Systemic Risk Relevance of Pension Funds, Insurers and Asset Managers

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Agenda

- Introduction
- Typical industry perspectives
- Typical (systemic risk) regulator perspectives
- Who is correct?

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Introduction

- Politicians and regulators worry about systemic risk, because of:
  - System-wide impact of the recent financial crisis, don’t want a repeat
  - Maybe worry that political revolutions have often been triggered by financial crises
- Sceptical about extent of differences across financial sector regarding potential to create, amplify or transmit systemic risk. Problems during the Crisis included
  - Lehman, other banks, Freddie Mac, Fannie Mae
  - But also AIG, monoline credit insurers, money market funds (MMFs) and shadow banking
- Further back in time: LTCM, HIH, Savings & Loans, fall-out from Great Depression

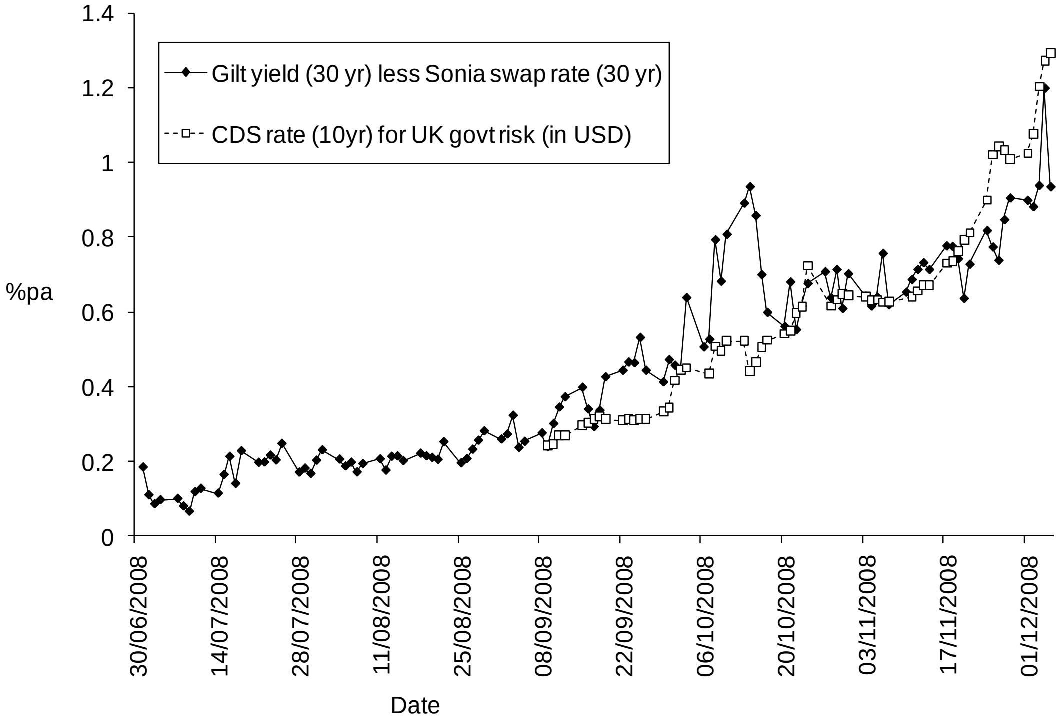
And possible spill-overs to sovereign risk

- Potential to 'nationalise' banking crisis already evident by end 2008

- And highlighted in e.g. Reinhart and Rogoff (2009)

