The Shift to Market-Based Financing – Understanding and Managing New Risks

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The opinions expressed are as of June 2015 and may change as subsequent conditions vary.
Putting Growth in Perspective

**S&P 500 Prices**
- Closing Price ($) over time from Jan-04 to Jan-15.

**U.S. Defined Benefit Plan Assets**

**Sovereign Wealth Fund Assets**
- Total AUM ($ trillions) over time from 2001 to 2015.

**Outstanding Bond Market Debt**
- Total Debt ($ trillions) from 2004 to 2013.

**U.S. Defined Contribution Plan Assets**
- 457 plans, TSP, 403(b) plans, Other private-sector DC plans, 401(k) plans.

**U.S. Insurance Company Assets**
- Life, Health, Property & Casualty.

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Sovereign Wealth Fund Institute. As of May 2015.

U.S. Defined Benefit Plan Assets:

Emerging Markets Data:
- BIS. As of December 31, 2013.

U.S. Defined Contribution Plan Assets:

U.S. Insurance Company Assets:
- SNL Financial. Includes only life insurance, health insurance, and property and casualty insurance companies in the US. As of May 2015.
# Regulatory Reform has Impacted Asset Owners and Markets

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<tr>
<th>Bond Market Liquidity</th>
<th>Cash Investing</th>
<th>Central Clearing</th>
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<td>▶ Capital rules, liquidity coverage ratios, limits on proprietary trading have reduced banks’ abilities to hold inventory.</td>
<td>▶ SEC 2010 and OCC 2012 reforms resulted in restrictions on portfolio maturity, liquidity, and diversification and enhanced disclosure.</td>
<td>▶ We support the concept of central clearing to reduce counterparty risk.</td>
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<td>▶ Opportunistic issuance in low rate environment has increased the number of bonds.</td>
<td>▶ SEC finalized structural reforms for MMFs in 2014. Fidelity, Goldman Sachs, and Federated have announced changes to product lineup.</td>
<td>▶ However, risk is being concentrated in CCPs, and measures to reduce the likelihood of a CCP failure are needed.</td>
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<td>▶ Market “plumbing” needs modernizing, including greater electronic trading which could be facilitated by greater standardization of issuance.</td>
<td>▶ State regulators have not issued reforms to state-chartered STIFs.</td>
<td>▶ We recommend capital standards for CCPs, stress testing, transparency to counterparties of CCPs, and identifying a resolution plan, including a clear waterfall, in the event of a CCP failure.</td>
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<th>“Search for Yield”</th>
<th>Bank Liquidity / Bank Deposits</th>
<th>Data on Alternative / Private Funds</th>
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<td>▶ Low interest rates have made it harder to meet investment objectives for asset owners who must fund liabilities or generate income (e.g., pensions, insurers, retirees).</td>
<td>▶ Liquidity coverage ratios impact banks as lenders.</td>
<td>▶ Form PF, Form PQR, AIFMD, etc. have provided regulators with significant amounts of data on private / alternative funds.</td>
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<td>▶ Many asset owners are necessarily taking on more risk to meet needs.</td>
<td>▶ Disadvantageous for banks to hold short-term (&lt;30 days) deposits due to regulation and low interest rates. J.P. Morgan considering fees for holding certain institutional deposits.*</td>
<td>▶ OFR’s preliminary conclusions show levered funds hold liquid assets.</td>
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<td>▶ Monetary policy is, thus, a primary driver of increasing allocations to higher yielding assets (e.g., high yield, emerging markets debt, bank loans).</td>
<td>▶ Asset owners are seeking alternative solutions for investing cash.</td>
<td>▶ Global harmonization of data collection would benefit policy makers, investors and managers.</td>
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A Product- and Activities-based Approach to Reducing Risk

1. Improve market structure for central clearing of OTC derivatives.
   – Require greater financial resources for CCPs and clear rules for recovery and resolution.

2. Revisit private fund reporting to standardize definitions and reduce overlap and bespoke requirements.
   – AIFMD provides a framework that should be emulated in other jurisdictions.

3. Clearly and consistently define leverage to improve oversight and reduce risk.
   – Include derivatives, recognizing that derivatives that are offsetting or hedging risks do not create leverage.

4. Further develop the toolkit for managing redemptions in funds.

5. Establish principles for stress testing fund liquidity.
   – Use AIFMD as the starting point.

6. Establish a global standard classification system for exchange-traded products (ETPs).
   – Review structural features of certain ETPs (e.g., leveraged, inverse, and bank loan).

7. Standardize guidelines for using cash re-investment vehicles in securities lending.

8. Improve underlying market structure for bank loans and for corporate bonds.

9. Broaden understanding and transparency of the entire financial market ecosystem.

10. Address the longevity crisis and pension underfunding.
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