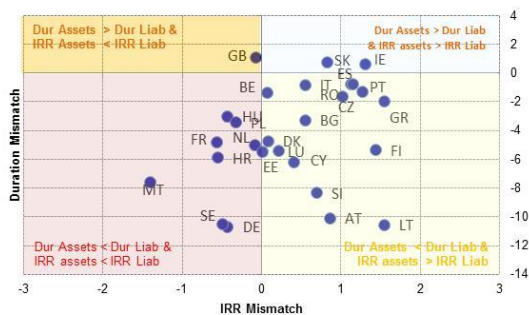
Source: EBA KRI

Figure 2: EU banks' cost to income ratio - numerator and denominator trends (December 2009 = 100)



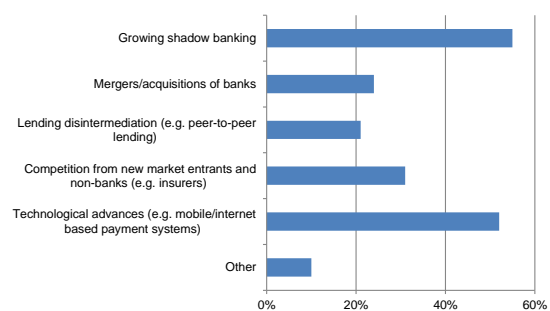
Source: EBA KRI

Figure 3: Joint mismatch of IRR and duration in insurance companies (assets minus liabilities)



Source: EIOPA 2014 Stress Test Report (end-2013 data)

Figure 4: Trends that are expected to impact European banks



Source: EBA Risk Assessment Questionnaire, March 2015

³ The combined ratio of an insurer is calculated as the sum of incurred losses (i.e. claims) and expenses, divided by earned premiums.

⁴ As noted in the ECB FSR, prices of financial assets traded across borders are affected not only by the ECB's monetary policy stance, but also by global monetary conditions, which remained in recent years very accommodative, and general reductions in market interest rates.

2.2 BUSINESS MODELS CHALLENGES

The **viability of financial institutions business models** in a context of low growth, low interest rates, subdued profitability and increased competition **remains a supervisory concern**, not least since potential drivers to boost profitability in a sustainable manner remain vague. Vigilance is also needed as ongoing profitability challenges may encourage **disproportionate risk taking or outright cost cutting** in an effort to increase profitability. It is therefore important that supervisors have a **clear picture of institutions' earnings potentials, funding mixes and strategies**.

In the banking sector, the 2014 Comprehensive Assessment process was a major step forward in enhancing the quality of banks' assets and in strengthening capital positions. **Additional supervisory efforts are nevertheless necessary to further improve the quality of banks' balance sheets and to adequately provision NPL**, which show significant national fragmentation. Such efforts will be needed not least to enhance banks' capacities to further build up capital buffers. Adequate capital levels are a precondition to provide lending to the real economy, though market-based financing can deliver further positive impetus. Further structural reforms will also be necessary to support reductions of legacy assets' NPL ratios. **Profitability challenges underline the necessity of in-depth supervisory assessment and scrutiny of institutions' business models, earnings potentials and strategies**.

Also, the observed increasing costs at banks in an environment of low profitability raise further concerns. **Supervisors need to be vigilant that banks' plans to address costs focus on increasing efficiency rather than outright reductions**, avoiding potentially compromising critical functions such as in risk management and IT security. It is also important to monitor that cost-cutting plans are aligned with the banks' risk appetite in terms of revenue generation.

As search for yield in the low interest rate environment incentivises engaging in higher risk assets, supervisors should discuss with institutions their **risk appetite and monitor asset valuations**. Moreover, supervisors should scrutinise strategies banks have in place to return to adequate levels of profitability **as they move away from official funding**.

For **banks' strategies**, responses to the EBA RAQ (Figure 4) suggest that if banks are envisaging further material change to their business models, such plans often reflect a **'back-to-basics' trend, refocusing on core activities and markets**. Non-domestic activities, within the EU as well as especially beyond, are a prevalent choice for scaling-down. While supervisory authorities recognise some progress in the adaption to economic and regulatory environment, they have identified substantial **risks to the execution of new strategies in a subdued economic and low interest rate environment** and amid low demand for credit products. There are also questions about the situation of subsidiaries in countries particularly affected by economic difficulties. The low interest rate environment and low demand for credit products are, in particular, challenging in this respect. Therefore, supervisors should **challenge business models, funding plans and capital plans** of financial institutions and assess whether they adequately cope with the prevailing operating environment.