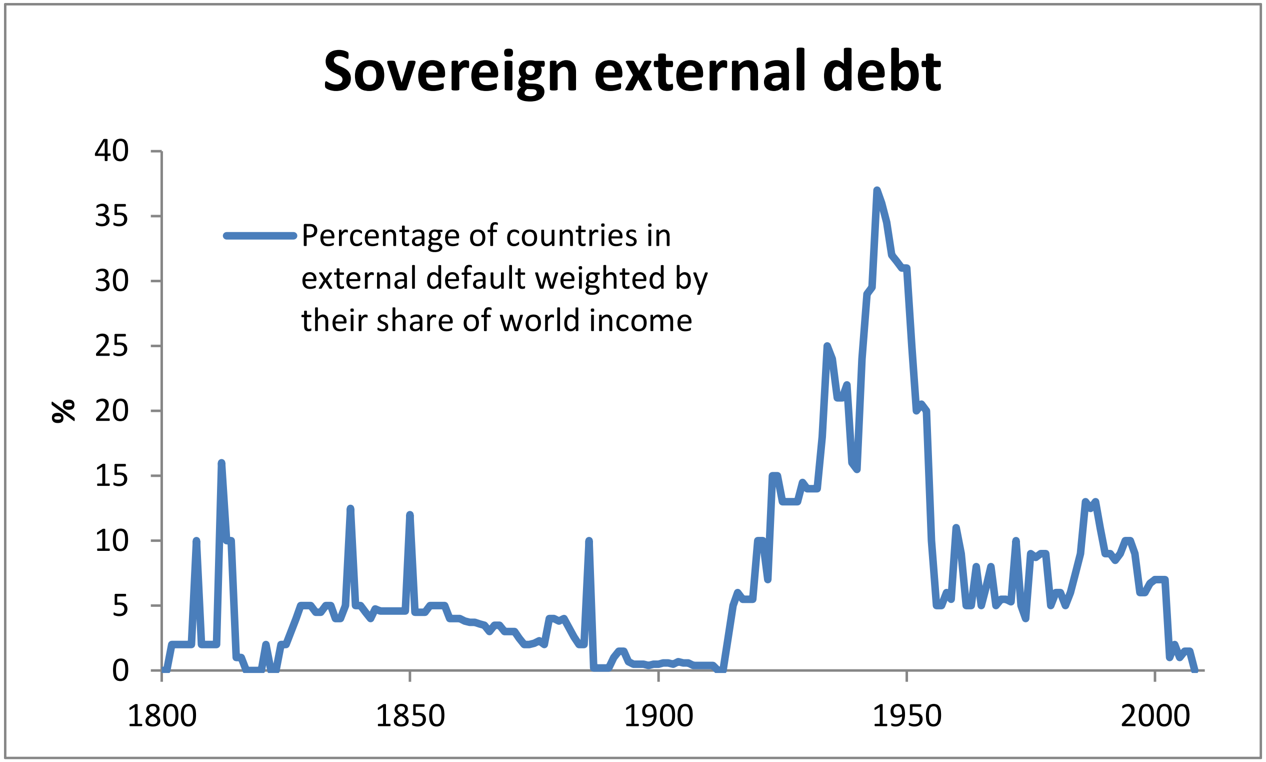
- Irish guaranteeing of bank debt seen as potentially unhelpful in retrospect

- C.f. Eurozone sovereign debt crisis



Source: Kemp (2009)

Sovereign risk: a longer term perspective



Source: Nematrian, Reinhart and Rogoff (2009)

- Period just before 2007-09 credit crisis may have been particularly benign

New regulatory structures and responsibilities

- E.g. UK has:
  - Prudential Regulation Authority (PRA, part of Bank of England) and Financial Conduct Authority (FCA)
  - But also BoE Financial Policy Committee, with financial stability remit, can issue recommendations to anyone (including PRA and FCA)
- E.g. European System of Financial Supervision
  - EBA, ESMA, EIOPA, but also European Systemic Risk Board (ESRB)
- EU Capital Requirements Directive / Regulation (CRD/CRR) requires member states to designate a body responsible for macro-prudential supervision
- Financial Stability Board at international level

On macro-prudential policy Haldane (2014) notes

- "*Macro-prudential policy is gaining ground every bit as quickly as central bank independence did in the 1990s. It has quite radical implications. Pre-crisis credit cycles were allowed to operate largely unconstrained. Macro-prudential policy overturns that orthodoxy, with policy instead leaning against the credit cycle to moderate its fluctuations, both during the upswing and the downswing.*"
- He was hopeful that the financial system and economy may become less prone to the low-frequency, high-cost banking crises seen in the past. However, he thought that the financial system could "*exhibit a new strain of systemic risk – a greater number of higher-frequency, higher-amplitude cyclical fluctuations in asset prices and financial activity, now originating on the balance sheets of mutual funds, insurance companies and pension funds*" which could in turn be transmitted to, and mirrored, in greater cyclical instabilities in the wider economy.
- He thought it "*… likely that regulatory policy would need to be in a constant state of alert for risks emerging in the financial shadows, which could trip up regulators and the financial system. In other words, regulatory fine-tuning could become the rule, not the exception*"

