Macroprudential Regulation and Systemic Risk

AAE Webinar

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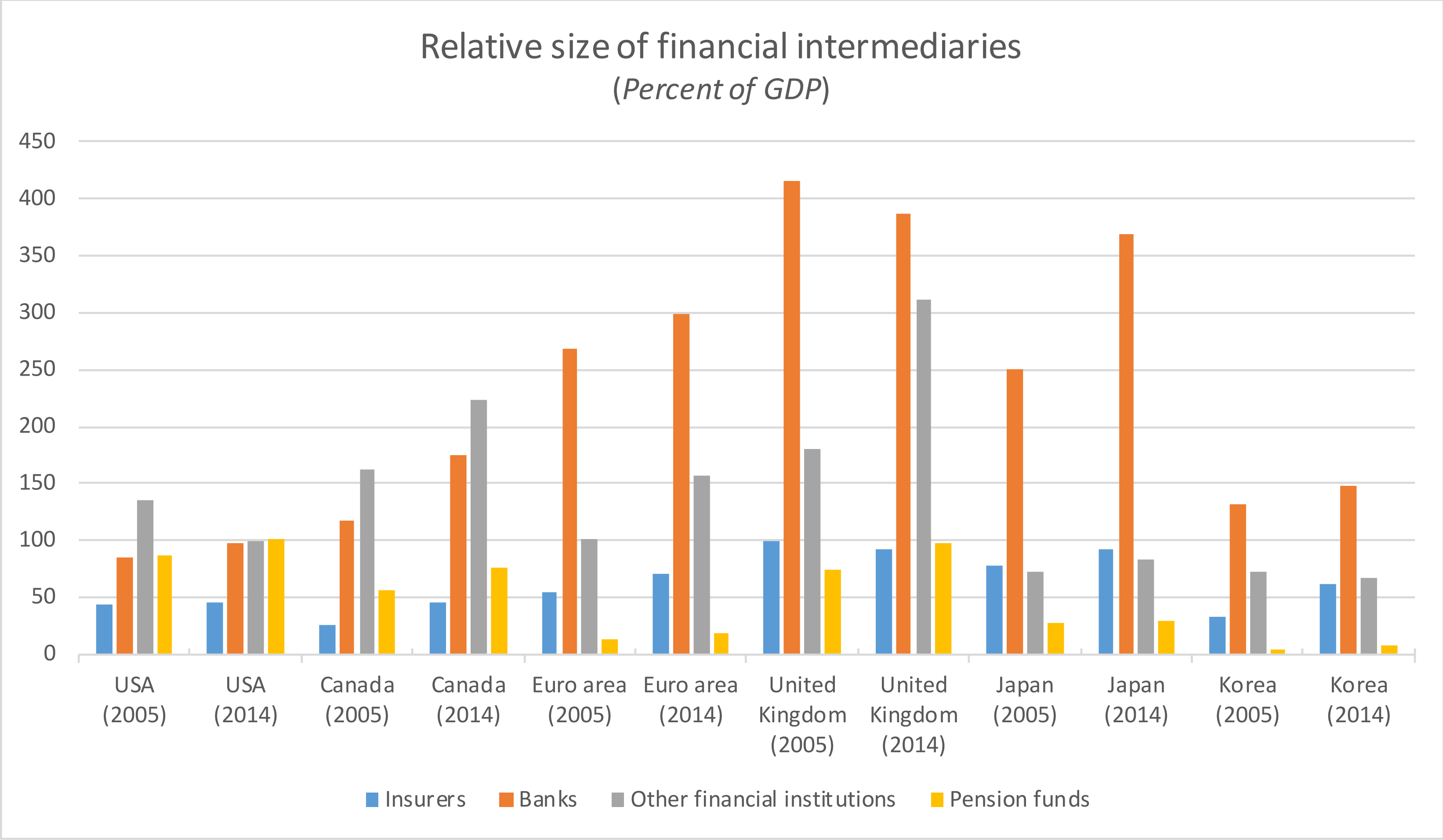
Introduction

