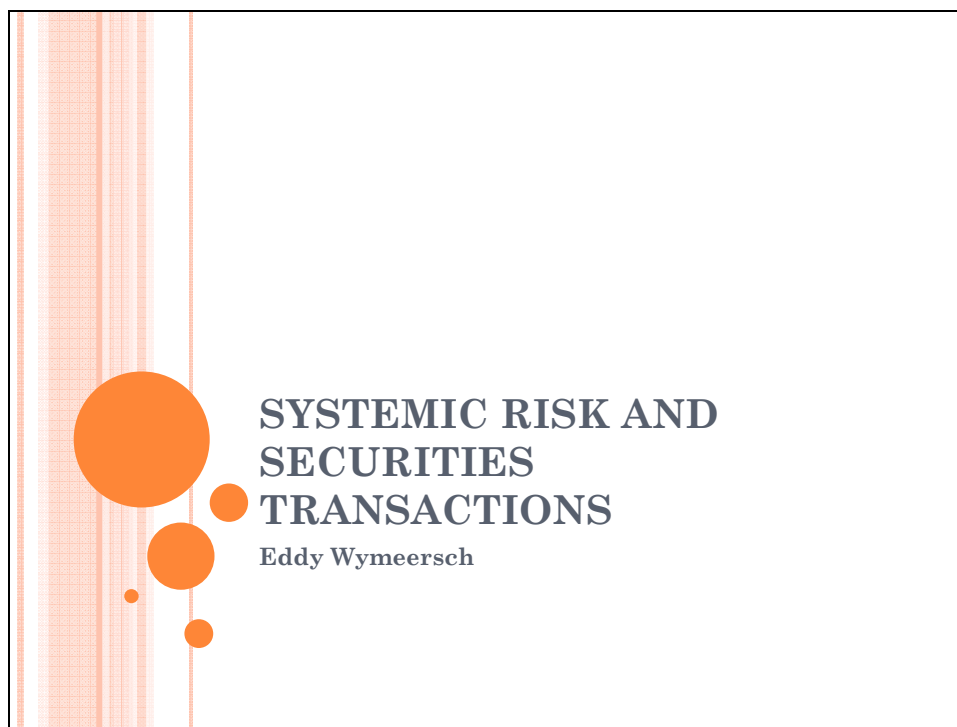


Systemic Risk and Securities Transactions

Day 2 opened with a presentation on the "Systemic Risk and Securities Transactions" by Eddy Wymeersch, Member of the Board of Directors, FINMA, and President of the Public Interest Oversight Board (PIOB), Madrid. Covered in the speech were systemic risk definitions, importance, origin, and events specific to the securities field. Also addressed were methods and organizations in place to address systemic risk. It was pointed out that securities regulators historically did not address systemic risk. New regulatory mandates resulted in a shift in the regulatory structure and regulators' objectives and the use of new tools to deal with the problem. This was followed by more interest in market structures and streamlining of the roles of gatekeepers such as bank directors, auditors, CRAs and financial analysts. Importantly, Eddy Wymeersch asked the question „What should top management do about systemic concerns?“, as well as pointing out the potential liabilities linked to flaws in risk management and the duties of the CRO, CEO and Board.

Note by the author: These slides reflect personal opinions that cannot be attributed to any of the institutions the author is connected with.



SYSTEMIC RISK

- Elusive concept
- Considerable attention in the financial crisis
- Trilogy
 - **Financial stability**: overarching concept
 - **Macro prudential**: toolkit
 - **Systemic risk**: ultimate objective
 - “a risk to disruption of financial services that (i) is caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy”



SYSTEMIC RISK


- **Systemic importance**:
 - Numerous factors, occurrences that may contribute to systemic risk
 - Usually neutralised by monitoring- countervailing measures: risk management- macro-economic measures
- Essentially different from systemic **risk**
 - **Outcome of systemically relevant events**



SYSTEMIC RISK

- Local origin, **worldwide** effects: US real estate/ mortgage crisis
 - **Local origin**- wider effects: Iceland bank crisis with effects in UK, NL, Lux etc
 - Small institution: triggers confidence crisis
 - Hypo Real Estate
 - Cross-sectoral: is insurance protected?
 - **Morphing**: credit crisis into liquidity into sovereign crisis
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SYSTEMIC RISK IN THE SECURITIES FIELD

- Often related to other segments of the society
 - Banking crisis affects all aspects of securities business
 - Sovereign crisis - euro crisis; General loss of confidence due to market turmoil – high volatility
 - High interconnectedness in securities activity: immediate worldwide reactions
 - Linked to **fundamental changes in society**: ageing, and provision for old age, immigration and sukuk bonds eg.
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SYSTEMIC EVENTS - 1

○ LTCM

- Systemic effects due to interconnectedness with all major banks
- Saved on insistence of NY Fed
- Causes;
 - Overleveraged
 - Freeze in the market due to Russian crisis
 - Small capital base
 - Mathematical risk model