Systemic risk not seen as just about banks

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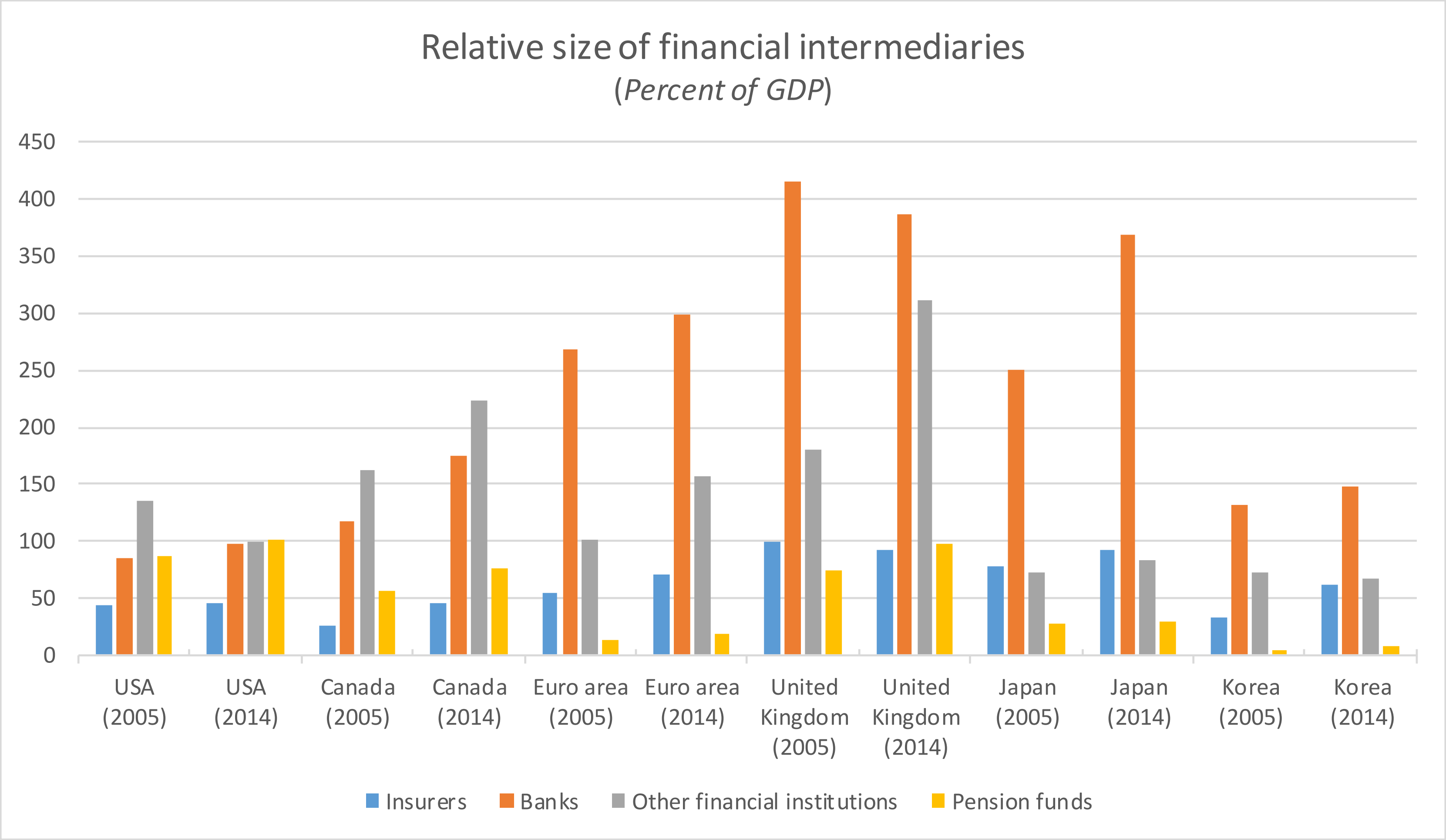
Relative sizes