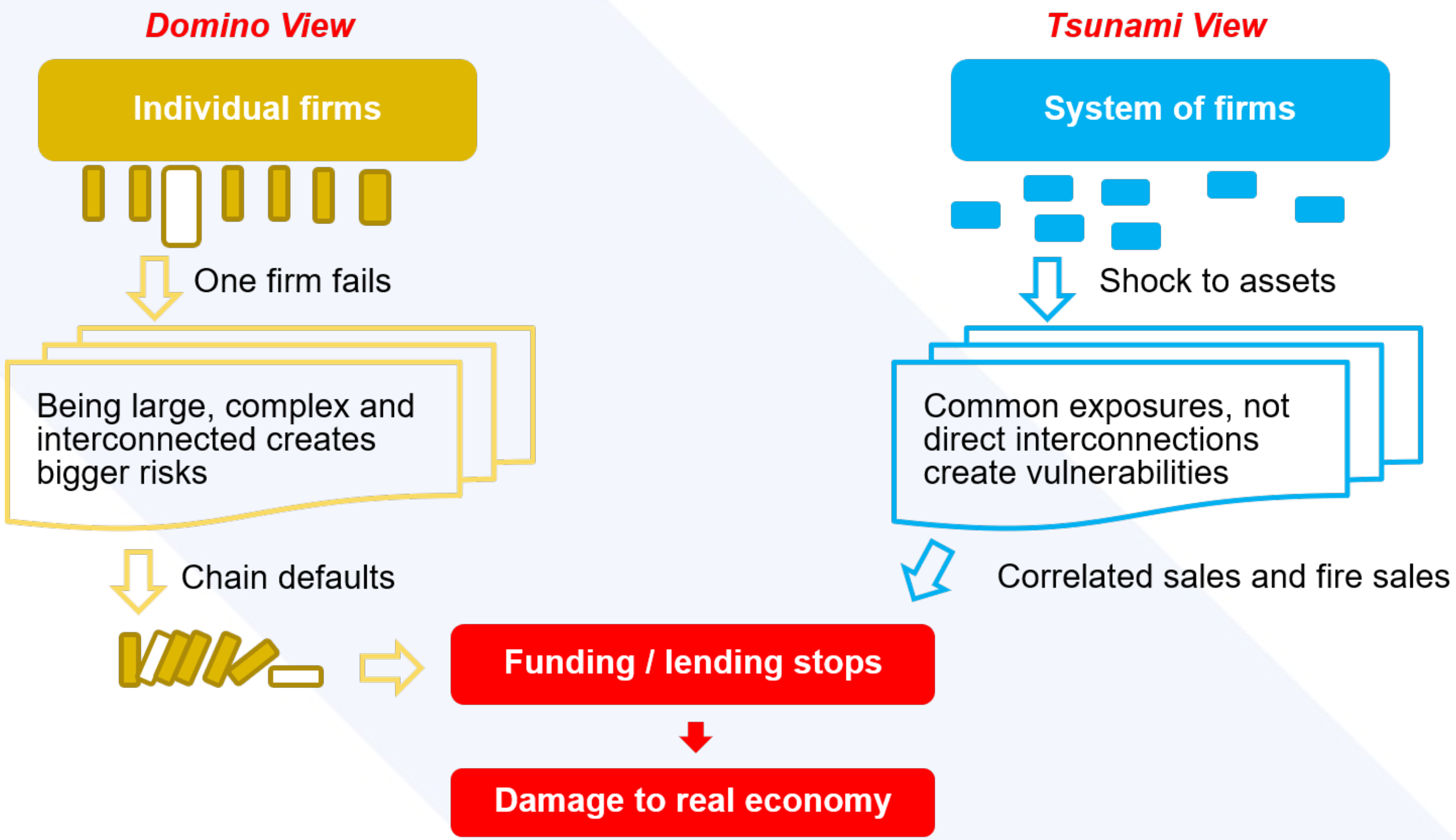
- Financial stability, systemic risk, macroprudential regulation
  - Topics closely linked. Thinking materially influenced by 2007-09 Global Financial Crisis, even though many previous systemic (financial) events (hyperinflation, sovereign defaults, S&L Crisis, 1929 Wall Street Crash, LTCM, Continental 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
  - Impact of Covid-19 currently prominent
- 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

