Regulation and supervision compact
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Focus on macroprudential policy

Expanding macroprudential regulation in the aftermath of the 2008 global financial crisis has made the financial system more resilient – the way the system has held up during the COVID-19 crisis and after Russia's attack on Ukraine has clearly shown that. However, those severe exogenous shocks did lead to higher stability risks again. Add to that fundamental structural changes in the financial system, and it becomes clear why efforts to further strengthen the macroprudential framework have been stepped up. Here are three important examples:

→ The European Commission outlines new macroprudential tools for insurance supervision in its proposal for the **reform of the Solvency II Directive**.

→ For **residential real estate markets**, additional macroprudential tools are being worked out.

→ **Climate-related risks and cyber risks** were identified as new systemic risks that need to be addressed.

The GDV supports an effective macroprudential framework. What's key in this regard, is a risk-based and proportionate system. Also, safeguarding financial stability long-term requires a holistic approach where monetary, fiscal and economic policy as well as micro- and macroprudential regulation go hand in hand.

Götz Treber
Head of Centre of Competence
Corporate Management
and Regulation
+49 30 2020-5470
g.treber@gdv.de

Dr. Anja Theis
Economics, financial markets
+49 30 2020-5133
a.theis@gdv.de

GDV
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Supervision of systemic risks

An important lesson of the 2008 global financial crisis was that microprudential supervision of individual financial institutions alone is not enough to guarantee the stability of the financial system. Therefore, developing a global macroprudential framework was a cornerstone of the regulatory reforms that happened after 2008. The goal was and still is to identify systemic risks early-on and counter them more effectively.

In order to strengthen macroprudential supervision, new institutions were created (e.g., the European Systemic Risk Board, ESRB), a comprehensive monitoring framework was established (with, among others, risk dashboards, financial stability reports and analyses as well as sector-wide stress tests) and new macroprudential instruments were introduced (e.g., countercyclical capital buffers for the banking sector and LTV limits for residential mortgages). Macro- and microprudential supervision are closely intertwined. Microprudential supervisors also play a key role in macroprudential supervision, and the macroprudential toolbox contains a lot of the same instruments microprudential supervisors use, for example regarding information requirements, stress tests and scenario analyses.

Because of the systemic risks inherent in the banking business model, macroprudential reforms focused on the banking sector, at first. However, macroprudential monitoring did cover all of the financial system from the very beginning. In light of a low interest rate environment, the COVID-19 crisis and profound structural changes, the non-banking part of the financial system increasingly came to the fore of macroprudential policy. This has already produced numerous reforms or reform proposals.

For the insurance industry, the most relevant developments are the IAIS "Holistic Framework for the Assessment and Mitigation of Systemic Risk in the Global Insurance Sector" from 2019 and the extensive macroprudential proposals for reforming Solvency II made by the European Commission in 2021, which were preceded by an intensive debate on the necessity and design of an expanded macroprudential supervision of the insurance sector. Ongoing climate change, COVID-19 and the war in Ukraine have further stoked the debate on making the financial system more resilient by putting more emphasis on macroprudential policy.

Structural changes in the financial system

The importance of the so-called **non-bank financial intermediation (NBFI) sector** comprising, among others, the insurance sector and the investment fund industry as a provider of financing has increased in the aftermath of the 2008 global financial crisis. According to the FSB's (Financial Stability Board) Global Monitoring Report on Non-Bank Financial Intermediation 2021 the NBFI's share of global financial assets had grown to 50% by 2019, before a Covid-19 crisis related decline by about 1,5 percentage points occurred in 2020.

The NBFI sector's bigger role had been expected as a result of more restrictive banking regulation and is, in principle, a desirable development because it helps to reduce systemic risks, for example through better risk diversification and a higher risk capacity of long-term investors. However, for macroprudential supervisors, it has become clear during the past few years that new systemic risks have emerged that need to be addressed by extending the macroprudential framework for the NBFI sector. Higher systemic liquidity risks are regarded as an important factor in this context. This reflects, e.g., the fact that in most countries NBFIs cannot access the central bank's credit facilities in a crisis. Also, supervisors point out the danger of unwanted regulatory arbitrage, if financial sectors are treated differently when this is not in line with the risks involved.

In addition, macroprudential supervisors have extensively studied the structural changes brought on by the digital transformation in the financial sector for some years now. They identified three major new sources of systemic risk:

- First, there are new actors who could be systemically relevant and as yet have not or not sufficiently been covered by financial regulation. Currently, the most important example will probably be the major cloud service providers, given that financial institutions are increasingly moving their IT to the cloud.
- Second, the strong growth of fintech start-ups, crypto assets and decentralised finance also poses new systemic risks: That includes the potentially systemic impact of crypto price crashes (e.g., through the exposure of traditional actors and the resulting contagion effects or through adverse confidence effects on retail investors suffering losses). A potential weakening of traditional institutions caused, e.g. by competition-driven incentives to accept higher risks, is also seen as a potential source of systemic risks by regulators.
- Third, the consensus is that cyber risks have also become a significant systemic risk by now.

On top of that, **climate-related risks** are also regarded as a potential danger to the stability of the financial system; macroprudential supervisors have made a considerable effort to analyse and assess these risks for several years now. In this context, additional nature-related risks that could become systemic have appeared on the radar lately, notably potentially destabilising effects of the loss of biodiversity.

