TRV Risk Monitor — key insights

ESMA Report on Trends, Risks and Vulnerabilities, No. 1, 2023

ESMA Economics, Financial Stability and Risk Department

ESMA50-165-2346

Overview – TRV RM No. 1, 2023

1.1 Risk overview

1.2 Risk assessment by market segments

ESMA risk assessment: High risks, fragile markets

Risk categories

	Level	Outlook
Overall ESMA remit	🔴	→
Liquidity risks	🔴	→
Market risks	🔴	→
Credit risks	🟡	↗
Contagion risks	🔴	→
Operational risks	🔴	→
Environmental risks	🟡	↗

Risk areas

	Level	Outlook
– Securities	🔴	→
– Asset management	🔴	→
– Consumers	🟡	↗
– Infrastructures and services	🟡	↗

Risk drivers

	Outlook
– Geopolitical risks	↗
– Macroeconomic environment	↗
– Inflation and interest rate environment	↗
– Sovereign and private debt markets	↗
– Infrastructure disruptions	↗
– Other political and event risks	→

Status: Relative stability amid high volatility and episodes of acute local stress

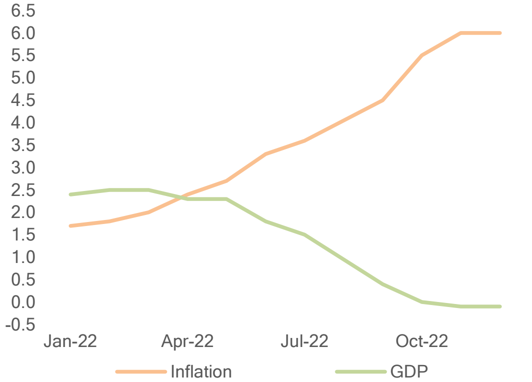
- Markets: Securities markets stable despite high volatility in 2H22 esp. in bond and energy derivatives markets; acute stress in GBP markets related to leveraged entities in September; FTX collapse and crypto-asset valuation decline
- Risks: Contagion and operational risks very high; market and liquidity risks remain very high; credit risks stay high with deteriorating outlook; environmental risks elevated

Outlook: Macrofinancial tailwinds, potential for corrections

- Risk drivers: Global tightening of financial conditions, inflation and slowdown of economic activity, with stagflation scenario now less likely; rise in already high public and private indebtedness; continuing geopolitical risks
- Risk outlook: Fragile EU market environment; high risk of corrections amid fragile market liquidity; sustained decline in valuations; delays in transition to green economy; crypto markets tested for ability to fix fundamental flaws

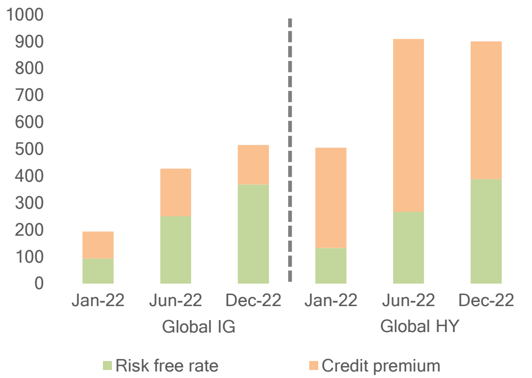
Deteriorating outlook amid tighter financial conditions

Stagflation risks had increased



Note: Median GDP growth and inflation forecasts for the euro area for 2023, by vintage month , in %.
Sources: Refinitiv EIKON, ESMA.

Sharp tightening of financial conditions



Note: Decomposition of bond yields of Bank of America Merril Lynch Global Corporate Index, in basis points.
Sources: Refinitiv Datastream, ESMA.

Deterioration of macrofinancial environment

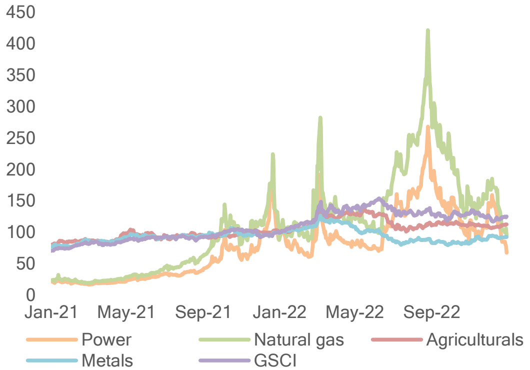
- Growth: Economic slowdown expected in 2023; recession now anticipated to be narrowly avoided as economic sentiment is becoming more positive
- Inflation: Expected to remain very high in 2023; headline inflation starting to decline, core measures still increasing
- Rates: Further expected hikes across central banks