SYSTEMIC EVENTS - 2

○ Money market funds- Lehman collapse


- Panic
- Shortage of liquidity
- Fire sales
- Treasury put up 50 bn in Sept 2008: Exchange stabilisation fund, now dissolved
- Long term effects; CP are not popular with MMF



SYSTEMIC EVENTS - 3

- “Flash crash”- May 6, 2010
 - 1000 points fall in DJIA – minus 9%
 - Recovered within 20 minutes 600 points
 - Causes; partly unknown, Algo trading
 - Circuit breakers 1989
 - Other voluntary measures; cost of unexecuted orders – volume reduced
 - Regulation ??
- 

SYSTEMIC EVENTS - 4

- “Madoff” – 60 bn Ponzi scheme, undiscovered
 - Trades not matched at DTCC – nobody inquired
 - EU Reaction
 - Depository regime in AIFMD + UCITS 5
 - Strict liability
 - Strengthen due diligence
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THE “PLUMBERS” - 7

- Clearing and settlement
 - No significant incidents have been reported
 - Commission initiatives
 - Derivatives- CCPs, Trade repositories- definition of clearable derivatives
 - CSDs - pre-proposed directive and Legal Certainty directive?
- Payments systems: very high systemic significance - functioned well



CCPs - 8

- CCPs
- Useful instrument for reducing volumes of outstanding: netting, compression
- High concentration of market participants:
 - Clearly systemic institutions
- Huge remaining volumes: are CCPs sufficiently safe? Are the required safeguards robust enough?
- Should one not reduce the use of derivatives in general? How are risks measured? Can these be effectively covered?



“SHADOW BANKING SYSTEM” - 9

- Difficult to define
- Some are already brought under the financial stability umbrella
 - Alternative Investment: systemic risk is the red line throughout the directive
 - MMF; capital requirements – controversial
 - Other measures considered



HOW TO DEAL WITH SYSTEMIC RISK

- Pervasive and evasive
- Not limited to finance
- OECD study - 2003
 - Demography
 - Environment
 - Technology
 - Socio economic structures – reduced role of government in 2003!



INSTITUTIONAL FRAMEWORK

- **Financial Stability Board**- at BIS: policy preparation for G 20, and implementation action in States
- **US FSO**, composed of heads of agencies under leadership of Treasury
- **European Systemic Risk Board**
 - Essentially central banks, ECB central position. Heads of ESAs
 - Relies on ESAs and national supervisors to obtain information – + own secretariat
 - Issues warnings and recommendation, no legally binding decisions
 - Eg carry trade in central Europe

SECURITIES REGULATORS - 1

- Systemic risk was traditionally not on the agenda of securities regulators
- **IOSCO** broadened mandate May 2012
- Several national regulators have adapted
- Change in approach from disclosure to more structural interventions

SECURITIES REGULATORS - 2

- More interest for **market structure**
 - See regulation on exchanges, MTFs, OTFs, SIs.
 - See structuring the derivatives markets

- Streamlining the role of the **gatekeepers**
 - CRAs, Auditors, Financial Analysts, bank directors

 - **CRAs**; regulation and deregulation



SECURITIES REGULATORS - 3


- **Auditors**: FSB declares them systemic
 - Strong action by EU Commission and PCAOB; reliance on accounts is core for confidence – too many deficiencies in large companies
 - Rotation and non audit services, conflicts of interest
 - Closer monitoring in US and EU

- **Corporate governance for bank directors**
 - See UK regime on SIF “Significant Influence Functions” beyond fit and proper, identify “right directors” as to expertise, engagement, behaviour, culture


- **Financial analysts**: independence?



INDIVIDUAL APPROACH ?


- Question: **what should top management do** with these systemic concerns? Should they adapt their behaviour, decisions, structures?
 - Obvious
 - Systemic risk is usually not concentrated in one institution; individual action helps, but is not sufficient
 - Systemic risk is risk and should be included in risk analysis and management: See AIG
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INDIVIDUAL APPROACH ?


- **Awareness** of system wide dimension of some decisions
 - Operational risk may affect the whole market
 - The system should be as safe as humanly possible – cost/benefit analysis includes wider risks
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INDIVIDUAL APPROACH ?

- **Each institution should contribute** to reduce risks
 - De-consolidated subsidiaries: Enron went too far
 - DVP in reduced settlement cycle: from T +3 to T+0 ?
 - Is HFT increasing risk?
 - Are bespoke derivatives not a danger to the system?

 - **Adhere to the spirit of the rules**; behave responsibly
 - Exploiting the rules to the limit leads to a backlash, sooner or later
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INDIVIDUAL APPROACH ?

- **Inform the regulator** of concerns in this field ?
 - Also about competitors: Madoff was refused as a client by the major banks, but the SEC did not know so.
 - The limits are evident however: denunciation!
 - **Keep eyes open** for the wider picture, including systemic developments
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LIABILITY ?

- Individual liability can only attach to specific instructions from the supervisors
- There may be liability for manifestly irresponsible conduct that led to systemic risks: theoretical ? See investor protection cases
- Liability would mainly be linked to flaws in the **risk management system**: duties of the CRO, CEO and the Board.

