Current financial stability initiatives relating to insurers and pension funds

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Agenda

- Models of systemic risk
- Macroprudential proposals for insurers
- Insurers versus pension funds

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Background

- Systemic risk
  - Largely new term coined during 2007-09 Credit Crisis (the ‘Global Financial Crisis’)
  - Borrows from multiple disciplines and hence has multiple angles
- Financial stability
  - The mandate given to bodies that have responsibility for mitigating systemic risk
  - E.g. Financial Stability Board (FSB, global), European Systemic Risk Board (ESRB, EU)
  - C.f. financial stability departments within e.g. EIOPA, BoE, ECB, Federal Reserve, IMF
- Macroprudential regulation/policy
  - Regulation/policy that tries to tackle systemic risk and to foster financial stability

Historical context

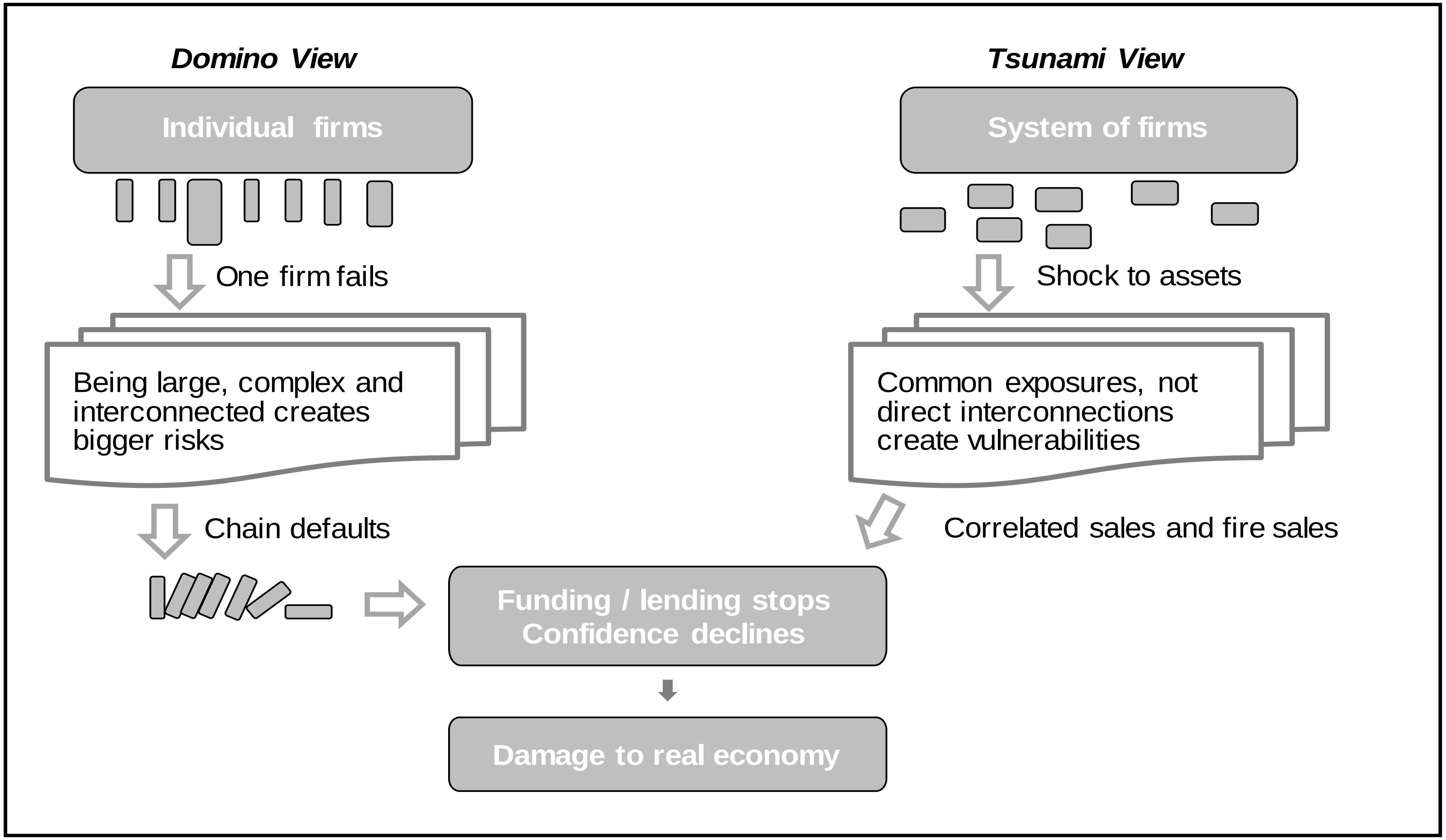
- Earlier systemic crises included e.g. Savings and Loans Crisis, 1929 Wall Street Crash, LTCM, Continental Illinois (‘Too Big To Fail’), LDC Debt Crisis
- 2007-2009 GFC particularly impacted the banking sector (and related areas such as ‘shadow banking’) as did many previous systemic crises
- But regulators don’t think insurers are immune from systemic risk
  - C.f. AIG (although the insurance industry argue that its near failure wasn’t insurance related), some EU insurers during the GFC (particularly ones with significant CDO / CLO exposures) and e.g. ESRB December 2015 Report on systemic risks in the EU insurance sector (including exposure to long-term interest rates: ‘low for long’)
  - Ignoring possible ways in which systemic risks might influence, be magnified by or even possibly be created by insurers may focus too much on solving the last crisis rather than mitigating the next one

