Systemic Risk and Financial Stability

The 2008 Global Financial Crisis (GFC) introduced into common financial speech the term systemic risk. For the EU this is commonly taken as 'a risk of disruption of the financial system with the potential to have serious negative consequences for the internal market and the real economy'. Closely associated with (financial) systemic risk is the notion of *financial stability*. We want our financial systems to avoid falling over. It is in the broader public interest (but perhaps not in the interest of every individual system participant) for regulation of financial systems to mitigate the system-wide risks that might create these instabilities.

Other examples of financial crises that dragged down entire economies include the 1929 Wall Street Crash (and subsequent Great Depression), several of the Twentieth Century's hyperinflation episodes and many past sovereign debt crises (which often went hand-in-hand with banking crises). The majority of systemic risk episodes are not this bad, but can still be very expensive. Whilst banking is commonly seen as more prone to systemic risk than other financial sectors, other parts of the financial system are not immune, as illustrated by the blow-up in the 1990s of Long Term Capital Management, a hedge fund. AIG, an insurance company, was bailed out in depths of the GFC, although insurance industry practitioners typically argue that it was not AIG's insurance business that caused its problems, but liquidity issues with e.g. its credit default swap activities. A handful of other insurers around the globe also needed support during the GFC. Looking further afield, several Japanese insurers failed in the late 1990s, partly because of declining interest rates.

Many central banks and financial regulators now have financial stability departments. Most also now produce regular financial stability reports. And rightly so! Large systemic risks can dwarf most other risks such organisations are aiming to manage. The EU has a specific institution in this area, the European Systemic Risk Board, which is part of the EU's System of Financial Supervision (alongside EIOPA, ESMA and EBA). For a systemic risk event to arise we typically need some underlying vulnerabilities to be present and for some trigger to come along that uncovers these vulnerabilities. Teams working in these departments generally focus on identifying potential vulnerabilities and then figuring out what policies might best contain these vulnerabilities.

Inevitably, the associated policymaking is coloured by the political and economic environment within which the policymaking is taking place. I wrote an article on systemic risk and financial stability for the European Actuary magazine in late 2020, in the middle of the Covid-19 pandemic. Policymakers were then highly focused on systemic risks arising from the pandemic, including ones linked to the large financial support packages many governments were providing to their citizens to mitigate the economic impact of the pandemic. Thankfully, the pandemic seems to have been contained and governments have generally found it practical to manage the extra debt burdens they took on. We are into the time of lesson learning. The ESRB's 2022 Report "*Fiscal support and macroprudential policy – Lessons from the COVID-19 pandemic*" is relatively positive on how authorities responded to the pandemic, arguing that "*the swift and ample fiscal support measures provided and sustained the liquidity and solvency of the real economy*". It also suggests some lessons that might apply to fiscal responses to future challenges, e.g. energy crises.

Regular central bank and financial regulator systemic risk dashboards provide up-to-date snapshots of financial stability risks then perceived to be of most importance. The broader evolution of financial stability is more commonly covered by in-depth thematic analysis of particular components of the financial system and of their vulnerabilities. I contributed to several such studies when I was a member of the ESRB's Advisory Scientific Committee, including e.g. that Committee's 2022 Report "*Will video kill the radio star? Digitalisation and the future of banking*". 2023 ESRB Reports have included ones covering climate risk, corporate debt and real estate investment funds, crypto-assets and decentralised finance, cyber risk and commercial real estate. Taking cyber risk as an example, as digitalisation becomes more embedded within the financial system, the susceptibility of the system to malicious disruption is likely to rise, highlighting the increased need to take cyber risk seriously. There is an added dimension here for insurers as they may provide cover for such risks either affirmatively or non-affirmatively to other players in the financial sector or elsewhere.

In 2020 I wrote that the banking sector appeared to be in a better regulatory shape (with respect to systemic risk) than before, following the adoption of many policy measures spawned by the GFC to improve the amount and quantity of bank capital and to reduce the tendency of the banking system to behave pro-cyclically. Generally speaking this viewpoint has proved correct. Banks typically weathered the pandemic relatively well and were able to assist with supporting the real economy when needed. However, some banks such as Credit Suisse and Silicon Valley Bank have since succumbed to the impact of volatile interest rates or poor underlying business models. Policymakers will no doubt continue to be vigilant in this area, given their long institutional memories.

EU insurers typically weathered the GFC better than banks. In the years immediately after the GFC they faced less explicit regulatory change in the area of systemic risk, although part of this was due to the more general upgrading of their regulation via the introduction of Solvency II. The EU Council's press release dated 14 December 2023 on the current review of Solvency II is an indication that policymakers still view the topic of financial stability as important for insurance regulation, e.g. with the planned introduction of a new Insurance Recovery and Resolution Directive.

The insurance industry sometimes focuses on a subtly different interpretation of "systemic risk" to the one typically adopted by policymakers, less linked to financial stability as such and more linked with system-wide issues such as insurance protection gaps. Policymakers do seem to be aware of these sorts of risks too. For example, in November 2023 EIOPA launched a dashboard on the insurance protection gap for natural catastrophes having previously started to explore shared resilience solutions and other potential means of addressing these gaps. In 2022 ESRB issued a report on trade credit insurance, another area where insurance protection gaps might be an issue.

Looking forwards, policymaker focus on financial stability and systemic risk is likely to continue for the foreseeable future. There are still many areas needing consideration, practical constraints on availability of relevant data and limits to the political and regulatory bandwidth needed to address them. For example, the Dec 2023 ESRB report "*Towards macroprudential frameworks for managing climate risk*" notes "*Available indicators suggest heterogeneous exposures to climate risk across EU countries, sectors and firms, with access to consistent information on adaptation measures remaining limited*". Financial stability considerations will continue be an important driver of regulation relevant to professionals such as actuaries who are involved in financial risk management. ■

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