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What’s next for capital markets?

Daniel Trinder, Executive Director, Strategy

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What’s next for capital markets?

Outline

1. Key structural and cyclical factors shaping capital markets
2. A macro view of private markets
3. Artificial Intelligence and capital markets
4. Tokenisation

Structural and cyclical factors are both shaping capital markets

Technology and Digital Transformation

- Today's capital markets operate through a complex and fragmented web resulting in operational friction
- AI and next-generation technologies, particularly Distributed Ledger Technology (DLT) offer the potential to improve global capital markets

Operational and Regulatory Innovation

- AI offers the ability to process vast datasets in real-time to allow financial institutions to better manage risks, reduce operational errors and ensure regulatory adherence

Democratisation and Market Access

- Retail investor empowerment and the blurring of public/private markets
- The growing influence of millennial and Gen Z investors is driving transparency and greater innovation

Institutional Evolution and Capital Allocation

- Superannuation and pension funds are increasing risk appetite and sector diversification

Rapid rise in public debt

- Large government fiscal deficits are influencing interest rates, investment patterns, and market performance

Market concentration

- Equity markets have become increasingly concentrated, so overall market returns increasingly depend on a small number of firms or sectors

A macro view of private markets

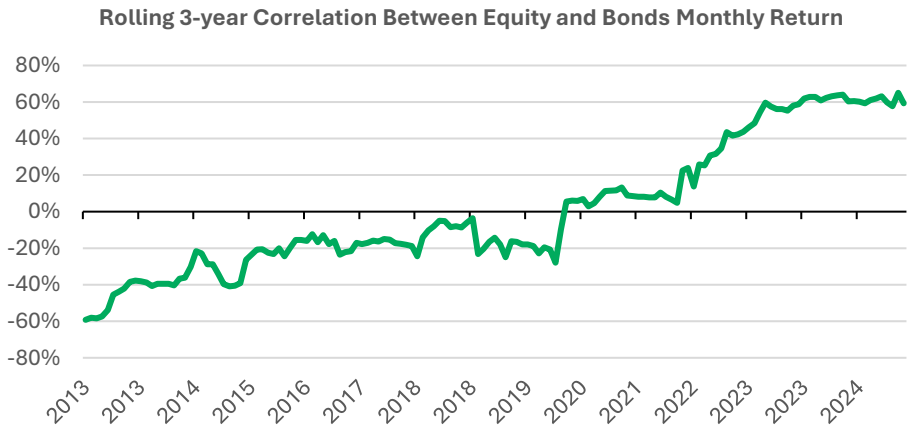
The importance of asset allocation strategies, diversification and cyclicality are often missed

Diversification: Investing in private markets isn't just about potentially higher risk-adjusted returns but also about diversification. The correlation of different asset classes post-2022 changed markedly

Cycle of investing: Interest rate cycles impact the shift of public to private. The performance of public markets v private markets recently has left many large institutions overweight in private markets and led them to seek other pockets of capital

Sectoral factors. Sectors such as infrastructure with long duration investments are finding they are sometimes less suitable to public markets, attracting high private investor interest in that asset class

Supply of private capital: Companies are staying private for longer as the prestige of listing a company has shifted for many founders. Private markets now offer founders liquidity and the ability to raise capital more quickly and cheaply than going public



From 2021 onward, the correlation between stock and bond returns turned positive in the US and other major markets, driven by a surge in inflation and central bank policy responses

The positive correlation made it harder for investors to use bonds as a hedge against equity market downturns

* Total returns on the S&P 500 and the iShares Core US Aggregate Bond ETF

A macro view of private markets

What has happened to open up private markets to retail investors?

Democratisation of investing: Making investment opportunities accessible and affordable for a much broader investor base, beyond just high-net-worth or institutional investors.

Factors:

1. **Illiquidity premium**: Historic private markets have offered higher returns in part due to the illiquidity premium, with investments typically locked in closed-ended fund structures. The emergence of semi-liquid, evergreen funds with quarterly redemption windows (e.g., 3 months) is enhancing accessibility for a broader range of investors
2. **Technology-Driven Access**: Private markets have been predominantly institutional capital. Tech-enabled platforms are now disrupting this model by aggregating retail demand and offering fund-of-fund structures, significantly expanding retail investor access
3. **Shifting Distribution Landscape**: Private equity firms are increasingly securing retail distribution by acquiring wealth management firms (e.g., Hargreaves Lansdown) or entering strategic partnerships with major retail platforms, reshaping market access channels.
4. **Infrastructure innovations**: The wholesale market is starting to adopt some standardised pricing and valuation frameworks such as NASDAQ Tape D, bringing greater transparency, efficiency, and confidence to private market investing

What to do?

