actuarial association of europe

Systemic risk / Macroprudential regulation

AAE Joint Meeting of Insurance, Pensions and Risk Management Committees

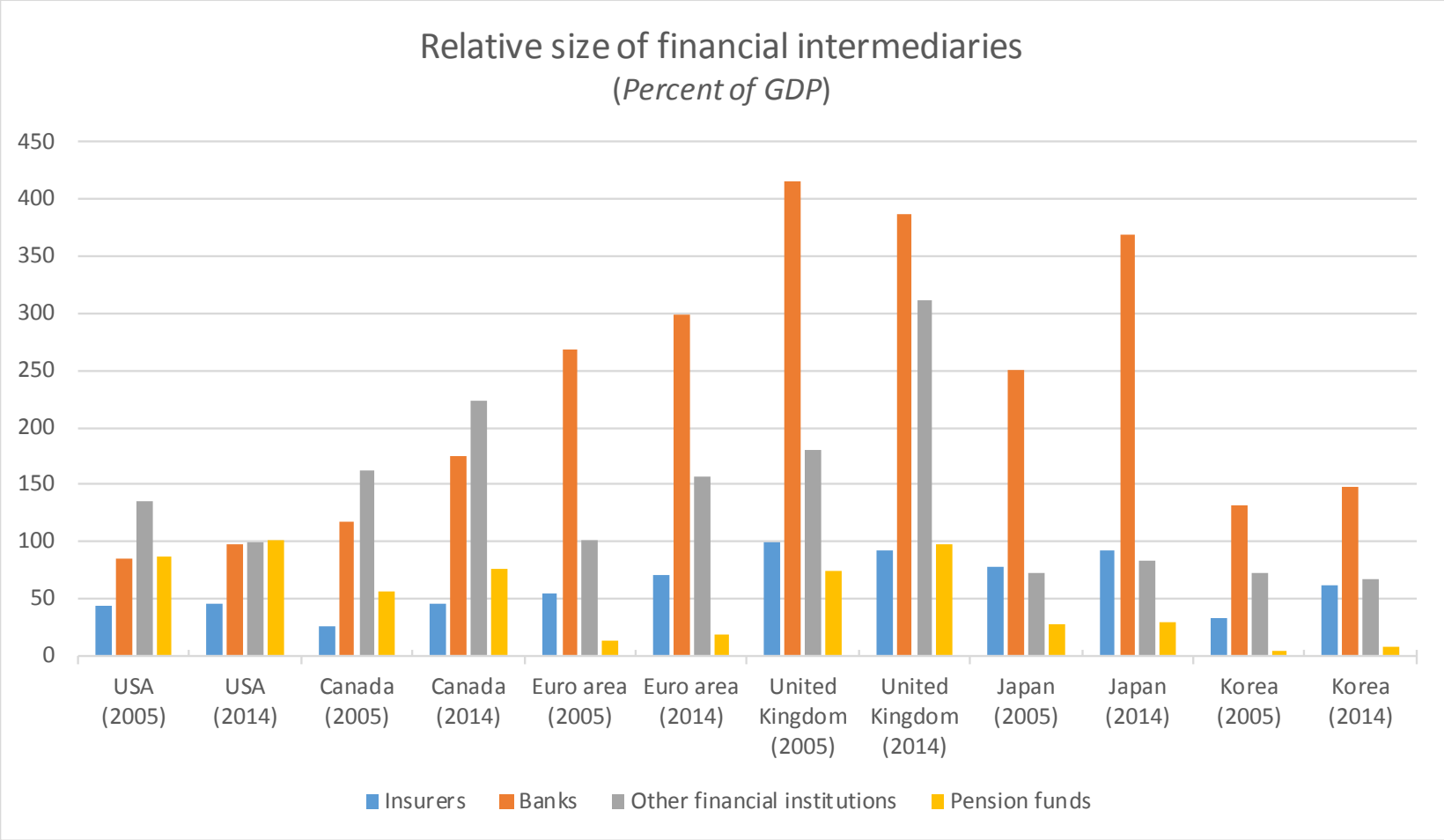
15 April 2021

Malcolm Kemp, Chairperson, AAE Risk Management Committee

Background

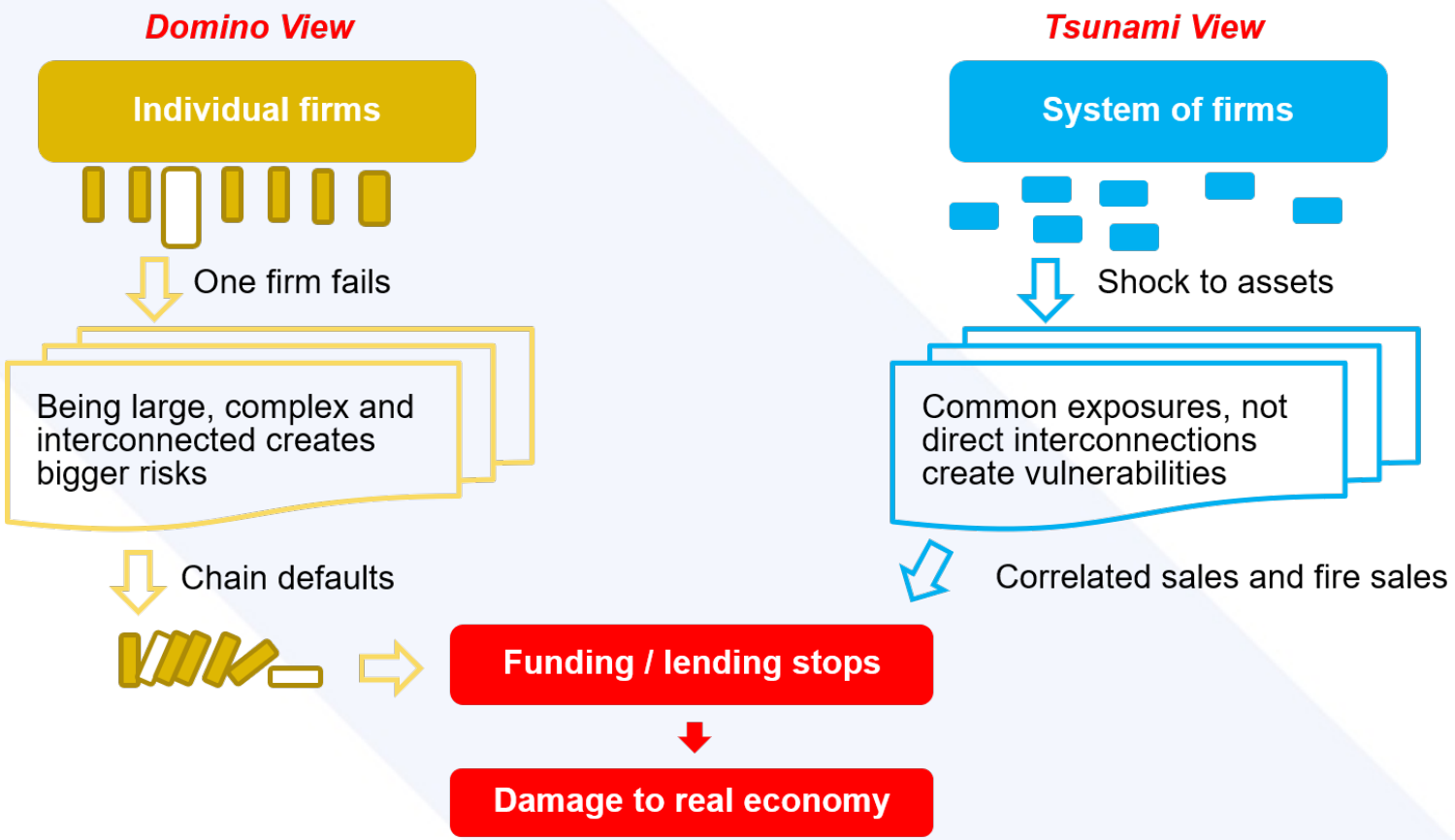
- Financial stability, systemic risk, macroprudential regulation
  - Thinking materially influenced by 2007-09 Global Financial Crisis (GFC)
  - Even though many previous systemic (financial) events (hyperinflation, sovereign defaults, S&L Crisis, 1929 Wall Street Crash, LTCM, Continental Illinois and 'Too Big To Fail', …) and new ones will no doubt follow
  - The system can behave in ways that are beyond just those of its parts
  - Covid-19 currently high on macroprudential agenda
- Banking (more generally credit intermediation and maturity transformation) often viewed as more prone to systemic events
- But modern finance doesn't operate in neatly defined buckets, so focus extends across the financial system (and beyond):
  - Money market (and other) funds, AIG, non-bank financial intermediation, insurers, central counterparties, pension funds, sovereigns, non-financial corporations, …