Rate hikes tighten financial conditions

- Yields: Corporate bonds at highest levels since 09, driven by increase of risk free rate (IG) and bond credit premia (HY)
- Real estate: Decline of commercial real estate prices; underperformance of bonds and equities related to real estate; ESRB warning
- Commodities: After sharp tensions end-Aug, energy prices and volatility down to pre-war levels

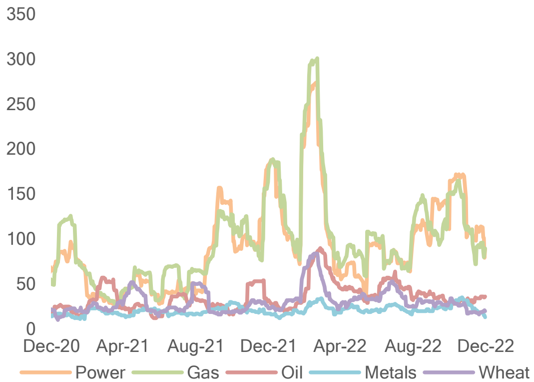
Commodities, energy: Prices down, tensions stay

Energy prices drop, but…



Note: Commodity price indices rebased at 1/1/2022=100. S&P GSCI indices for global commodities, agricultural products and metals, ICE Dutch TTF futures for natural gas and EEX Phelix futures for power.
Sources: Refinitiv EIKON, Datastream, ESMA.

… derivatives volatility shows nervousness



Note: Commodity price realised volatility (annualised 20D volatility) in %. German Phelix futures for power, Dutch TTF for gas, Brent for oil, S&P GSCI industrial metals index and Euronext wheat futures.
Sources: Refinitiv Datastream, ESMA.

Commodities: Relaxation in 2H22

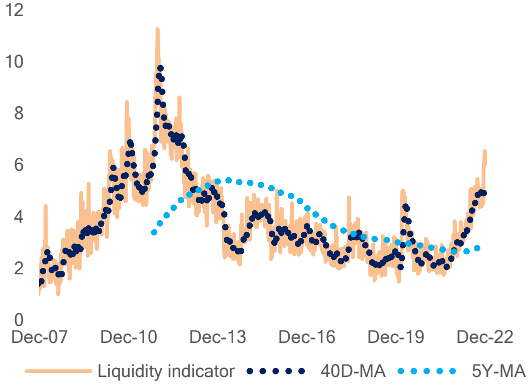
- Composite: Aggregates of commodity prices normalising
- Components: Agri and metals stable; remaining volatility driven by energy

Energy: Massive drop from peak, but nervousness prevails

- Prices: Spike in prices end-Aug., followed by sharp drop (import substitution, EU storages to 88% vs 53% in 21, conducive weather)
- Volatility: Power and gas volatilities remain 2-3 times higher than historical, illustrating high nervousness in markets
- Outlook: Investors remain subject to large price swings, incl. extreme valuations of energy-related assets

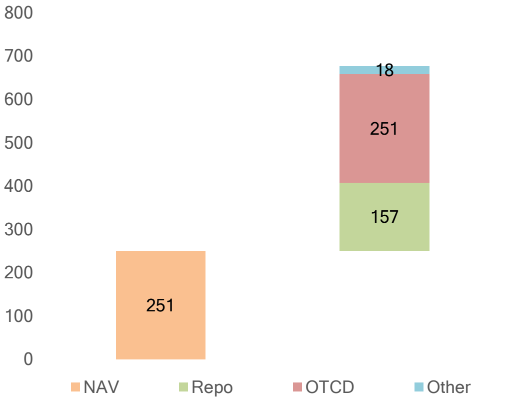
Securities markets: Fragile liquidity

Higher bond bid-ask spreads



Note: Liquidity measured as median across countries of the bid-ask yields difference for 10Y sovereign bonds, in bps. Lower figures mean more liquidity and vice-versa. 22 EEA30 countries are included.
Sources: Refinitiv EIKON, ESMA.

High leverage of EU LDI funds



Note: NAV and sources of leverage, in EUR bn for AIF LDIs, end-2021. OTCD: Over-the-Counter derivatives.
Sources: AIFMD, ESMA.

Decline in liquidity across bond markets

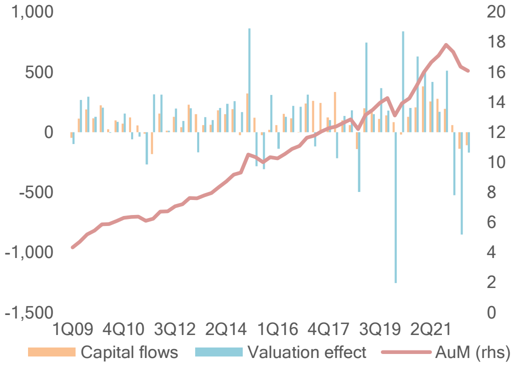
- Sovereign: Broad liquidity drop in bonds
- Corporate bonds: Increase in bid-ask spread
- Drivers: Rate hikes; fixed-income volatility