Source: adapted from IMF (2016)

Systemically important institutions

- Most obvious implication is for organisations deemed global systemically important financial institutions (G-SIFIs), including banks and insurers (called G-SIBs / G-SIIs depending on jurisdiction and type of entity)

- And FSB has consulted on including others, i.e. non-bank non-insurer (NBNI) G-SIFIs, see e.g. FSB (2014) and FSB (2015)

  - Proposed methodologies for assessment of (i) finance companies, (ii) market intermediaries (securities broker-dealers) and (iii) investment funds (including hedge funds)

  - Backstop methodology for all others, with market infrastructures assumed to be systemically important, at least in jurisdiction in which they are located

Banks

- Circa 30 banks deemed globally systematically important, subject to additional capital requirements of 1% - 2.5%
  - G-SIBs also subject to:
    - Group-wide resolution planning and resolvability assessments
    - Higher supervisory expectations for risk management functions, risk data aggregation capabilities, risk governance and internal controls
    - Additional Total Loss Absorbing Capacity (TLAC) requirements phasing in from 2019
  - Other banks may be deemed systemically important in their own jurisdictions
    - By end 2015 around 160 EU banks caught by CRD systemic risk buffer (with more expected, some member states had not yet selected their approach). Source: ESRB
- Logic for classification: negative externalities relating to implicit support and moral hazard, i.e. “too big to fail”, assessment based on: size, interconnectedness, complexity, lack of substitutability, global scope

Insurers

- Circa 9 insurers deemed globally systematically important, subject to additional Higher Loss Absorbency (HLA) requirements and to:
  - Enhanced group-wide supervision (including group-wide supervisor to have direct powers over holding companies and to oversee the development and implementation of a Systemic Risk Management Plan and a Liquidity Management plan)
  - Group-wide resolution planning and resolvability assessments
- Classification rationale similar in theory to banks but weightings to factors differ and are currently under review, see IAIS (2015)
  - Views differ about appropriateness of systemic risk classification, IAIS stance: “Little evidence.. traditional insurance generates.. systemic risk”
  - Hence greater focus on non-traditional insurance / non-insurance (NTNI) activities, but exactly how should this be defined? Financial guaranty insurance, credit default swaps, derivatives trading? Variable annuities?

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Typical insurer and pension fund perspectives

- Insurers:
  - Traditional insurance is not systemically important
  - As little (direct) interconnection with each other or with banks
  - However NTNI activities (as per AIG and monoline credit insurers?) can create greater interconnectivity (as can e.g. banking subsidiaries)
- Pension funds (in UK)
  - No desire to be considered even akin to insurers let alone other parts of financial system. Part of real economy not the financial sector
  - Or at most so obliquely linked with (banking) sector that systemic risk not relevant to (private sector) pension funds
    - Sufferers rather than creators of systemic risk

Typical asset manager perspectives

- More nuanced. Industry clearly:
  - Large and picking up business as banks retreat
  - Manages a lot of other people’s assets including those of insurers, pension funds, sovereign wealth funds and even banks
- But liquidity risk borne by investors or managed by exit / deferral powers
  - So typically argue that systemic risk exposures are in practice limited to a handful of fund types, e.g. some types of MMFs and some hedge funds

Other industry perspectives

- Falling within the systemic risk net can feel highly intrusive (but what regulation doesn't feel intrusive?)

