European Securities and Markets Authority

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PRESS RELEASE

ESMA sees valuation risks in key market segments rising

The European Securities and Markets Authority (ESMA) has published its Report on Trends, Risks and Vulnerabilities No. 2, 2014, and the Risk Dashboard for 3Q 2014. Overall, ESMA's report finds that valuation risks in key market segments are rising and merit investor attention. In the first half of 2014, conditions in the EU's securities markets, asset management industry and market infrastructures remained favourable. Prevailing optimistic market sentiment was at odds with sluggish underlying economic fundamentals, but in line with the ultra-low interest rate environment.

Key developments in EU securities markets, fund industry and infrastructures:

- **Securities markets:** EU securities markets realized significant gains amid low volatility. This underscored positive market sentiment in a low interest rate environment, which motivated investors to search for yield. Risk appetite remained strong as yields continued to compress and solid high-yield bond issuance was readily absorbed by markets. Consequently, valuation concerns rose along with the risks of future volatility and its effects.
- **Asset management**: the European fund industry continued to expand, partly due to capital inflows, with assets under management growing by about 6.7% or €0.5tn in 1H14. Investment fund returns were relatively low, though moving slightly upward, also driven by positive valuation effects. Allocations focused on bonds, notably high-yield and corporate bonds. Overall, investors are searching for yield. Within an active primary bond markets potentiallyfewer market makers could limit the functionality of secondary bond markets.
- **Market infrastructures**: activity in trading venues increased strongly before easing off from May onwards. Volumes of securities settled by CSDs were broadly flat before tailing off somewhat in late 1H14, while the volatility of settlement fails generally stabilised below levels seen in the second half of 2013. The share of interest rate derivatives cleared via CCPs fell slightly. Benchmark panels reported limited withdrawals, but even these decreased as administrators introduced reinforced governance rules.

ESMA also monitors market developments which may present future vulnerabilities. This Report provides an in-depth analysis of four topics:

- **Trading venue developments, operational risk and new challenges:** driven by technological innovation, in recent years the market for trading venues experienced significant changes in its infrastructure and trading practices. In particular, increased complexity and trade frequency has increased operational risks. Concerns arose about potential adverse effects on trading venues' capacity to ensure orderly trading and market efficiency. This may give rise to new types of misconduct and market abuse. ESMA's report explains that enhanced corporate governance, improved risk management, and higher-quality information may help mitigate such concerns;
- **The systemic relevance of securities financing markets in the EU:** this report considers the significance, roles and risks of securities financing transactions in the EU. Securities financing is widespread while the underlying transactions are essential to market participants for liquidity and risk management. Yet, their contribution to interconnectedness and procyclicality, as well as their re-pledging of collateral, has implications for financial stability. ESMA's report examines their role in the financial crisis. Global regulators have been prompted to look more closely at this market segment in order to better understand existing market practices and their implications for systemic risk;
- **Performance and risks of ETFs:** Exchange-Traded Funds (ETFs) combine elements of index-tracking funds and exchange-traded shares. They are one of the fastest-growing types of financial investment vehicles. This report considers ETFs' market structure, performance relative to index-tracking funds, and related risks. For example, product innovation in replication techniques, underlying asset classes and benchmark indices may increase the complexity of ETFs and in turn involuntarily contribute to both investor protection and financial stability risks; and
- **Crowdfunding:** crowdfunding has received considerable attention recently as a potential complementary source of funding for small and medium-sized enterprises and the economy as a whole. Volumes are growing quickly, albeit from a small base. Crowdfunding, however, is not exempt from risks and challenges, especially with regard to investor protection. While a number of Member States have taken or plan taking regulatory initiatives, ESMA argues that regulatory and supervisory convergence is important.

Next steps

As part of its on-going market surveillance, ESMA will update its report semi-annually, complemented by its quarterly Risk Dashboard. ESMA's Reports on Trends, Risks and Vulnerabilities examine developments in EU securities markets while assessing trends and risks in order to establish a comprehensive picture of systemic and macro-prudential risks in the EU that can serve both national and EU bodies in their risk assessments.

Notes for editors

1. ESMA is an independent EU Authority and works closely with the other European Supervisory Authorities responsible for banking (EBA), and insurance and occupational pensions (EIOPA), and the European Systemic Risk Board (ESRB).

2. ESMA's mission is to enhance the protection of investors and promote stable and well-functioning financial markets in the European Union (EU). As an independent institution, ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. ESMA contributes to the regulation of financial services firms with a pan-European reach, either through direct supervision or through the active co-ordination of national supervisory activity.

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