Perceptions linked to size / importance



Source: Nematrian, adapted from IMF (2016) Global Financial Stability Report

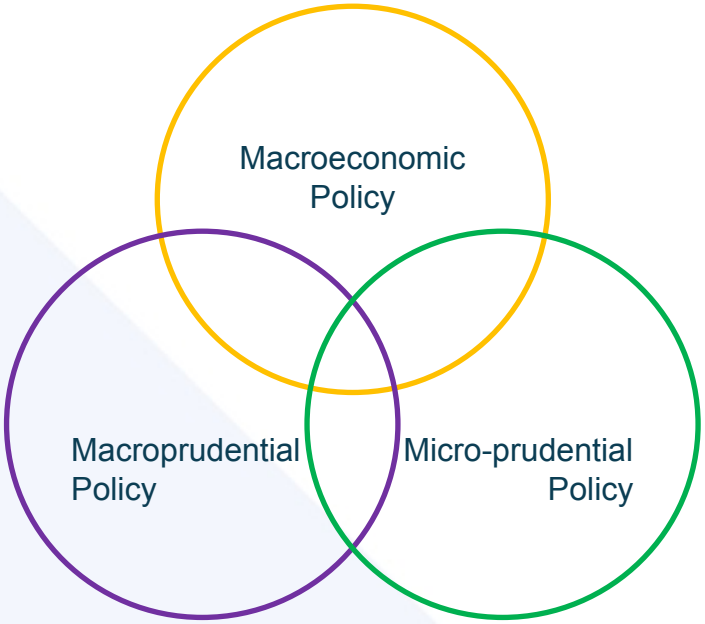
… and by what is thought to drive the risk



Source: Nematrian, adapted from IMF (2016) Global Financial Stability Report

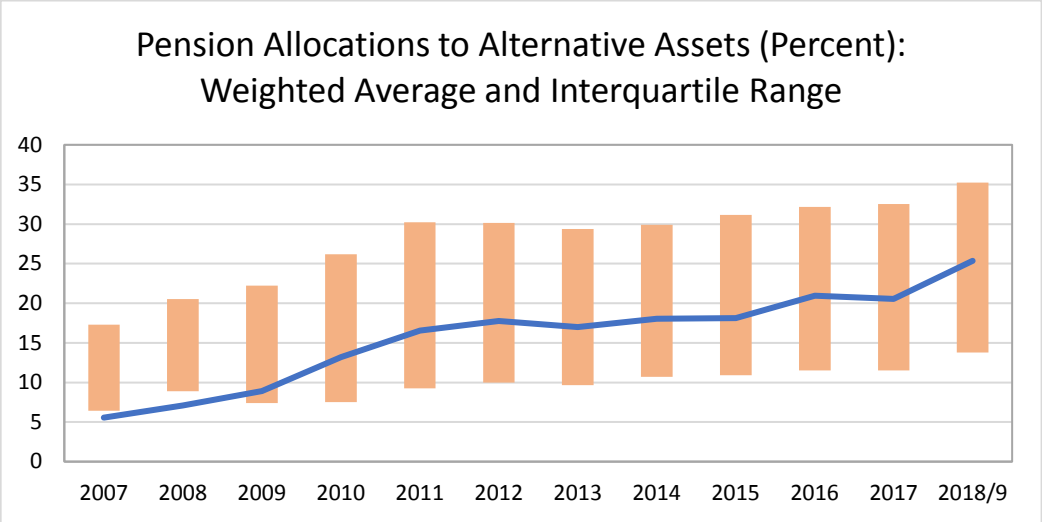
A policymaker perspective

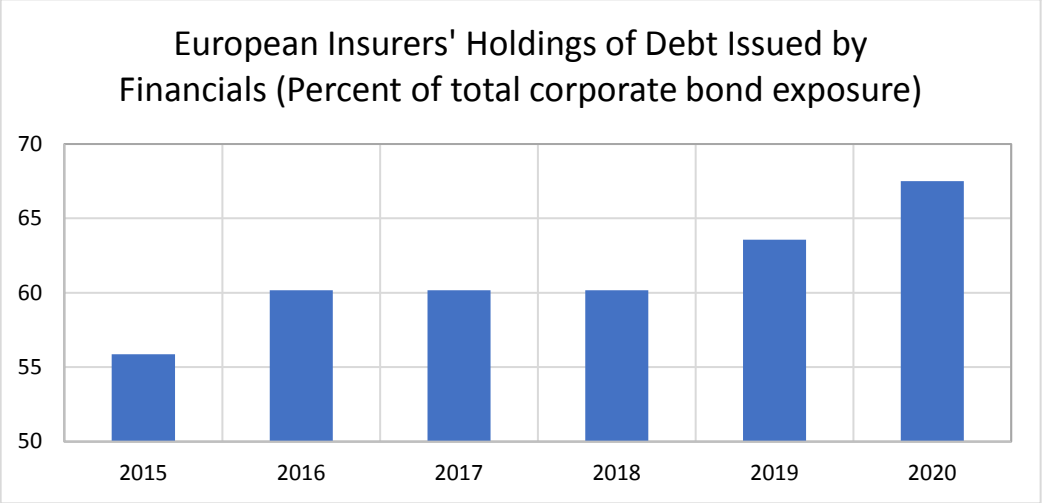
- Big systemic events can have sizeable economic impacts
  - Fuzzy division between macroeconomic, macroprudential and micro-prudential policy
  - E.g. “Growth at risk” (GaR) a conceptual way of setting macroprudential policy
- Regulation (or maybe just the possibility of regulation) creates implied responsibilities
  - In scope: any part of the financial system large enough to be important to society
  - Tension: how to identify and mitigate vulnerabilities whilst still allowing financial system to assist society