Regulatory reforms already implemented and the essential restructuring of the banking sector after the crisis have triggered important changes to banks' business models. **Further changes stemming from regulatory initiatives are expected**, mainly related to resolvability of institutions envisaged in the context of the Bank

Recovery and Resolution Directive (BRRD), to the structural separation of banks' business proposed in the Liikanen report⁵ and in related regulation proposals on measures improving the resilience of EU banks.

Moreover, ample liquidity positions at financial institutions, search for yield by investors, incentives to reduce capital-intensive business and tighter regulation may all be encouraging a **shift of traditional banking activities into market-based credit intermediation and other market-based funding structures**. An increasing role of market-based credit intermediation coupled with disintermediation of financial activities may further impact bank revenues, and limit opportunities for growth in areas that could compensate for subdued interest income. Also, growing competition from new financial intermediaries and products emerging through technological developments may put further pressure on banks' income.

In the insurance sector, to remain competitive, **life insurers respond with various measures**, but often by reducing the risk profile of future commitments through the introduction of more flexible guarantees and the development of new products with different structures, such as contracts that guarantee a return only at maturity rather than throughout the life of the product. Thereby investment flexibility is increased and the capital costs are reduced as short-term market fluctuations can be absorbed over time. Insurers are expected to continue to adapt business and investment strategies to meet the challenges of the current low interest rate environment.

However, supervisors need to take a forward-looking approach and should consider the sustainability of the promises made to policyholders, both new and in the back-book. In particular, **supervisors need to take a holistic view on the capitalization of insurers and pension funds in order to assess their ability to keep all promises made to policyholders** also in light of the current low interest rates. The recently launched **EIOPA pension fund stress test** should help enabling participating pension supervisors to form such a view.

To address the cross-sector concerns mentioned, **supervisors should evaluate the business models of financial institutions** and assess their sustainability in the prevailing operating environment. Here, closer cross-sector cooperation among banking, insurance and security markets supervisors is also needed. Supervisory scrutiny is not least required as there are incentives for banks and insurers to reduce capital-intensive business lines while they build up or conserve capital positions, since such business might be shifted to market-based credit intermediation. In the banking sector, the EBA Guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP) provide a common framework for the work of supervisors in the assessment of risks to banks' business models, their solvency and liquidity.

Finally, the prolonged low interest rate environment continues to highlight the **need for rigorous valuations of assets and liabilities**, especially when inputs to such valuations are not observable in active markets. Here, it is important to highlight the **need for coordination** when conducting such assessments for cross-border and cross-sector institutions. Similarly, **transparent disclosure of risk exposures** to the market (e.g. as part of periodic financial reporting) continues to be a key supervisory concern. In particular, the scope and level of granularity of Solvency II public disclosure should be similar across Member States in order to ensure a consistent level of information to customers and investors. To further promote enhanced transparency in the banking sector, the EBA will carry out a transparency exercise towards the end of 2015, publishing detailed data on EU banks' balance sheets, including on risk weighted assets (RWA) by risk type, sovereign exposures, credit risk exposures, market risk and securitisation exposures. The data will also include information on asset quality.

⁵ Please refer to: http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf

Box 1 – Risks related to the financial situation of Greece

Risks concerning the financial situation of Greece re-emerged since April 2015 and culminated in June with the service of sovereign debt being delayed, capital controls being introduced and banks, exchanges and market infrastructures being closed down for temporary holidays. The trading of Greek assets on EU trading venues was temporarily suspended. Similarly, transactions changing net short positions in shares admitted to trading on the Athens Exchange were temporarily banned in the EU. Immediate concerns, however, were alleviated, when the Eurogroup and the European Stability Mechanism (ESM) entered negotiations about a financial assistance programme for Greece, after respective preconditions were met. An agreement on a comprehensive financial assistance programme and its swift and credible implementation, including of policy conditionality linked to a programme, will be instrumental to restore confidence and to contain financial stability risks.