Different business models: banks vs. insurers

	Banks	Insurers
Monetary role industry mainly fulfils	A means of payment in exchange for goods and services	A store of value, permitting deferred consumption and smoothing
Other roles	Financial services	Risk pooling
Comparative advantage	Screen and finance short-term projects	(As investors) invest long-term and gain from illiquidity premium
Core business activities	Largely asset-driven, often supported by leveraged balance sheets	Mainly liability-driven, less leveraged and often less exposed to 'runs'
Exposure to systemic risk from any one firm?	Higher	Lower
Risk that safety net costs fall on government?	Higher (more 'essential' to current economic activity)	Lower

Source: Nematrian and Kemp (2017). Systemic risk: A Practitioner's Guide to Measurement, Management and Analysis

Models of systemic risk



Source: Nematrian and Kemp (2017). Systemic risk: A Practitioner's Guide to Measurement, Management and Analysis. Adapted from IMF (2016). Global Financial Stability Report, April 2016, Chapter 3: The Insurance Sector - Trends and Systemic Risk Implications

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European Systemic Risk Board (ESRB)

- ESRB set up by EU Regulation in December 2010 in response to GFC
  - Part of the European System of Financial Supervision (ESFS) along with EBA, ESMA and EIOPA
- Responsible for macroprudential oversight of EU financial system and the prevention and mitigation of systemic risk. Operates primarily by persuasion:
  - Its General Board is currently chaired by Mario Draghi (ECB president)
  - Other permanent representatives include national central bank governors, chairs of EU sectoral supervisory bodies (EBA, ESMA, EIOPA), a representative of the EU Commission, Chairs and two Vice-chairs of the ESRB's Advisory Scientific Committee and Chair of the ESRB's Advisory Technical Committee
  - Insurers and pension funds therefore more likely to interact with EIOPA or national supervisory authorities

ESRB (November 2018)

Systemic risk type (insurers)

Generic risk type

Targets	Options
- Mass lapses - Number and pace of failures - Transmitters - Impact	Recovery and resolution framework
- Procyclicality - Under-capitalisation - Under-pricing - Under-reserving	Extending Solvency II reporting requirements
Under-capitalisation (significant institutions)	Extension of HLA concept
Under-capitalisation	Market-wide capital increases and dividend restrictions

Specific systemic risk

Contagion

Targets	Options
Procyclicality	1. Symmetric capital requirements for cyclical risks 2. Liquidity requirements
Mass lapses	Discretionary intervention powers
Bank-like activities	Alignment of the treatment of loans

Source: ESRB (2018). Macroprudential provisions, measures and instruments for insurance (adapted)

EIOPA

- European Insurance and Occupational Pensions Authority: three previous papers on macroprudential policy (in 2017 and 2018) plus 2019 Consultation
  - Greater emphasis on Solvency II than ESRB, but mostly similar conclusions
- European Commission also raised topic in its call for advice from EIOPA on 2020 Solvency II Review