- For organisations deemed systemically important as well as eventually for everyone else, e.g.:

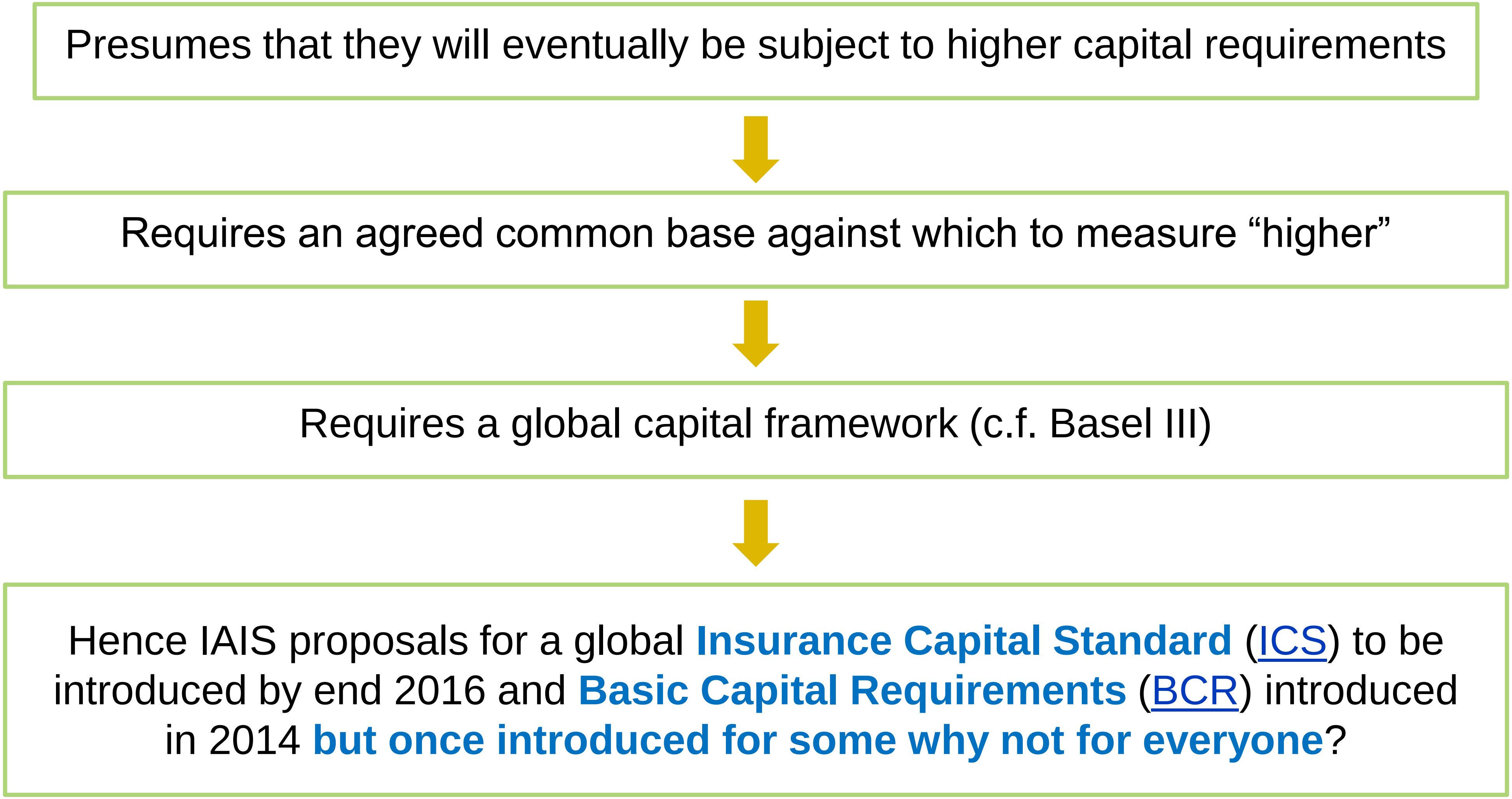
  - Assicurazioni Generali business model changes, removal from G-SII classification, see e.g. Jenkins (2016)

  - MetLife legal action to challenge FSB designation, and now apparently planning to shrink

  - Development of IAIS ICS

- Push-back on FSB's proposals for asset managers, even apparently from some other supranational bodies

Consequence of decision to have some insurer G-SIFIs



Presumes that they will eventually be subject to higher capital requirements

Requires an agreed common base against which to measure “higher”

Requires a global capital framework (c.f. Basel III)

Hence IAIS proposals for a global **Insurance Capital Standard** (ICS) to be introduced by end 2016 and **Basic Capital Requirements** (BCR) introduced in 2014 **but once introduced for some why not for everyone**?

