

Activities-Based-Approach to Systemic Risk – some initial reactions to the consultative document

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General Remarks

- \ We welcome the direction of travel that the IAIS has set out in the ABA consultation document (CD)
- \ It is positive that more nuance is added to the analysis of potential sources of systemic risk in insurance.
- \ Along with the IAIS, we believe that traditional insurance operations are unlikely to cause systemic risk: IAIS (2011), *Insurance and Financial Stability*: **“The characteristics of the insurance business model including insurance techniques make it very unlikely for traditional insurance to be systemically relevant.”**
- \ In this light, we support – at the broad level - the methodology of the CD and adding more nuance to its analysis of potential sources of systemic risk in insurance
- \ We see the CD as making an important development beyond the current entity-based approach (EBA)

EBA and ABA

- \ The ABA approach should enable the IAIS to substantially review and replace the current approach to EBA
- \ The definition of ABA should be further clarified. The consultation document seems to imply that the Domino view is not addressed
- \ However, examples are included in the CD of loss given default which are relevant to the Domino view
- \ An appropriately developed activities-based approach would address risks to financial stability arising from *both* a “domino” *and* “tsunamic” view of systemic risk

Sound overall approach

We welcome specific aspects of the ABA as laid out in the CD:

- \ The stepped approach
- \ The recognition that assets and liabilities need to be viewed holistically, as part of an ALM policy
- \ ‘Net’ exposures and the role of existing risk management & policy measures are rightly considered
- \ Considerations on liquidity exposure represent steps in the right direction
- \ Liquidity Risk Management Plans (LRMPs) are a good focus for a potential policy measure in this respect. But there is a need to include national standards applying at group level
- \ However, the consultation document does not make a proper differentiation between the origins of systemic risk and its propagation channels. Transmission mechanisms and channels need to be clearly defined

On Macroeconomic Exposure

- \ The treatment of liquidity risk and macro-economic exposures is quite theoretical and potentially too broad in scope
- \ Further clarification of the vulnerabilities & amplifying factors that could plausibly lead to systemic risk is needed
- \ Large losses do not necessarily imply systemic risk
- \ Especially on macroeconomic exposure further work is needed

Procyclical behaviour

- \ Procyclical behaviour is seen as an important source of systemic risk. But procyclical behaviour (especially § 52) should not in itself be a strong concern of systemic risk analysis. Not all procyclical behaviours listed in § 58 through § 61 can be seen as contributing to systemic risk
- \ On macroeconomic exposure, a number of examples are mentioned to illustrate cases where common behavior could lead to problems of systemic risk
- \ However, such common behavior does not necessarily represent sufficient conditions to lead to systemic risk – and often also is done in order to protect policyholders....**very important, often such behavior should be of no concern as to systemic risk implications**
- \ GA study June 2016 “Insurance Sector Investments and Their Impact on Financial Stability” – procyclicality is likely **not** a systemic concern
- \ The ICS is seen as a policy measure – careful the ICS is not designed to create procyclical behaviour

On Stress Testing

- \\ Stress testing as a means to assess macro-prudential exposure is sensible if conducted in a proper manner (par. 74)
- \\ The absence of consideration of the plausibility of scenarios, and transmission channels leads to a lack of clarity over measures that may be appropriate
- \\ Policy measures should be targeted – stress testing is not a panacea to all problems
- \\ Here, caution is needed

On Counterparty Exposure

- \ The consultation document concludes tentatively that counterparty exposure is “not a key consideration for this consultation paper”
- \ However, linkages – closely related to, but more broadly defined than counterparty exposure – needs to be taken into account
- \ Linkages may propagate as well as mitigate risk exposures
- \ Relevant examples include a number of activities like i.e. derivatives, securities lending etc.
- \ Further consideration is needed here

Other potentially relevant aspects

- \ We support the scope of the consultation document
- \ A number of potential risks – linked to common behavior are mentioned: Operational risk, cyber risk, inadequate provisioning.....etc.
- \ Again: large losses do not necessarily imply systemic risk
- \ Do not try to solve **any** potential problem
- \ These potential risks require separate analysis – but should not be elements of immediate concern

Messages and conclusion...

- \ We appreciate the IAIS's work on the activities-based approach
- \ The interim paper on ABA lays out a framework that has the potential to more effectively identify potential systemic risk than entity-based designations
- \ An appropriately developed activities-based approach would address risks to financial stability arising from *both* a “domino” and “tsunamic” view of systemic risk
- \ It is sound to build policy measures on the existing “tool box” – importantly, capital is not the right answer to all potential risks
- \ Especially concerning macroeconomic exposure, there is still room for further analysis to explore how and why the transmission channel would lead to systemic risk
- \ There are important outstanding practical issues to consider and define
- \ We look forward to explore these issues with the IAIS going forward and, not least, in the consultation to be released later in the year
- \ Thank you for the opportunity to present a number of discussion points today