Direct financial market contagion has to date been limited, and was mainly reflected in elevated market volatility at times of heightened uncertainty. Limited contagion is attributable to reduced exposure of EU financial institutions to Greece and to coordination between relevant competent authorities regarding the operations of Greek banks outside Greece. Exposures towards Greek borrowers by the 200 major EU non-Greek banks are below EUR 20bn, or 1.4% of common equity tier 1. The direct exposure of the EU non-Greek insurers towards Greek sovereign and bank bonds is less than 0.02% of total assets. The exposure of EU funds focusing their strategy on Greek assets amounts to EUR 2.5bn, less than 0.1% of the entire EU fund industry. Beyond individual financial industries, 39% of the volume of EUR 1.2tn of total financial assets issued by Greek residents are currently held by foreign investors, including EU ones.⁶ Hence recent market volatility is expected to imply some losses for EU investors.

Indirect channels of contagion and possible second-round effects remain a concern and require monitoring while an ESM programme is being rolled out. These channels may include the impact on funding costs, asset prices, market liquidity, and counterparty credit quality elsewhere. Also, renewed episodes of heightened uncertainty and volatility arising from the situation in Greece cannot be ruled out. A timely implementation of BRRD by all Member States is important in this regard. Continued cooperation and ex-ante coordination of possible supervisory actions across relevant competent authorities across financial sectors will remain important.

3 RISKS RELATED TO MARKET-BASED FUNDING AND MARKET-BASED CREDIT INTERMEDIATION

Since 2007 the size of the EU asset management industry, including IF as well as discretionary mandates, and the EU insurance and pension fund industry increased significantly, in particular driven by fund types focused on and undertakings' holdings of fixed income products.

Similarly, the contribution of asset managers (AM), insurers and pension funds to the provision of market-based funding intermediation has increased, with respective assets managed standing at EUR 8.5tn for IF (1Q15),⁷ 4.8tn for insurers (4Q13) and 2.2tn for pension funds (4Q13) (Figure 5). In addition, the three sectors provide loans and deposits of up to EUR 0.7tn, 0.6tn and 0.1tn.⁸ Hence the volumes provided by these three investor types to funding markets, even if only partially allocated to non-financial corporates (NFC), provide substantial potential to complement bank-based credit intermediation. Recently, however, valuation effects dominated the massive growth in the respective positions of e.g. EU IF between 1Q14 and 1Q15 by explaining EUR 1.2tn of a total increase of EUR 1.8tn (Figure 6). Hence, the flow of funds effectively available for investments was considerably more moderate.

Market-based financing of NFC in the EU stood in 4Q14 at some EUR 8.8tn, compared with EUR 11tn funded through loans. The composition of EU NFC funding is uneven, with smaller companies being dependent on bank funding. A reduction in the dependence of NFC on bank loans over the last two years was accompanied by lower volumes of banks loans outstanding. Increases in the issuance of new securities did not fully match this reduction, implying a decline in the volume of total funding obtained. Current plans for the Capital

⁶ Total financial asset issued by Greek resident include central bank reserves such gold and special drawing rights, currency and deposits, debt securities, listed shares, investment fund shares and other financial assets.

⁷ Reliable data on discretionary mandates in the EU are currently not available.

⁸ Data based on ECB SDW 2015 and EIOPA Statistics 2013. AM funding volumes include shares, other equity and debt securities.

Market Union address this characteristic of EU capital markets and attempt to promote a more balanced funding model for the economy by fostering the potential of market-based funding structures.

Complementing the direct issuance of securities by NFC, total **European securitised assets** (excluding RMBS) stood at EUR 0.6tn at the end of 2014,⁹ with 0.1tn dedicated to SME. Loans and deposits by EU institutional investors amounted to EUR 1.4tn. NFC benefitted, however, only of a share of both volumes, as they were allocated across all commercial sectors in the EU.

Notwithstanding several measures already undertaken¹⁰ to promote market-based funding, **EU securities markets remain to some degree still exposed to fragmentation and distortions**. Affected market segments include **securitisation and related features of loans to SMEs and geographically segmented conditions for cross-border settlement and cross-border retail access to UCITS**. Distortions appear as entry barriers, e.g. generated by multiple, sometimes not fully harmonized disclosure requirements; geographical heterogeneity in accounting methods used, even those needed to access multilateral trading facilities (MTF); the general lack of consolidated and consistent data on various aspects of EU securities markets¹¹ and geographically heterogeneous attitudes towards the disclosure of risk and costs associated with retail funds.

Easing the access of borrowers and investors to the intermediation through **market-based financing** would deliver an additional positive impetus to the promotion of funding sources for the real economy.