Policymakers naturally keen to explore potential risks

- Risky behaviours, e.g.
  - Search for yield
  - Widespread under-reserving
- Risks to critical functions, e.g.
  - Cyber risk, operational resilience, outsource risk. What impact would a bad hack or major outage have?
- Bigger picture risks, e.g.
  - Climate change: a near certain to materialize risk, just unclear when?





Source: Nematrian, adapted from IMF (2021) Global Financial Stability Report, April 2021

And to question the status quo

- Organisations want to believe they have a long-term future
  - Is Europe ‘overbanked’, given push towards Capital Markets Union?
  - If interest rates stay low(er) for long(er), how robust are some life insurance (and DB pension) business models?
  - What if disruptors (Fin Tech, Insure Tech, Big Tech, …) seize the profitable parts of the value chain?
- Policymakers have an interest in ensuring that large enough organisations consider other possible outcomes
  - C.f. recovery and resolution planning, existence of guarantee schemes
  - Firms ‘die’, just like individuals!

Tools explored by EIOPA in 2018

Tool	Type of tool	Proposed for further consideration?
Enhanced reporting and monitoring		
Leverage ratio	Capital and reserving-based	Yes
Enhanced monitoring against market-wide under-reserving	Capital and reserving-based	Yes
Additional reporting on liquidity risk	Liquidity-based	Yes
Liquidity risk ratios	Liquidity-based	Yes
Enhancement of Prudent Person Principle	Exposure-based	Yes
Enhancement of own risk and solvency assessment (ORSA)	Exposure-based	Yes
Recovery plans	Pre-emptive planning	Yes
Resolution plans	Pre-emptive planning	Yes
Liquidity Risk Management Plans (LRMP)	Pre-emptive planning	Yes
Systemic Risk Management Plans (SRMP)	Pre-emptive planning	Yes
Intervention powers		
Counter-cyclical capital buffer	Capital and reserving-based	No
Capital surcharge for systemic risk	Capital and reserving-based	Yes
Liquidity requirements	Liquidity-based	No
Temporary freeze on redemption rights	Liquidity-based	Yes
Concentration thresholds	Exposure-based	Yes

- Most of the above picked up in 2020 Solvency II Review EIOPA Advice to Commission. Complementary to corresponding advice from ESRB

With risk, perhaps, comes opportunity

- Insurer and pension funds investments
  - Might they be a source of ‘patient capital’ that can help fund infrastructure needs and support other desired social goals?
  - Can such institutions (and sovereign wealth funds) counter pro-cyclical behaviours of others in the financial system?
  - Could they substitute for credit provision otherwise supplied by banks?
    - But is this good because it shares risk more broadly, or bad because it may be indicative of regulatory arbitrage?
    - Experience with CDOs and CLOs in GFC: repackaging and sharing of risks across the financial sector does not always end well
- Risk sharing expertise and insights
  - Insurance (or insurance-like) solutions might help to address other challenges, e.g. Covid-19 (or similar future) events? C.f. Social security programmes (called “National Insurance” in the UK)

Summary

- Financial stability, systemic risk and macroprudential regulation
  - Key insight: behaviour of whole system can diverge from those of its components
  - A bank / money market fund / insurer “run” can trigger depositors / investors / policyholders to “run” elsewhere. No direct connection needed (c.f. domino versus tsunami models), if broader situation sufficiently challenging
- In scope: all sufficiently sizeable parts of the financial system
- Policymakers in this area may adopt a more expansive analysis and may be more sceptical about business model sustainability than is comfortable for affected organisations
- With risks, perhaps, come opportunities. Could institutions we advise (or insights we can draw from them) provide solutions rather than problems?