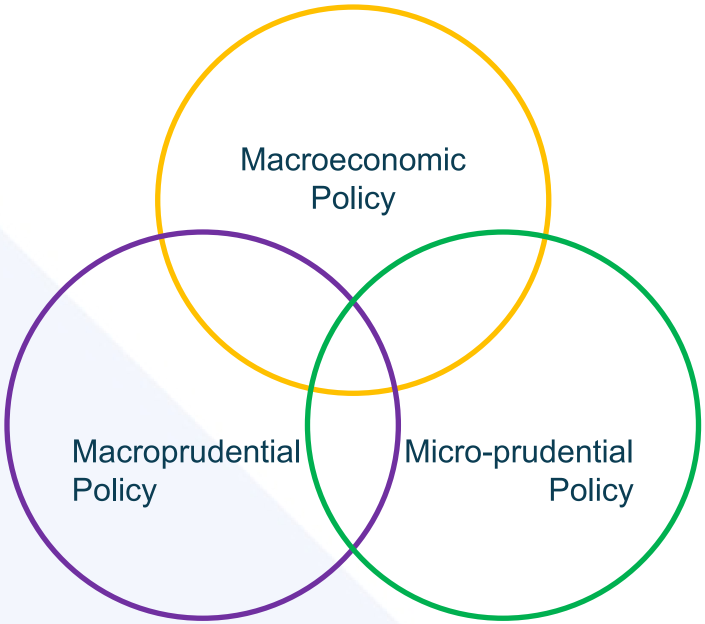


Probably both types of driver needed for particularly large systemic risk events

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

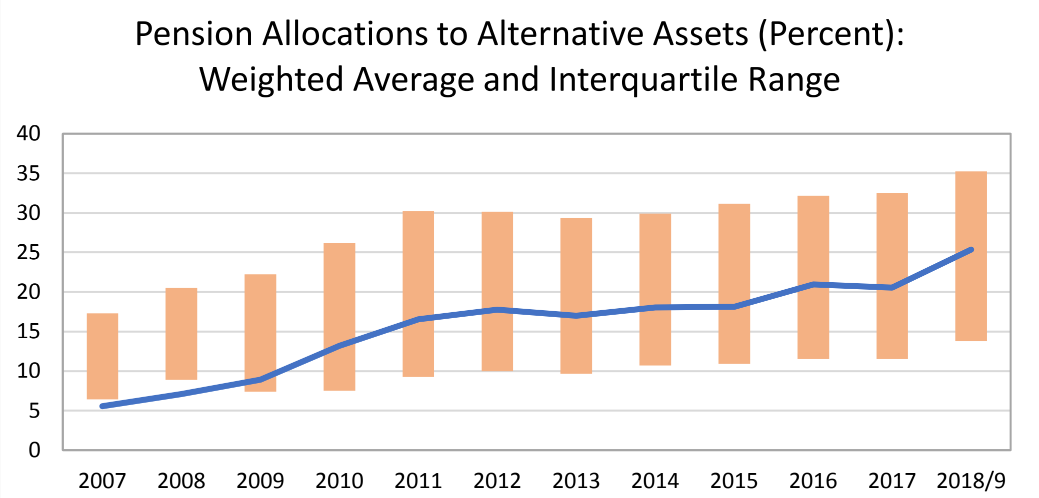
A policymaker perspective

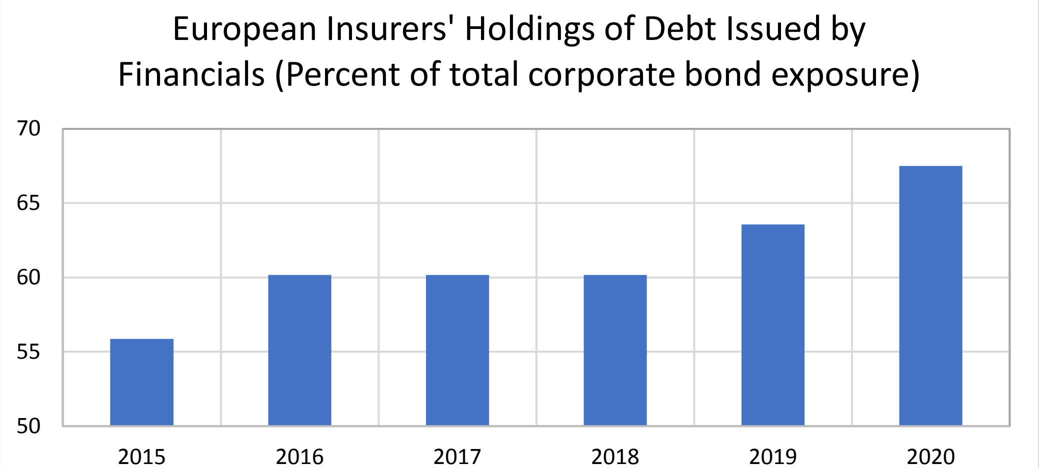
- Big systemic events can have sizeable economic impacts
  - Fuzzy division between macroeconomic, macroprudential and micro-prudential policy
  - E.g. “Growth at risk” (GaR): a conceptual way of setting macroprudential policy
  - Macroprudential regulation often aims to avoid (excessive) procyclicality (especially of credit provision)
- Regulation (or 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?
  - Interconnections (e.g. banks owning insurers and vice-versa)