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Typical (systemic risk) regulator perspectives (1)

- Insurers:
  - Generally seen as potentially systemically important, e.g. AIG, HIH
  - Seem to be growing in importance as banks retreat, e.g. IMF (2016)
  - Some life insurers writing guaranteed policies particularly exposed to low interest rate environment (and in EU possible future rebasing of Ultimate Forward Rate)
- Pension funds
  - Limited knowledge base within macro-prudential (‘macropru’) community
  - A priori also expected to be challenged by low interest rate environment
  - Any issues might take a long time to emerge and many political issues

Typical (systemic risk) regulator perspectives (2)

- Asset managers:
  - Some specific concerns, e.g. Constant Net Asset Value (CNAV) versus Variable Net Asset Value (VNAV) MMFs
  - Asset Manager / Investment Fund based shadow-banking activities (hedge funds and others)
- Possible signs of a “search for yield”, although multiple interpretations of what we actually mean by this term
- Conversely, if we want safer banks then someone must carry the risks (e.g. other institutions / end customers?)
  - C.f. EU political enthusiasm to broaden sources of funding away from banks

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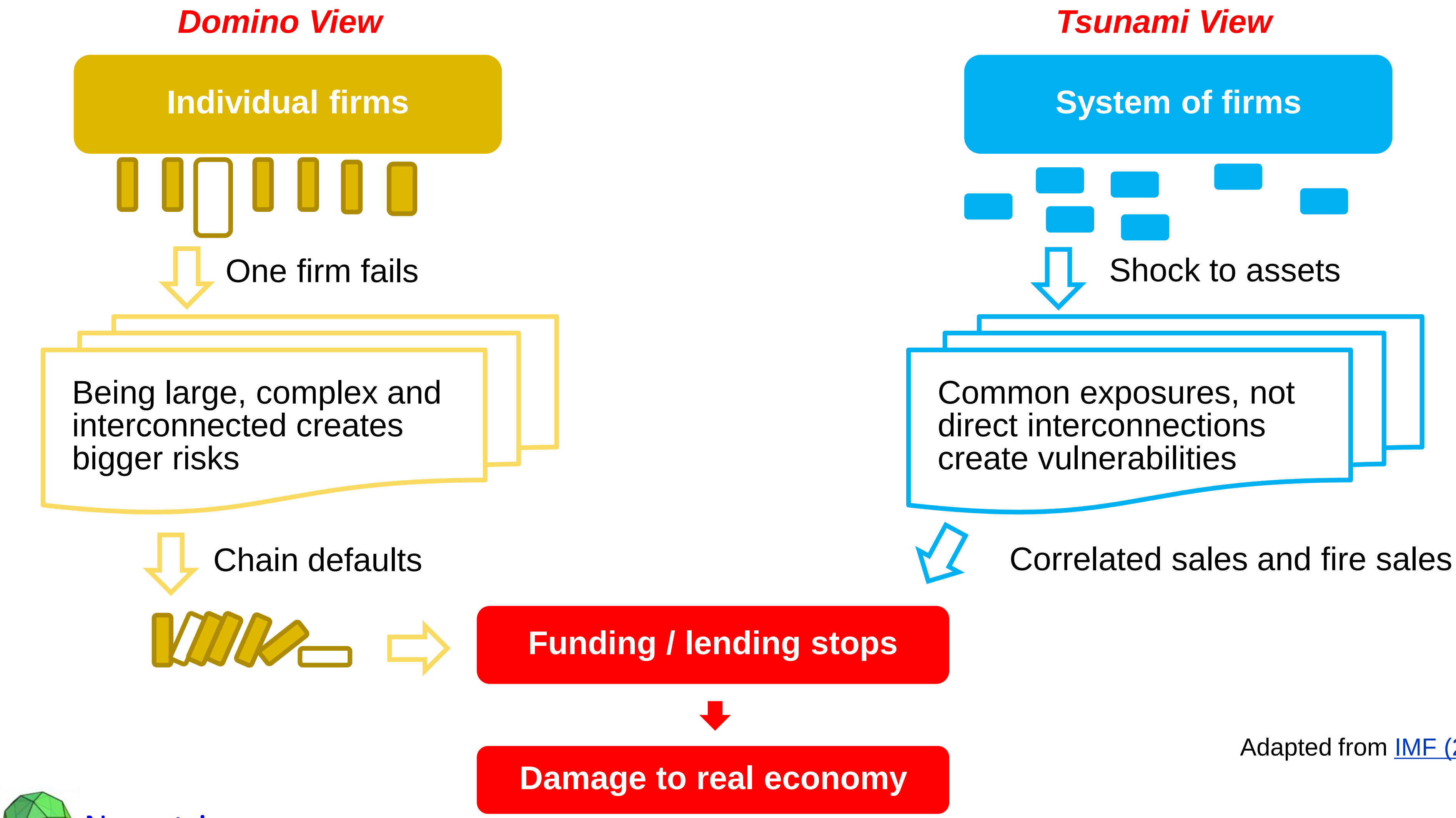
- Some differences reflect different possible interpretations of data
  - E.g. is there currently a “search for yield”?
- Some differences highlight macro-economic orientated modes of thought common in the macro-prudential community
  - E.g. analyses include bond fund “leverage” statistics that focus on proportion in bonds divided by proportion in cash
  - Aligns to fractional banking and maturity transformation banking concepts
  - But result of investor choice to invest in a bond fund, not manager actions?
- Some reflect different emphasis given to different sorts of interconnectedness