Liquidity in some securities markets has been affected by structural changes, potentially including regulatory reforms in the post-crisis period. Since 2007 increased competition in trading facilities contributed to an increase in liquidity observed in EU equity and some bond markets. However, this was accompanied by a bifurcation: Traditionally more liquid markets (equity, sovereign and liquid corporate bonds) benefitted more than less liquid ones (e.g. illiquid corporate bonds), while liquidity appeared to shift in between different derivative market segments (i.e. from CDS markets to markets for bond futures). **Technology, regulatory and competition developments** have altered the market structure. Lower profit margins and structural changes at banks may have **contributed to reduced ability and willingness of dealers to act as counterparties to immediate trading needs**, typically performed by contractual or de facto market-makers. Liquidity depends on whether market-makers stand ready to fill in temporary imbalances in supply and demand by accepting reverse trade positions. This affects in particular corporate bond markets featuring discontinuous, but relatively large trades. Thus the bifurcation in liquidity provision deepened, leaving less liquid markets with a relative low supply of immediacy services.¹² Moreover, the **quantitative easing programme may have reduced market volumes for some assets classes** thereby adding to volatility of their daily returns (see Figures 7-8). In such an environment, a risk reversal scenario, as mentioned in the introduction, could be triggered by a relatively limited market move.

Some AM, such as **open-ended UCITS and AIF funds and MMF**, are particularly **dependent on market liquidity, in so far as their fund shares can be redeemed on a daily base**. Concerns regarding the sensitivity of this particular intermediation chain were voiced by several institutions. Liquidity measures for the underlying asset classes fluctuated and spilled over into elevated performance volatility observed for EU IF and high volatilities in fund flows especially for EU funds focussing on riskier assets, such as high-yield (HY) bonds,

⁹ This compares to EUR 0.5tn outstanding in Q1: 2013. All data are taken from AFME (2014), Securitisation Data Report Q3:2014.

¹⁰ Include new legal EU acts (PRIIPS, SFT, ELTIF, IMD II, IORP II) and revisions of applicable EU laws (EUSEF, EUVECA, MiFID, MAD, UCITS).

¹¹ However, recent enhancements of trade repositories data access and quality provide an example for progresses made in this area.

¹² Immediacy services refer to the provision of intermediary functions facilitating the prompt execution of trades in securities markets.

emerging markets bonds and equity.¹³ Disrupting consequences of sudden increases in volatility and dry up of liquidity were even observed in very liquid markets, as the 15 October 2014 episode in the US sovereign bond market demonstrated.¹⁴

Evidence available for **market liquidity** indicates **rising risk** since 2013, in particular for EU bond funds and MMF, both of which experienced increases in their respective shares of **illiquid assets**.¹⁵ As investment decisions of investment funds are frequently dominated by portfolio rebalancing motives,¹⁶ the current environment of volatile asset prices implies elevated probabilities for substantial flows in and out of asset classes. Recent upticks in funds' leverage ratios concentrate such fluctuations into even more pronounced reactions in their NAV base, corroborating run incentives in case of rapid market reactions.¹⁷ Reduced availability of immediacy services to institutional investors, as indicated by decreasing volumes of outstanding EU repos and securities trading of the largest 20 European banks, implies higher liquidity risk for such entities and additional potential for price contagion in case of adverse shocks.¹⁸

Price fluctuations of shares issued by funds imply some risks due to fund clients' option to redeem their shares with contractually agreed frequencies. As far as AM can attempt to avoid adverse effects generated by frequent adjustments of share prices, they are exposed to potential mismatches between, on the one hand, liquidity conditions in asset markets and, on the other hand, fund shares issued. In the US, and also in the EU, redemption fees can be used by funds to partially mitigate undesired withdrawals and related liquidity risk; other instruments currently discussed among experts include general fees, stress tests, buffers of liquid assets held¹⁹ and swing pricing.²⁰ Liquidity buffers, however, decreased for some fund types,²¹ and delays in redemptions are limited by applicable laws or the commitment of the fund provided in the prospectus.²² Search for yield increased the yield sensitivity of final investors, adding further to funding liquidity risk. This additional risk is particularly serious for bond funds being invested in assets exposed to thin secondary market liquidity (e.g. corporate and HY bonds).