COVID-19 crisis and the war in Ukraine

In light of the **corona pandemic's** severe macroeconomic impact, macroprudential supervisors have assessed risks to the stability of the financial system as significantly elevated since 2020. The pandemic has also accelerated digitilisation which in turn has led to higher systemic cyber risks. And with the **war in Ukraine** and the high degree of uncertainty about the further development, stability risks have yet again increased significantly (see chart 1). Substantial risks result from, among others, the elevated inflation and the monetary policy challenges it causes. The danger of an abrupt repricing of assets due to some markets being overvalued at the moment, e.g., real estate is considered to be high. There is also cause for serious concern about substantially higher systemic **cyber risks** in connection with the war in Ukraine.

Increase in systemic risks

Chart 1 **· Composite Indicator of Systemic Stress Euro Area**

Source: ESRB

Overview of selected initiatives for macroprudential regulation

→ On the **international level** IAIS is currently reviewing the implementation of the Holistic Framework for Systemic Risk introduced in 2019. Based on this review the FSB will decide in autumn 2022 if the Global Systemically Important Insurers (G-SIIs) regime that has been suspended since 2019 will be re-enacted or terminated. At the same time, the FSB will present the results of a comprehensive analysis of systemic risk in the NBFI sector to the G20 for their summit in November 2022. Climate risk and digital transformation, two priorities on the agenda of global regulators, could result in further macroprudential obligations for the insurance industry.

→ On the **European level** the current legislative procedure to reform the Solvency II Directive contains comprehensive proposals for expanding macroprudential supervision; including new obligations for insurers, such as liquidity risk management plans, as well as new macroprudential tools for supervisors, e.g., restraints on dividend payments. At the same time, further reforms of the European macroprudential framework that are relevant to insurers are being discussed. They include for instance the ESRB recommendations on the integration of macroprudential tools in the European Mortgage Credit Directive and on addressing systemic cyber risks, as well as the European central banks' and regulators' work on system-wide climate stress tests.

→ On the **national level**, one of the measures currently under review is the introduction of borrower-based macroprudential tools for residential mortgages. And later this year, the IMF will publish the results of its (five-year) assessment of the German financial system and supervision it performed as part of its Financial Sector Assessment Program (FSAP). Recommendations on expanding macroprudential supervision are to be expected.

Enhancing macroprudential policy

These past years have already been characterised by intensive conceptual work and reform efforts aiming to improve macroprudential policy. Since systemic risks have increased and it has become apparent that monetary and fiscal policy can only go so far in stabilising the economy and the financial system, there has been a growing consensus that macroprudential policy has to play a more prominent role in meeting the current substantial policy challenges. In this context, the existing macroprudential toolbox is widely deemed insufficient. Furthermore, there are calls for more consistency in macroprudential supervision.[1]

The insurance industry is affected by the current reform debate both directly and indirectly – first, by the ongoing supervisory review processes for insurance supervision, and second, by a number of other macroprudential reform initiatives, for example regarding residential mortgages, climate risks and cyber risks. The text box on page 3 will give you an overview of selected macroprudential initiatives.

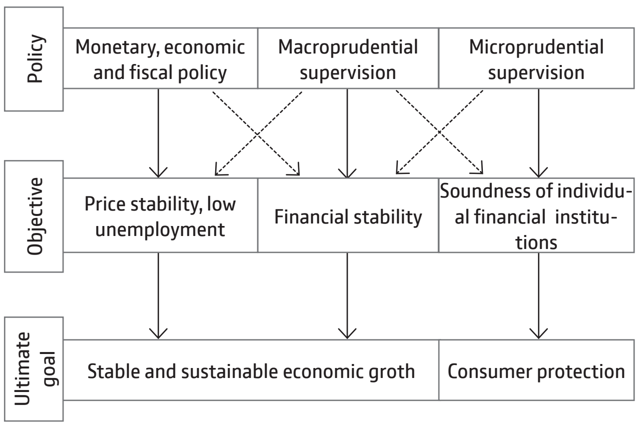
GDV position

Insurers' business activities depend crucially on financial stability. Therefore, the GDV supports an effective macroprudential regulation. What's key is an unequivocally risk-based and proportionate approach that sufficiently appreciates the specific characteristics of sectoral business models as well as the existing regulatory framework. The insurance industry is already governed by a comprehensive macroprudential framework (including, among others, macroprudential elements of Solvency II, the monitoring frameworks of EIOPA and IAIS, stress tests as well as scenario analyses). At the same time, insurers pose only limited systemic risks due to the defining characteristics of their business (e.g., long-term investment horizon, financing of insurance benefits through premiums paid in advance, and in most cases, benefits tied to external events). Therefore, from the perspective of the insurance industry there is little need for additional macroprudential measures for the insurance sector.

In GDV's view, it is important to consider both the possibilities and the limits of macroprudential policy which can only be one of several building blocks ensuring financial stability. Meeting the enormous current challenges and permanently safeguarding financial stability requires a holistic approach where a proactive and stability-oriented fiscal and economic policy, an appropriate monetary policy as well as micro- and macroprudential supervision go hand in hand.

Interplay of policy and supervision areas

Chart 2



Source: Schoenmaker (2010), own admendments

1 See e.g. ESRB (2022): [Review of the EU Macroprudential Framework for the Banking Sector – A Concept Note]

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Issuer
Gesamtverband der Deutschen Versicherungswirtschaft e. V.
German Insurance Association
Wilhelmstraße 43/43 G, 10117 Berlin
Post office box 08 02 64, 10002 Berlin
Phone +49 30 2020-5000, Fax +40 30 2020-6000
www.gdv.de, berlin@gdv.de

Person responsible
Götz Treber
Head of Centre of Competence
Corporate Management
and Regulation
Tel. +49 30 2020-5470
E-Mail: g.treber@gdv.de

Publication assistant
Ursula Küpper

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Author
Dr. Anja Theis
Economics, financial markets

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