Stress related to leveraged funds using Liability-Driven Strategies (LDI) shows how leverage risks can crystallize

- Scope: Majority of UK-owned LDI funds are EU AIFs (EUR 250bn, >80% of pooled funds)
- Risks: LDI funds obtain leverage through GBP repo funding, short positions on interest rate derivatives
- Trigger: Sharp increase in GBP yields following UK mini-budget end-Sep 22
- Consequences: Large collateral and margin requests faced by (EU) GBP LDI funds; redemptions from EU GBP money market funds; substantial pressures on GBP sovereign markets due to forced sales amid low liquidity

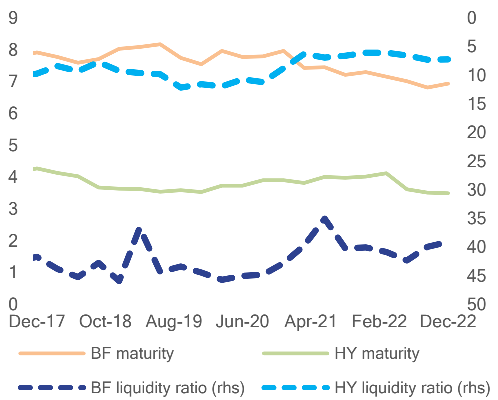
Asset management: Funds resilient, but risks rising

Strong decline in AuM



Note: Net valuation effect related to the AuM of EA investment funds, computed as the intraperiod change in AuM, net of flows received in the respective period. Capital flows and valuation effects in EUR bn. AuM expressed in EUR tn.
Sources: ECB, ESMA.

High maturity risk for IG funds



Note: Quarterly effective average maturity of EU27 fund assets, in years; ESMA liquidity ratio (rhs, in reverse order).
Sources: Refinitiv Lipper, ESMA.

Decline in assets under management (AuM)

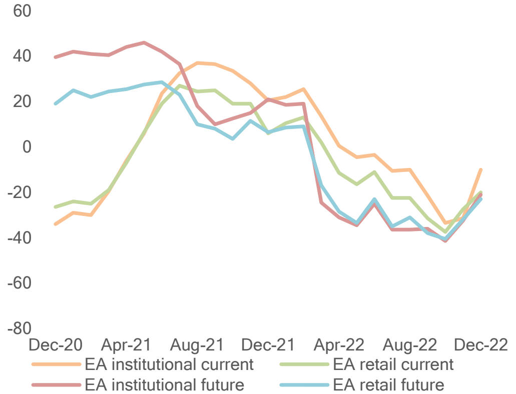
- AuM: -6% to EUR 16trn, largest drop since Global Financial Crisis of 2007-2008
- Drivers: Mainly valuation effects
- Flows: Most fund types with outflows; high MMF inflows, esp. GBP after Sep 22 BoE intervention related to LDI stress
- Liquidity: Funds met redemption requests without resorting to use of LMTs

Higher risks for bonds funds

- Interest-rate risk: Funds reduced their maturity transformation; but duration remains close to 7Y for Investment Grade (IG), 3.5Y for High Yield (HY)
- Credit risk: Deterioration of credit quality for HY funds; materialisation of credit risks more likely amid high and rising rates
- Liquidity: Decline in cash holdings by corporate bond funds

Consumers: Sentiment, savings, fund flows fall

Despite pick-up confidence stays low



Note: Sentix Sentiment Indicators for the EA retail and institutional investors on a ten-year horizon. The zero benchmark is a risk-neutral position.
Sources: Refinitiv Datastream, ESMA.

Retail UCITS fund returns plummet

Note Evolution of net annual performance (net of ongoing costs (TER), subscription and redemption fees) of EU27 UCITS, retail investors only, by asset class, in %.
Sources: Refinitiv Lipper, ESMA.

Consumer sentiment remains negative

- Consumer sentiment: Some improvement but remains below zero
- Complaints: Close to average levels in 3Q22

Market participation declines as savings and investment flows fall

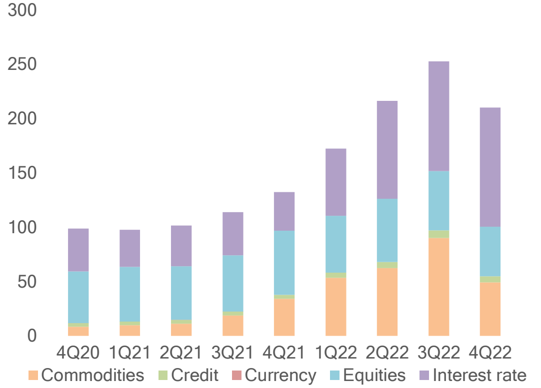
- Household savings: Fall from the record highs during pandemic
- Investment flows: Flows into UCITS bond and equity funds collapsed as performance worsened