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

… and how the financial system might evolve

- Firms typically believe they have a long-term future. Policymakers need to consider other possibilities:
  - Hence discussions about recovery and resolution planning, guarantee schemes
  - Firms 'die', just like individuals! A major source of credit risk
- For sectors as well as individual companies:
  - 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?
  - Will disruption come from central authorities, e.g. Central Bank Digital Currencies?
  - Broader still, how will Environmental, Social and Governance Risks (ESG) play out across the whole economy?

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 EU Commission. Complementary to corresponding advice from European Systemic Risk Board (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) counterbalance procyclical behaviours of others in the financial system?
- Risk sharing expertise and insights
  - Could insurance (or insurance-like) solutions help address other challenges, e.g. protection needs relating to pandemics?
  - C.f. many countries have extensive social security programmes (called “National Insurance” in the UK)

EU Commission SII Proposals (Sep 2021)

- Identified objectives for Solvency II Review include:
  - Provide incentives for insurers to contribute to long-term sustainable financing of the economy
  - Improve risk-sensitivity
  - Mitigate excessive short-term volatility in insurers' solvency positions
  - Improve policyholder protection, including when insurers fail
  - Better address potential build-up of systemic risk in the insurance sector
- Proposals include
  - Some that are specifically identified as "macroprudential"
  - Many others that might be argued to have a macroprudential element (as sound transparent regulation should assist financial stability), e.g. proposed modifications to long-term guarantees measures, interest rate risk measurement, yield curve extrapolation, volatility adjustment, …

Proposals specifically badged as “macroprudential”

Area	Summary (for insurers)
Solvency II Directive	
Own Risk and Solvency Assessment	Assess impact of plausible macroeconomic and financial market developments on insurer’s own risk profile and reciprocally how its activities may affect market drivers
Prudent person principle	Factor plausible macroeconomic and financial markets’ development into its investment strategy
Liquidity management and planning	Develop liquidity risk indicators and monitor liquidity risk
Liquidity risk: exceptional powers	Supervisory intervention where liquidity vulnerabilities not appropriately addressed by insurer. Also possibility, in exceptional situations and as a last resort measure, to impose on individual companies or entire market temporary redemption freezes
Distributions to shareholders and other subordinated lenders	Exceptional powers to suspend or restrict such distributions before any actual breach of Solvency Capital Requirement
Insurance Recovery & Resolution Directive (IRRD) **N.B. Separation of IRRD from Solvency II Directive akin to separation of Bank Recovery & Resolution Directive (BRRD) from Capital Requirements Directive (CRD)**	
Pre-emptive recovery planning	Groups and solo firms (covering >80% of market) to draw up and submit to group supervisor pre-emptive recovery plans
Resolution authorities	Identified by Member States and rules to deal with cross-border failures
Resolution plans	Resolution authorities prepare plans (for > 70% of undertakings per Member State) envisaged to be followed if conditions for resolution are triggered
Resolution triggers	Common parameters across Member States for triggering application of resolution tools
Resolution tools and powers	Include (a) write-down / conversion of capital instruments, (b) solvency run-off, (c) sale of business, (d) bridge undertaking, (e) asset and liability separation / work-out
Safeguards, procedures etc.	Various. Resolution can implicitly alter priority status of different parties versus alternatives. Text around valuation, cross-border, third countries, company law, …

Summary

- Financial stability, systemic risk and macroprudential regulation
  - Topics are closely linked. All share insight that behaviour of whole system may diverge from those of its components
  - Relevant interlinkages do not need to be direct to be problematic. Bank / money market fund / insurer “runs” can trigger depositors / investors / policyholders to “run” elsewhere, if broader situation sufficiently challenging
- Policymakers in this area may adopt more expansive and more sceptical mindsets than firms might like
  - With aim of supporting the broader economy and society
- In scope:
  - All sufficiently sizeable parts of the financial system
  - Most regulatory elements, if financial stability viewed expansively enough