TRV Risk Monitor
ESMA Report on Trends, Risks and Vulnerabilities, No. 2, 2023

ESMA Webinar, 7 September 2023
ESMA Economics, Financial Stability and Risk Department
Overview

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1. Risk publications

Overview of 2023 schedule

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For a full list of publications, visit our [ESMA Risk Analysis webpage](https://www.esma.europa.eu).
2. TRV risk assessment: Overview

Overall assessment: High risks, fragile markets

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Risk drivers
- Geopolitical risks
- Macroeconomic environment
- Inflation and interest rate environment
- Public and private indebtedness
- Infrastructure disruptions
- Other event risks

Status: Rebound amid high volatility and event-driven stress
- Markets: Securities markets rebound in 1H23 despite high volatility in March; impact from bank stress non-lasting, but markets remain nervous
- Risks: Risk levels unchanged compared to last TRV (Feb 2023)

Outlook: Market nervousness linked to ongoing macrofinancial uncertainty
- Risk drivers: Transition to a new regime of higher rates and inflation; rise in already high public and private indebtedness; continuing macrofinancial and geopolitical risks
- Risk outlook: Ongoing uncertainty related to macrofinancial environment (higher growth forecasts vs. weak actual growth figures; receding inflation vs. long term inflation outlook); high risk of corrections (fragile market liquidity; sensitivity to news and event risks) in equity, bond and crypto markets; significant short-term risks for consumers (market volatility, losses from negative real interest rates); AI developments pointing to further significant industry change
3. Risk assessment by market segments

Securities markets: Rebound amid high volatility

Equity markets rebound

Equity markets up, despite March stress episode

- **Markets**: Equity market up over the reporting period, despite volatility in March, with large daily swings in valuations driven by bank sector shares

- **Bank turmoil impacts**: Drops in equity prices in March before rebounding; European banking sector valuations overall increased by 16% in 1H23

Bonds: Decline in yields, surge in volatility

- **Sovereign**: Temporary decline in yields in March linked to banking turmoil, investors moving away from EQ

- **Corporate**: In contrast to sovereign, yields increased in March in IG and HY, spreads peaked

- **CS deal impact on AT1 bonds**: Peak-to-trough fall of 18% in March; continued lower valuation levels

Credit quality: early signs of a deterioration

- **European corporate high-yield defaults**: Up to 0.76% in 1H23 (0.5% in 2H22)
3. Risk assessment by market segments

Asset management: Slow recovery

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**Performance improves**

![Graph showing performance improvements over time with categories for alternatives, bond, commodity, and mixed assets.]

- **Assets**: AuM increase (+3%), but still EUR 1.4tn below end-21
- **Performance**: Higher (except commodities), now positive year-on-year
- **Flows muted**: Only bond funds clearly positive after significant outflows in 2022, likely linked to monetary policy expectations; EU USD MMF flow sensitivity during US regional bank stress

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**Adaptation to the macro environment**

- **MMFs**: WAM at historic low in 2022; slight increase in 1H23
- **Bond funds**: Continued decrease of maturity transformation and portfolio duration
- **Credit risk**: Still elevated for HY funds
- **Unrealised losses**: Concerns in areas not subject to MtM valuation (esp. REIFs, PE)

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**Slow recovery in 1H23**

![Graph showing slow recovery in 1H23 with categories for alternatives, bond, commodity, and mixed assets.]

Note: EU27-domiciled investment funds’ annual average monthly returns, asset weighted, in %. Sources: Thomson Reuters Lipper, ESMA.

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**MMF WAL low but increasing**

![Graph showing MMF WAL low but increasing over time with categories for WAM and WAL.]