Higher liquidity risks within the fund industry do not per se imply their transmission to the wider financial system. Some fund types, however, dominate certain asset market segments.²³ Thus significant asset liquidations on their behalf is likely to result in **indirect contagion via asset prices**,²⁴ as reflected by high sensitivities of prices of less liquid assets to net flows to funds active in these markets, in particular also in times of elevated stress in financial markets.²⁵ **While the risks around asset price contagion are currently assessed as moderate** for the EU insurance and pension fund sector, volatile asset prices still imply rising liquidity risks for the primary and secondary markets in which banks operate.²⁶

¹³ ESMA TRV 2 2015, appendix: for securities: A.19, A.29 and A.37, for funds: A.90, A.95-98.

¹⁴ Please refer to: "Joint Staff Report: The U.S. Treasury Market on October 15, 2014", http://www.treasury.gov/press-center/press-releases/Documents/Joint_Staff_Report_Treasury_10-15-2015.pdf

¹⁵ ESMA TRV 2 2015, pp.34-39 and appendix: A.85; ECB FSR, May 2015, Charts 3.35, p.89 and 3.38, p.97.

¹⁶ IMF (2015), Global Financial Stability Report (GFSR), April 2015.

¹⁷ ESMA TRV 2 2015, appendix: A. 94, 109.

¹⁸ BIS (2014), CGFS Paper 52, p.17, graph 7, middle panel.

¹⁹ IMF GFSR, April 2015.

²⁰ Swing pricing refers to the allocation of trading costs via price discounts to shares the redemption of which induced respective trades.

²¹ IMF GFSR, April 2015, Fig. 3.5, p. 104; ESMA TRV 2 2015, V.6-7, p.37 and appendix: A.88.

²² Directive 2014/91/EU (UCITS V); however, most UCITS commit to settle any redemption request within 3 working days.

²³ IMF GFSR, April 2015. Fig. 3.7, p. 107.

²⁴ ESMA Working Paper 2 2014; IMF GFSR, April 2015 reports a domination of bond market segments by the biggest five US mutual funds.

²⁵ IMF GFSR, April 2015; ESMA Working Paper 2 2014; ESMA TRV 1 2015, pp. 60-65.

²⁶ EIOPA Risk Dashboard June 2015, EBA Risk Dashboard 1Q15.

Cross-holdings between AM, banks and insurers provide another transmission channel, in particular between IF and banks, each of which holds EUR 4tn of assets of the other sector. The positions of IF and MMF in bank debt are sizeable in the EU, with the contribution of MMF to short-term bank funding and the size of the assets of EU MMF and other financial intermediaries (OFI) relative to the assets of banks rising.²⁷ Synthetic exposures further increase this interconnectivity, as they generate additional counterparty risks. Support commitments, such as sponsorship of MMF, credit guarantees or other measures within financial conglomerates, insurance arrangements or the cross-holding of equity add further potential transmission channels, even where designed to improve risk allocation in the first place.

Concerning the observed **reductions in market liquidity and implications for asset managers**, any adequate policy action should target the **resolution of frictions detected in the valuation of assets** and the **functioning of markets** in which those assets are traded, thereby improving liquidity conditions and pricing efficiency. Measures promoting market based financing for NFC should aim at investors as well as borrowers. Funding of NFC via capital markets can be promoted by **efficient conditions for the issuance of securities**, by the **securitisation of existent claims**, including those held by NFC and those held by their creditors **incentivising AM and institutional investors** to use applicable legal opportunities for the **granting of loans to NFC**.

On securitisation, the EBA advice to the European Commission on a framework for qualifying securitisations outlines criteria for defining simple standard and transparent securitisation transactions suitable to further promote efficient conditions for securities issuance

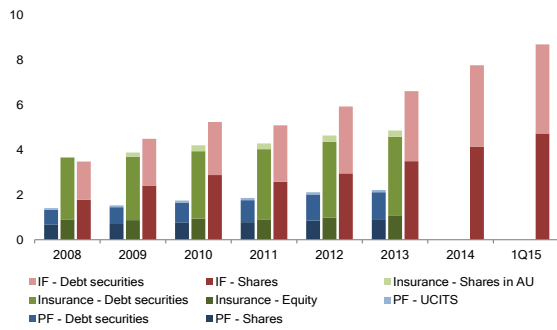
A further harmonization of nationally segmented rules governing the **loan origination by funds** may provide a possible road forward with respect to market-based credit intermediation. **Promotion of adequate diversity in financial instruments offered** to final investors by investment advisers and of compatibility in respective EU settlement platforms is likely to further increase the attractiveness of market based investment forms. Further clarification of eligibility criteria for applications to authorisation under the European Venture Capital Funds Regulation (EUVECA) and the European Social Entrepreneurship Funds Regulation (EUSEF) may yield positive effects in particular for SME financing.

