The potential systemic risks identified in this Outlook are based on a number of information gathering exercises of the IOSCO Research Department and discussions with the IOSCO Committee on Emerging Risks. The identification and descriptions of risks in this report is based on the judgment of the IOSCO Research Department alone and not of the IOSCO membership. As such, the assessment of the potential systemic risks in this Outlook should be interpreted as the views of the authors and does not necessarily represent the views of IOSCO committees, task forces or its broader membership. Information and opinions presented in this note have been obtained or derived from sources believed by the authors to be reliable.

For further information please contact the authors via research@iosco.org or visit www.iosco.org/research
This IOSCO Securities Market Risk Outlook 2013-14 (the Outlook) is the first external publication of an annual series of Outlooks that aim to identify and assess potential systemic risks from securities markets. The Outlook is a forward-looking report focusing narrowly on issues relevant to securities markets and whether they are, or could become, a threat to the financial system as a whole.

This Outlook, written by the Research Department of IOSCO, is based on a number of inputs including: data collection and robust analysis, construction of quantitative systemic risk indicators, extensive market intelligence interviews for major financial centres, risk roundtables with prominent members of industry and regulators, a survey on emerging risk to the market, analysis from academia and the regulatory community, input from IOSCO’s Committee on Emerging Risks (CER, formerly known as the Standing Committee on Risk and Research) and risk reports and presentations by experts. The Outlook synthesises these inputs to adopt a global and forward-looking approach to understanding risks that could become systemic and to highlight some noteworthy trends and potential vulnerabilities.

The purpose of the annual Risk Outlook series is three fold. First, it is intended to inform the IOSCO Board and other IOSCO members about potential systemic risks to securities markets. The Outlook constitutes one data point to assist national regulators in implementing IOSCO’s two new principles on identifying, assessing and mitigating systemic risk (Principle 6), and on reviewing the regulatory perimeter (Principle 7). Second, this series aims to support the global risk identification and mitigation efforts by the Group of Twenty (G20), the Financial Stability Board (FSB), the IMF and other global organisations that are tackling similar issues. Third, in the interests of public disclosure, this annual series presents in a single, accessible document key issues and potential systemic risks currently being discussed by market participants, securities experts and regulators around the globe.

The Outlook represents one aspect of IOSCO’s new role in the assessment and mitigation of global systemic risks. It is one of IOSCO’s next steps along with the publication of the new mission and goals, the new Principles and their assessment methodology, the discussion paper on systemic risk, and an upcoming report by the IOSCO CER providing guidance on systemic risk identification (anticipated in the fall of 2013).

This Securities Markets Risk Outlook 2013-14 was prepared by staff of the IOSCO Research Department with the benefit of discussion with and input from members of the Committee on Emerging Risks, under the general direction of David Wright, Secretary General of IOSCO and Carlos Tavares, Chairman of the

1 The IOSCO Board is the governing body of IOSCO and consists of 32 securities markets regulators around the globe. It merges the functions of the former Technical Committee, Executive Committee and Emerging Market Committee Advisory Board.
2 http://www.iosco.org/about/
Increasing systemic risk by similar risk management standards

In line with Principle 5 of the CPSS-IOSCO PFMI’s, CCPs should be attentive when managing liquidity and enforcing appropriate haircuts for collateral. They also should use criteria and models to evaluate price risk, liquidity risk etc. of that type of collateral.

A staff working paper of the Dutch central bank (DNB) indicates that similar risk management models are shared amongst CCPs. The common elements include establishing selection criteria for clearing participants, implement risk-based marging, mutualise extra stress test-based risk exposure among clearing participants, and finally use own capital or other financial resources under certain conditions, subject to the replenishment and replacement conditions outlined in Principle 7 of the CPSS-IOSCO PFMI’s. However, CCPs are permitted to choose the order in which stand-alone fund and other mutualised financial buffers can be applied to dissipate any remaining losses after the initial margin and other paid-in amounts.

There is a continual need to assess a risk management system in its entirety, and regulators should ensure that it is appropriate for the CCP’s business model. Assessments should consider both the CCP’s risk management procedures and how the CCP management implements these (Principle 6).

Interconnectedness of CCPs and the banking system

Market intelligence highlights (see Annex A) some cases where collateral is recycled back to clearing members and has provided examples where it is not, strictly due to internal controls within the CCP. The CPSS-IOSCO PFMI’s do not provide guidance on this practice in particular. They do, however, require a CCP to have deposit holdings “at creditworthy commercial banks” (Principle 7), meaning that CCPs should hold their own assets and those of their participants at supervised and well regulated entities (Principle 16), and any assets that are held in custody are to be protected against claims of a custodian’s creditors (Principle 16).