1. Both public and private markets are crucial components of capital markets
2. Most regulatory focus tends to be on recalibrating public market settings
3. Continue to deepen our understanding of private markets
4. As private markets mature, expect greater transparency to investors
5. Focus on reducing potential risks to retail investors where retail participation high

Risks in private markets

Investors face a distinct set of risks from those that exist in public markets

- **Transparency and opacity**: Less transparent than public markets, with limited disclosure requirements and less frequent reporting. This opacity makes it difficult for both investors and regulators to assess risks, monitor market health, and detect misconduct
- **Leverage**: Increase use of NAV (Net Asset Value) loans that add leverage at the portfolio level. Uncertain public markets fueling secondary funds to keep good assets private; risk that public exits are highly levered portfolio companies
- **Governance:** Multilayered conflicts of interest can arise not only between investors and managers but also among investors and within institutions, raising questions about fair treatment and governance standards
- **Valuation and pricing**: Assets are less liquid and harder to value than public securities, leading to concerns about valuation uncertainty and lagging price discovery relative to public markets. This can obscure the true risk profile of investments
- **Fee structures**: Fee arrangements in private markets can be complex and opaque, with concerns about hidden or excessive fees and expenses that may not be fully disclosed to investors

Artificial Intelligence and capital markets

AI is fundamentally reshaping capital markets, driving change across trading, operations, compliance, and client engagement

Recent and potential use cases for AI and MI in Capital Market Activities

Key Processes	Client/Institution Profiling	Asset Allocation			Trading	Risk Management	
	Identification of Needs and Constraints	Asset Class Allocation	Sectoral Allocation	Security Selection	Orders Placement and Execution	Risk Monitoring	Reporting
Potential Benefits from Adopting AI	**Enhance client's profile assessment** • Analyze unstructured or alternative clients' data to understand unique objectives, idiosyncratic needs, and risk preference • Generate simulated scenarios and visualization of potential outcomes of different asset mix	**Enhance optimization and forecast techniques for strategic allocation** • High dimensional forecasting and predictor selections • Deep learning methodologies for dynamic multiperiod portfolio optimization • Clustering/network analysis to analyze multidimensional interactions/ correlations		**Improve analysis precision** • Feature extraction (beta, momentum, and so on) • Network/ multidimension analysis for relative value analysis and identify price dislocation	**Minimize market impact** • Structured trade execution algorithms to minimize market impact • Analyzing unstructured data and cross-market indicators to identify prevailing liquidity conditions **Assist price discovery** • Modelling executable prices for illiquid securities through multiple market indicators **Improve liquidity management efficiency** • Forecast liquidity needs (margin management, collateral, etc.) through clustering/network analysis	**Dynamic risk sensing** • Generate risk hypothesis • To identify performance drivers and anomalies through multidimensional analysis **Generate risk scenario** • Value-at-risk estimation through generative adversarial networks to capture temporal dynamics in time-series data	**Customize insights** • Customized content generation, reports, and dashboards • Chatbot **Ease compliance monitoring** • Screening, flagging, and reporting of anomalies
		Derive signals from unstructured and alternative data • Natural language processing models for sentiment analysis to identify thematic opportunities • Polarity detection, microtext analysis, aspect extraction, or sarcasm detection to improve signal quality					

IMF: Advances in Artificial Intelligence: Implications for Capital Markets, October 2024, Page 79

Artificial Intelligence and capital markets

AI has the potential to largely exacerbate existing risks and introduce other risks

Three categories of risks

Market Manipulation:

- New forms of market manipulation that existing regulatory frameworks may not adequately address

Systemic risks:

- Market correlation and herding behaviour
- Model risk
- Cybersecurity threats

Consumer protection and ethical concerns:

- Fraud
- Disinformation

What to do?

1. Setting out supervisory expectations permits greater adoption, but in a way that minimises risks
2. Good governance is paramount to allow for safe AI adoption

Tokenisation

What are tokens?

Tokens are part of the crypto asset ecosystem and are digital representations of assets that are recorded and managed on a blockchain or distributed ledger. They enable the ownership, transfer, and trading of these assets in a more efficient, transparent, and programmable way than traditional financial instruments

Key Features

Digital Representation of Assets: Tokens can represent both tangible assets (property or commodities) and intangible assets (securities)

Programmable Functionality: Tokens can embed rules and logic (via smart contracts) that dictate how they can be used, transferred, or traded. For example, a tokenised bond might automatically pay interest to holders when certain conditions are met

Enhanced Liquidity: Tokenisation breaks down large assets into smaller, tradable units, making it easier for investors to buy and sell fractions of assets, thus increasing market liquidity

Automated and Efficient Processes: Tokenised assets can streamline processes such as settlement, compliance, and payment, reducing the need for intermediaries and lowering transaction costs

Tokenisation

Key trends in tokenisation?

Institutional Adoption and Mainstream Integration

- Major financial institutions and governments are moving from pilot projects to implementation
- Central banks and regulators are increasingly involved (central bank digital currencies (CBDCs) and stablecoin legislation)

Expansion Across Asset Classes

- Expanding beyond crypto to encompass real-world assets (RWAs) such as real estate, commodities and fine art
- Investment funds (mutual funds, ETFs), are being tokenised offering 24/7 settlement and broader investor access
- Commodities (gold, agricultural products) and fixed-income products (bonds, repo transactions) are among the fastest-growing segments for tokenisation, driven by improved liquidity and transparency

Increased Liquidity and Accessibility

- Enables fractional ownership, allowing more investors to access assets and democratising investment opportunities
- Liquidity is enhanced as traditionally illiquid assets can now be traded on blockchain networks, reducing settlement times and operational costs

Automation, Efficiency, and Transparency

- Smart contracts automate trading, settlement and compliance, leading to faster, more efficient, and transparent processes
- Blockchain's shared ledger reduces manual reconciliation errors, increases transparency, and lowers operational costs

Security, Regulation, and Risk Management

- While blockchain offers inherent security, risks such as smart contract vulnerabilities and fraud remain, prompting focus on robust security measures and regulatory oversight
- Many jurisdictions developing frameworks for tokenised assets and stablecoins, further supporting institutional adoption

Thank You

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