Interconnectivity doesn't have to be direct to matter



Domino View

Individual firms

One firm fails

Being large, complex and interconnected creates bigger risks

Chain defaults

Tsunami View

System of firms

Shock to assets

Common exposures, not direct interconnections create vulnerabilities

Correlated sales and fire sales

Funding / lending stops

Damage to real economy

Adapted from IMF (2016)

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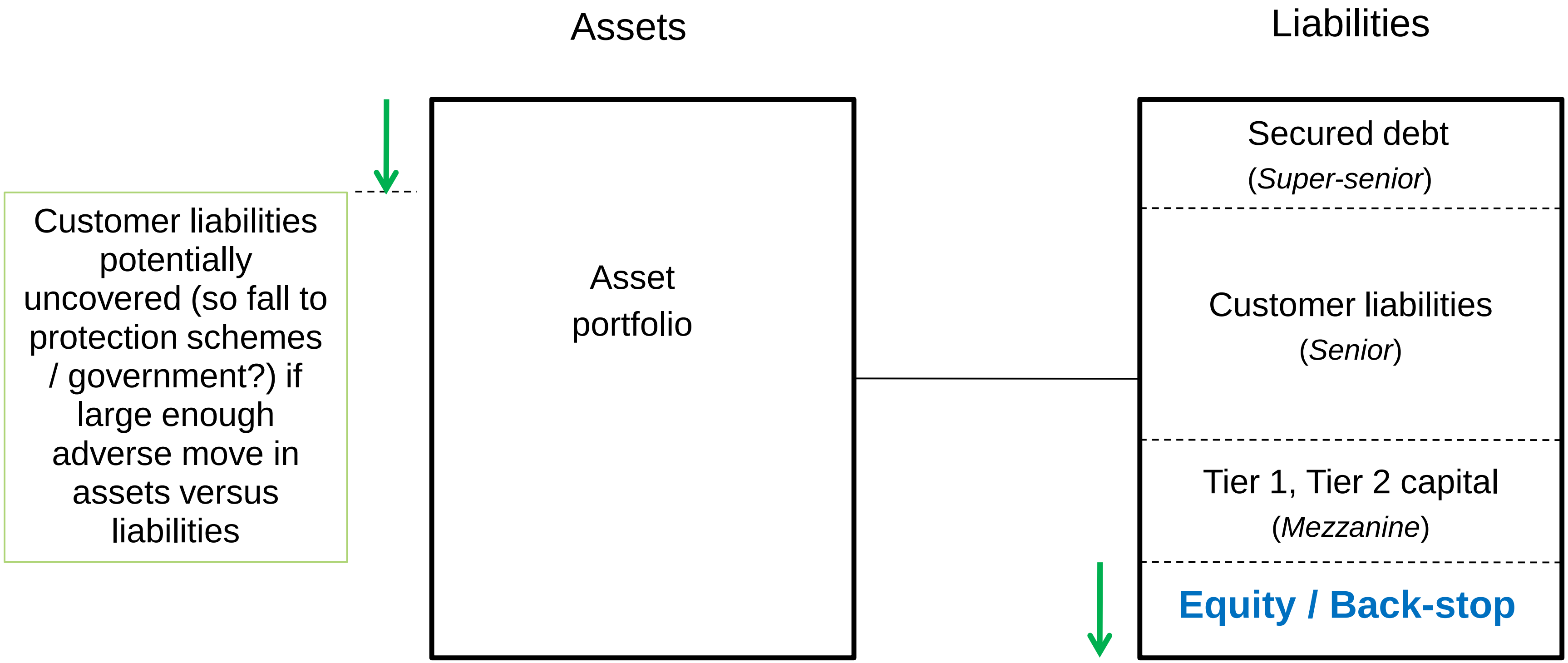
The capital waterfall: subordination, tiering and tranching