Note: Weighted average maturity (WAM) and weighted average life (WAL) of Europe-domiciled MMFs, in days. Aggregation carried out by weighting individual MMFs’ WAM and WAL by AuM. Sources: Fitch Ratings, ESMA.
3. Risk assessment by market segments

Consumers: Low sentiment, digitalisation continues

Investor confidence remains negative

— **Confidence:** Overall slightly negative, though up from lows in 3Q22

— **Outlook:** Uncertainty in economic outlook and inflationary developments, especially in the longer term

Bond holdings increase

— **Financial assets:** Debt securities holdings increase (+7%), alongside rising interest rates; equity and investment fund holdings decrease

Rising use of digital financial services

— **Digitalisation:** Neo-brokers market penetration among younger generations rising, with 18% of 25 to 34 year olds using digital brokerage. Risk of exclusion of investors not digitally literate

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**Improved current investor confidence**

![Chart showing improved investor confidence](chart1.png)

**Digitalisation continues**

![Chart showing digitalisation](chart2.png)
3. Risk assessment by market segments

Infrastructures: Functioning well in stressed conditions

**Circuit breakers surge in March**

![Graph showing circuit breakers surge in March](image)

**Uptick in circuit-breakers in March**

- **Trading venues**: Surge in circuit breakers in March 23 (65% of trading halts in 1H23 on financials)
- **Equity trading volumes**: Turnover increased again in 1H23 (+12%), in line with market volatility

**Commodity margins down to pre-war level**

- **CCP margins**: Commodity margins decreased in 1H23, in line with drop in energy derivative prices

**CRAs: over 14,000 new EEA ratings issued**

- **Rating activity**: CRA issued over 50,000 new ratings, of which 14,000 EEA issuers.
- **Market share**: 58% of new EEA ratings from small CRA. Big Three still represent 92% of solicited ratings

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**Note:**

Outstanding amounts of initial margin required and excess collateral received by EU27 CCPs for derivatives, in EUR bn.

Sources: TRs, ESMA.
3. Risk assessment by market segments

Market-based finance: Bond issuance rises

Sharp drop in IPOs

Subdued equity issuance amid market uncertainty
  — IPOs: Subdued in 1H23, most deals waiting for more favourable secondary market conditions
  — Outlook: Market uncertainty remains the main factor shaping equity primary markets

Renewed confidence in bond markets
  — Levels: Corporate bond issuance increased by 50% in 1H23 esp. in 1Q23 (EUR 543bn; 45% above the 5Y moving average)
  — Risks: 90% of IG issuance; uncertainty around riskier issuers following the banking turmoil
  — Outlook: High level of outstanding corporate debt (EUR 10.4tn) implies significant refinancing risk in upcoming years
3. Risk assessment by market segments

Innovation: Crypto rebounds and generative AI gains popularity

**Crypto assets rally, with market value back to pre-FTX levels**

- **Market cap:** EUR 1.2tn, +40% since end-22 but still half below peak of Nov 21
- **Investors:** Rally largely driven by technical factors, including low liquidity and seller exhaustion, rather than renewed investor appetite
- **Regulation:** Tougher regulatory stance with series of enforcement actions by US regulators

**Generative AI gaining increasing popularity**

- **Potential:** Generative AI technologies, like ChatGPT, well positioned to enter a wide range of financial market operations, including information processing, compliance, reporting, and customer services
- **Concentration trend:** Large, general-purpose AI models developed by few providers while generative AI start-ups space is turning increasingly crowded
3. Risk assessment by market segments

Sustainable finance: Investor attention to ESG products remains high

Flows into SFDR Art 9 funds particularly resilient

- **SFDR Art 9 funds**: No outflows from Art 9 funds (with a sustainable investment objective) since SFDR application in Mar 21 despite recent waves of reclassification from SFDR Art 9 to Art 8

- **SFDR Art 8 funds**: Investors pulled EUR 177bn out of Art 8 funds (with environmental or social characteristics) in 2022

Biodiversity as the next frontier in ESG investing

- **Assets**: Still small market niche, EUR 933mn AuM (around 0.1% of SFDR Art 8-9 AuM)

- **Flows**: Cumulative inflows surged, reaching EUR 116mn in 1Q23, 6x 1Q22 volumes; 73% of EEA biodiversity funds launched since 2022, confirming growing appetite
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