> *"EIOPA is asked to assess whether the existing provisions of the Solvency II framework allow for an appropriate macro-prudential supervision. Where EIOPA concludes that it is not the case, EIOPA is asked to advise on how to improve the following closed list of items:*
> - *the own-risk and solvency assessment;*
> - *the drafting of a systemic risk management plan;*
> - *liquidity risk management planning and liquidity reporting;*
> - *the prudent person principle.*
>
> *This assessment should be based on strong supporting evidence, also assessing the possible impact of such additional specifications of insurers' behaviour and possible interactions with other Solvency II instruments."*

EIOPA observations

- Lessons from crisis include
  - Supplement **microprudential** with **macroprudential**, and avoid conflicts if possible
  - Identify sources of risk: include **entity-based**, **activity-based** sources and **behaviour-based** sources of systemic risk
  - Widely acknowledged that traditional insurance activities generally less systemically important than banking, but insurance can also potentially create or amplify risks
- Conceptual approach focusing on:
  - Triggering event, company risk profile, systemic risk drivers, transmission channels, sources of systemic risk
- Solvency II has many elements that can mitigate systemic risk

EIOPA (March 2019)

Tool	Type of tool proposed for further consideration
Enhanced reporting and monitoring	
Leverage ratio	Capital and reserving-based
Enhanced monitoring against market-wide under-reserving	Capital and reserving-based
Additional reporting on liquidity risk (*)	Liquidity-based
Liquidity risk ratios	Liquidity-based
Enhancement of Prudent Person Principle (PPP) (*)	Exposure-based
Enhancement of own risk and solvency assessment (ORSA) (*)	Exposure-based
Recovery plans (*)	Pre-emptive planning
Resolution plans (*)	Pre-emptive planning
Systemic Risk Management Plans (SRMP) (*)	Pre-emptive planning
Liquidity Risk Management Plans (LRMP) (*)	Pre-emptive planning
Intervention powers	
Capital surcharge for systemic risk	Liquidity-based
Temporary freeze on redemption rights	Liquidity-based
Concentration thresholds	Exposure-based

Source: EIOPA (2019) Systemic Risk and Macroprudential Policy in Insurance (adapted)

(*) tools referred to in EU Commission call for advice on 2020 Review of Solvency II

IAIS (November 2018)

- International Association of Insurance Supervisors: Exposures potentially leading to systemic impact include:
  - Liquidity risk, interconnectedness, lack of substitutability, other
- Liquidity risk: e.g. derivatives, securities lending transactions, backing liquid liabilities with illiquid assets
- Transmission channels include:
  - Asset liquidation
  - Exposure channel. Can be **indirect** (via macroeconomic exposures) or **direct** (via interlinkages, so distress at one institution can propagate to rest of financial system)
- Critical functions: interruption systemic if important for wider functioning and large market share
- Other
  - E.g. Cyber-risk or widespread under-reserving without possibility to reprice (c.f. EIOPA)

IAIS Overview of supervisory policy measures

	Policy measure	ICP	ComFrame (IAIG)	G-SII
Macroprudential surveillance	Enhance link of macroprudential monitoring to the supervisory framework	●	●	●
Requirements on insurers	Liquidity management & planning	○	●	●
	Strengthened enterprise risk management	○	●	●
	Disclosure requirements on liquidity risk	●	●	●
	Higher loss absorbency (HLA)			●
Crisis management and reporting	Crisis management groups		●	●
	Recovery plan	○	●	●
	Resolution plan		○	●
Powers of intervention	Preventive and corrective measures based on macroprudential concern	○	○	○
	Including reporting on the management of systemic risk	○	○	● (SRMP)

[ ] Not applicable; [○] Required as necessary only; [●] Required; [●] G-SII Policy measure

Source: IAIS (2018) Holistic Framework for Systemic Risk in the Insurance Sector (adapted)