Assets
Liabilities
Customer liabilities potentially uncovered (so fall to protection schemes / government?) if large enough adverse move in assets versus liabilities
Asset portfolio
Secured debt
(*Super-senior*)
Customer liabilities
(*Senior*)
Tier 1, Tier 2 capital
(*Mezzanine*)
Equity / Back-stop

- C.f. (regulatory) capital designed to absorb unexpected losses. Hence tiering.
- We can also apply same waterfall concept to entire financial or economic system (with asset portfolio now consisting of multiple firms)

Insights from balance sheet analogy (1)

- Concept of tranching and a capital waterfall can be applied to financial systems as well as individual firms (but also to CDOs etc.)
  - Implied correlation can go very high in very stressed circumstances
- Common firm-level systemic risk measures, such as conditional value at risk (CoVaR) and Marginal and Systemic Expected Shortfall (SES), in effect represent marginal contribution to value of the lowest tranche
  - Contributions to systemic risk can be significant even if no direct interconnectivity.
  - Quantification of risk (unlike understanding of risk) is largely agnostic to the source of an unwanted correlation:
    - Could merely reflect common investment holdings or exposures
    - Or even just market worries about possible commonalities, c.f. MMF ‘runs’ during financial crisis, Roosevelt’s “the only thing we have to fear is fear itself”

Insights from balance sheet analogy (2)

- Bigger firms typically have bigger reach, so typically have more direct interconnections
  - If direct interconnectivity less important then size maybe also less important
- Increases relevance of tools applicable to whole sector rather tools targeting just the largest players?
  - More likely that ICS etc. will morph towards an industry-wide standard?
- And increases focus on sector-wide vulnerabilities, such as those arising from a low interest rate environment

Pension funds and financial stability

- Capital waterfall concept also applies to pension funds
  - Indeed to the whole economy?
  - Systemic risk debates can be very wide-ranging, c.f. Carney (2015) and climate change
- Pensions community often refers to a pensions system
  - So presumably this system is subject to ‘systemic risk’ at least in relation to itself
  - E.g. what would happen if there was a severe enough recession to cause a national pension protection scheme to run into difficulties?
- How do those outside the pensions community view the link between the pension system, the (wider?) financial system and the (wider?) economy?
  - And will this view change in the future?

Summary

- Introduction
  - Greater emphasis on financial stability a very important regulatory development
- Typical industry perspectives
  - Primarily a banking issue as most directly interconnection involves banks
- Typical (systemic risk) regulator perspectives
  - Systemic risk of banks is being tackled. Where else is vulnerable?
- Who is correct?
  - Industry perspective looks possibly complacent and overly focused on the view that the only thing that counts in practice is level of direct interconnectedness (to banks)

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