Large reduction in real and nominal returns

- Performance: Nominal returns close to zero and negative real returns more than 100bps below LT averages

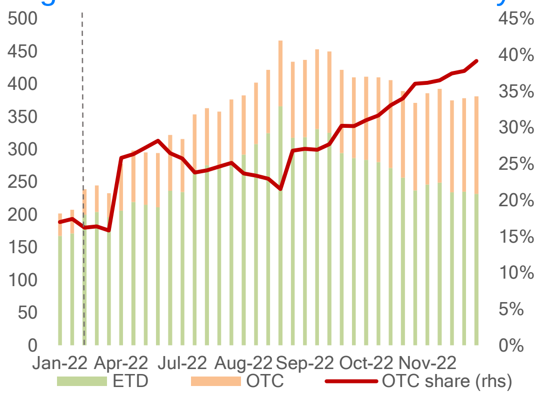
Infrastructures: IRD margins up, OTC rising

Margins up for IRDs



Note: Outstanding amounts of intital margin required and excess collateral received by EU27 CCPs for derivatives (CCP.A, CC&G, BME data missing). in EUR bn.
Sources: TRs, ESMA.

Migration to OTC continues steadily



Note: Outstanding amounts on natural gas and power derivatives for NFCs, in EUR bn and share of OTC in %. Intragroup trades are excluded. Dashed line shows the beginning of the invasion of Ukraine.
Sources: TRs, ESMA.

Trading venues: Trading stable

- Trading: Equity trading volumes stable in 2H22
- Circuit breakers: Incidences decline with lower equity volatility

Central clearing: Margins up for interest rate derivatives (IRDs), further migration to over the counter (OTC) derivatives for energy

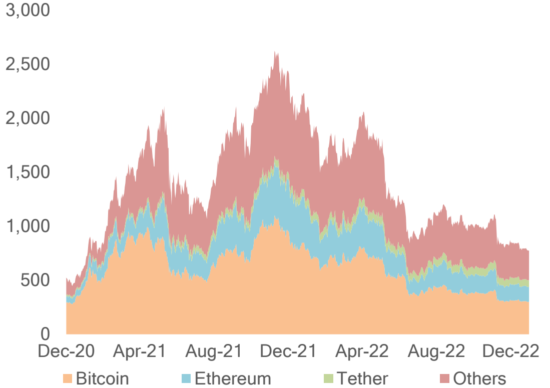
- Initial margins: Margins collected by EU CCPs for IRDs rose, while those for commodity declined significantly in 4Q22, reflecting market conditions
- Energy derivatives: Migration from exchange-traded derivatives to OTC continues, with OTC exposures increasing to 40% for NFCs (compared to 25% in Aug 22)

Credit rating agencies (CRAs): Credit outlook turning negative

- Assessment: Overall credit outlook by CRAs weakened in 2H22, turning negative for corporates

Innovation: Crypto in crisis, growing viability concerns

Falling crypto valuations



Note: Market capitalisation of Bitcoin, Ethereum, Tether and other crypto-assets, in EUR bn.

Crypto risk summary

	Level	Outlook
Liquidity	○	→
Market	○	→
Credit	○	↗
Contagion (internal)	○	→
Contagion (external)	○	↑
Operational	○	↗

FTX: Leading crypto-exchange collapses

- Drivers: Misconduct; management failure; absence of robust internal controls; inherent conflicts of interest
- Consequences: Misuse of and large losses on customer assets; crypto valuations shed another 20%, but no contagion to traditional markets

Crypto markets set to stay in crisis

- Market cap: Crypto markets lost two-thirds in value over the course of 2022
- Entities: Series of collapses among crypto intermediaries; growing concerns over sustainability of business models
- Onward risks: Extreme market, valuation risks; strong contagion among crypto markets; very high operational issues

Financing: Net issuance negative, greenwashing

Market finance: Issuance drops

- Market environment: Uncertainty, higher financing costs and tighter credit standards weighed on funding opportunities
- Financing: Turned negative in 2022 as initial public offering plummeted (-60% compared to 2021) and bond issuance dropped (-40% compared to three previous years)
- Other deals: Subdued activity for securitisation in 22Q3 (-18% compared to a year ago), decline in collateralised loan obligation issuance in 2H22 (-48% compared to 2021)

Sustainable finance: Risks are rising

- Greenwashing risks:
  - Enforcement actions in the US, UK and EU against financial institutions
  - Potential risks to investors from the use of SFDR disclosure as proxy-labels for communication purposes
- ESG markets: ESG bond issuance positive in 2H22 but driven by public issuance while corporate issuance turned negative, in line with broader corporate bond market developments

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