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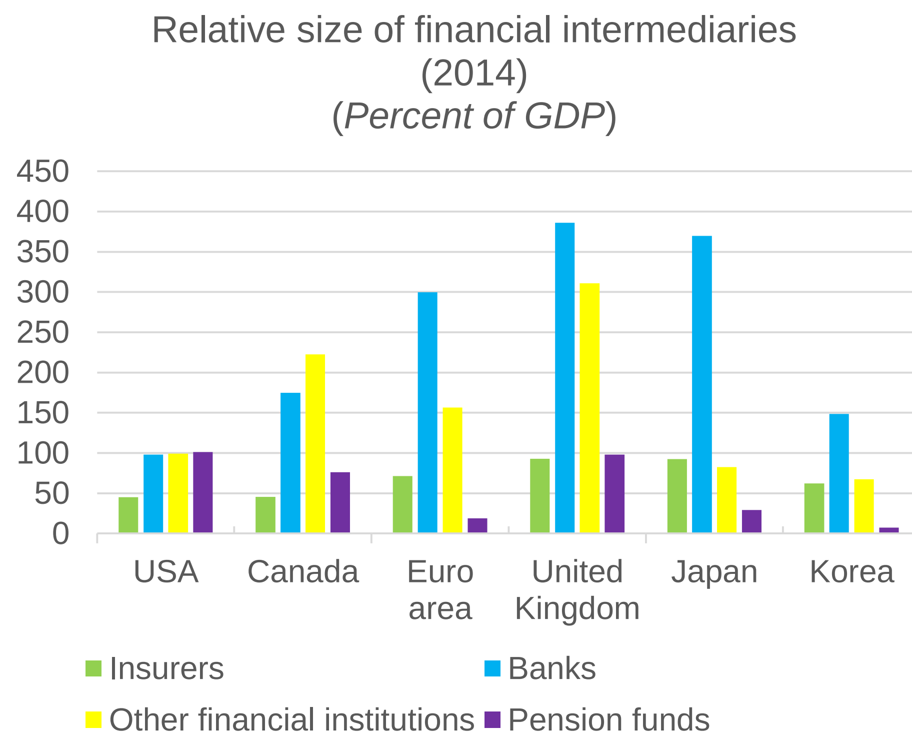
Pension fund interaction with systemic risk (1)

- Limited regulatory focus to date on systemic risk
  - C.f. EU IORP II Directive largely avoids specific 'solvency' requirements
- Significant differences between jurisdictions
  - Even within EU
  - Social nature of pensions
  - Is the 'pension' system even part of the financial system?
  - Pillar 1 / Pillar 2 / Pillar 3 and DB / DC



Source: Nematrian and Kemp (2017). Systemic risk: A Practitioner's Guide to Measurement, Management and Analysis and IMF (2016) Global Financial Stability Report, April 2016, Chapter 3: The Insurance Sector - Trends and Systemic Risk Implications (adapted)

Pension fund interaction with systemic risk (2)

- Usual (Anglo-saxon?) policymaker view: pension funds have long-term investment horizons and **probably make a positive contribution to financial stability**
  - Typically unleveraged (but derivatives, securities lending, asset management links?)
- But **maybe only true in the past**, when DB schemes were open, well-funded (or at least benefits were substantially discretionary) and the norm across industry
- Challenges include:
  - DB funding (and buy-out!) shortfalls, demographics
  - Optimistic asset return assumptions (e.g. some US local government schemes)
- Possible exposure channels:
  - Centralised Pension Protection Schemes
  - Corporates needing to divert funds from investment towards underfunded pension schemes?
  - Breakdown of social contract underlying pension provision?

For now (in EU)

- EIOPA December 2018 Financial Stability Report:
  - Current macroeconomic environment and ongoing low interest rates continue to pose challenges for European occupational pension fund sector. Sudden increase in yields might also be problematic depending on accounting treatment
  - For now, focus is principally on monitoring, reporting and (system-wide) stress testing: "***EIOPA closely monitors potential negative impacts of macroeconomic developments on the IORP sector and financial stability through stress test exercises***"
- Recent EIOPA IORP stress tests have included a common assessment framework which aims to quantify exposures (including benefit security mechanisms) in a market consistent manner
  - Potentially challenging for pension funds to comply with

Summary

- Models of systemic risk
  - Regulators accept insurance is different to banking, but still think insurance has some systemic relevance
  - Domino versus tsunami model
  - Activity-, entity- and behavior-based drivers
- Macroprudential proposals for insurers
  - A range of interested regulatory bodies
  - A recent flurry of proposals, but with many common strands
- Insurers versus pension funds
  - Pension funds usually considered stabilisers
  - But maybe less true now than in the past, depth of analysis increasing

Important Information