Ongoing work with regard to **disclosure standards concerning risks and costs of UCITS and retail products** covered by the Packaged Retail and Insurance-Based Investment Products Regulation (PRIIPs) may address some of the still existent fragmentation issues. Similarly, the **standardisation of investor compensation schemes** as well as **their respective funding principles** and **of resolution mechanisms for investor complaints** would promote the efficiency of EU securities markets. From the side of issuers, **further harmonization of accounting principles for SMEs**, by providing the choice between IFRS or, alternatively, harmonized national accounting standards to SME wishing to access MTF, would promote their access to national and in particular foreign EU funding markets.

Finally, measures aimed at **restoring cross-border funding in the banking sector** may sustain a healthy credit intermediation as a valuable complement to market-based funding.

²⁷ IMF GFSR, April 2015 reports a share of EU IF in long-term EU bank bonds of around 7%, a share of MMF in EA short-term bank funding of some 50% and a majority of bank and insurers among the 25 biggest global AM. ESMA TRV 2 2015 reports that securities issued by EA MFI account for 10-20% of EA IF assets and up to 70% EA MMF assets (A.84). Recent reductions, however, signalled rising diversification for both fund groups.

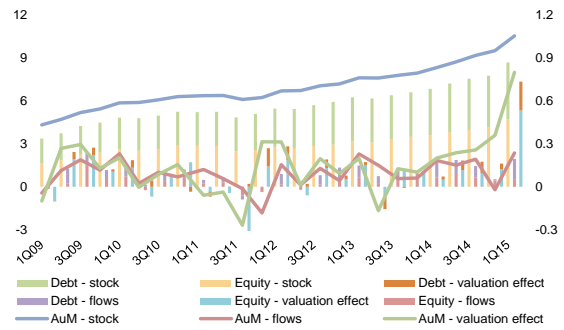
Figure 5: Volume of market-based financing



Note: Shares, equity and debt securities held by EU IF, insurers and pension funds. Data for insurers and pension funds not available for 2014 and 2015. EUR tn. PF - Pension Funds; IF - Investments Funds; AU - Affiliated Undertakings.

Sources: ECB, EIOPA,ESMA

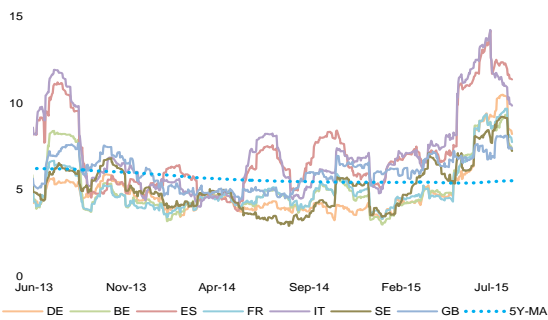
Figure 6: Evolution of EA IF AuM, debt and equity; respective decomposition into capital flows and valuation effects



Note: Level of and change in AuM, debt and equity held by EA IF. Changes split into flows and valuation effects, the latter computed as intra-period changes of respective stocks net of flows received in respective periods. EUR tn for AuM (lhs) and for flows and valuation effects (rhs).

Sources: ECB, ESMA

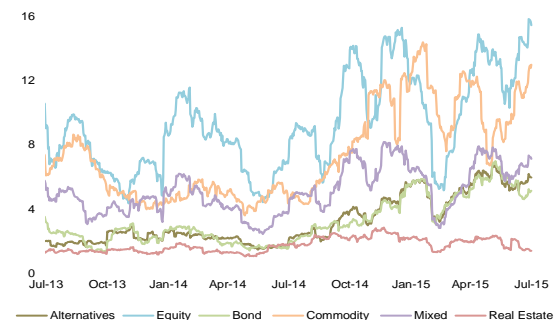
Figure 7: Volatility of 10-year sovereign bond performance



Note: Annualised 40D volatility of 10Y sovereign bonds, selected EU members, %. 5Y-MA=5Y moving average of EA 10Y bonds indices computed by Datastream.

Sources: Thomson Reuters Datastream, ESMA

Figure 8: Volatility of fund returns for different fund types



Note: Annualised 40D historical return volatility (%) of EU domiciled mutual funds.

Sources: Thomson Reuters Lipper, ESMA