The Principles also recognise that a custodian bank might be a participant in a CCP and offer clearing services to other participants. In that case, “An FMI should carefully consider all of its relationships with a particular custodian bank to ensure that its overall risk exposure to an individual custodian remains within acceptable concentration limits” (Principle 16).

Other trends

There is some evidence that CCPs invest cash collateral at longer maturities to provide a better return to members. It is the case, however, that this practice only moves overnight cash into highly liquid securities such as bank bills. If this practice continues, the overall impact is likely to be minimal. Moreover, there is no evidence that CCP soundness has been compromised by such actions. Nonetheless, regulators should be attentive to competitive pressures that may induce standards to slip.

Looking Forward

OTC derivatives are increasingly centrally cleared. Global regulation along with changes in industry practices will further increase this trend. CCPs can help mitigate the risk of a systemic crisis by: 1) reducing bilateral counterparty risk 2) by netting outstanding positions, reducing the gross exposures,122 and 3) by requiring highly liquid collateral to cover credit and liquidity risk. However, CCPs could become a source of systemic risk in the event of significant market stress because they concentrate risk and financial resources.

How the regulatory environment and changing business operations of CCPs will affect the macro

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121 Based on information obtained from Thomas Murray

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Investment Policy of selected CCPs

SIX x-clear

SIX x-clear invests a small proportion of its own assets in equities. The remainder, along with cash contributions from members for required margins, is managed by SIX x-clear. Any cash invested is overnight against repo by 3.30pm and received back by 8.15am the following morning. As of 31 December 2011 CHF 44.8 million was held in GBP at a U.K.-based bank, which is also a clearing member. The majority of the cash flows (all the default fund cash plus any surplus cash from margin contributions) is routed to SIX SIS and managed there.

CC&G

CC&G can invest in money market or financial instruments issued by a sovereign state of the EU with an investment-grade credit rating of diff (or above). The minimum credit rating for deposit taking counterparties is A2 (or equivalent) and the maximum amount is limited to €1.5 billion per institution and can be no more than 30% of the total liquidity available to CC&G. Limits apply to the maturity structure of time deposits, e.g., no more than 10% of time deposits can be invested in maturities between 3 to 6 months, although up to 100% can be invested in maturities up to one week.

SGX-DC

Of SGX-DC’s own funds of SGD 171 million, 32% had a maturity of less than 6 months, while 68% was 6-12 months. The investments were in the following currencies:

<table>
<thead>
<tr>
<th>Currency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD</td>
<td>45%</td>
</tr>
<tr>
<td>JPY</td>
<td>45%</td>
</tr>
<tr>
<td>SGD</td>
<td>10%</td>
</tr>
</tbody>
</table>

There were no Euros at 30 June 2012. This currency allocation reflects the currency of the underlying contracts that SGX-DC clears, although participants are not required to provide margins in the currency of the contract. SGX-DC takes a 5% haircut on any non-contract currency – it does not hedge the FX exposure. SGX-DC does hedge its own clearing revenues in USD via currency forwards. (Presumably if SGX-DC were to “hedge” the FX exposure arising from clearing members’ margins, this would not qualify as a hedge in its own books since these cash funds are off-balance sheet). All cash placements of SGX-DC’s own funds are unsecured. It is not known if this is also the case with clearing members’ funds. There is no evidence of any repo activity. Clearing members receive an undisclosed portion of interest earned on their cash collateral invested on their behalf by SGX but they do not receive interest on securities lodged as collateral – this is retained by SGX-DC.

ICE Clear Credit

As of 30 September 2012, ICC had $13.06 billion cash deposits from clearing members. The majority of the cash deposits are invested in reverse repos via a third party custodian bank. Under the reverse repos, the clearing house buys US Treasuries and other US securities and then sells them back on the following business day at a predetermined price. None of the counterparties to the reverse repos are clearing members.

ICE Clear Europe

As of 31 December 2011, ICE Clear Europe had $16,586,628,000 cash from clearing members for initial margin and default fund purposes. Of this total cash deposits, $16,020,673,000 was invested in repo with several banks through a third party custodian bank. A further $480,162,000 was directly invested in government bills. In addition, ICE Clear Europe

162 Source: Thomas Murray.