Macroprudential Policy and Financial Stability in the Caribbean

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Insurance Activities

Traditional

- Life Insurance
  - Term, Health,Personal Accident, Critical Illness
  - Pure life insurance where benefits are based solely on death, sickness, accident
- General Insurance
  - Property, Motor, Liability, Legal Expenses
- Pure hazards of death, disability, sickness, accident, fire, theft, natural catastrophe
- Premiums paid in advance
- Asset liability management

Non Traditional

- Both
  - Short term funding
  - Securitisation
  - Securities Lending
- Life Insurance
  - Annuities
  - Universal Life
  - Mutual Funds
  - Deposit Administration Funds
- General Insurance
  - Credit insurance
  - Financial guarantees
  - Insurance linked securities
  - Industry loss warranties
  - Credit default swaps

Insurance Failures

Entity	Size (USD)	Cause
Equitable Life,UK	1.6 bn	Guaranteed annuity rates
Lloyds,UK	16bn	Asbestos,pollution
ING,Netherlands	€10bn	Sub prime mortgages
Hartford,US	5.9bn	Variable annuities
AIG,US	182bn	Credit default swaps,securities lending
HIH,Australia	AUD 3.6-5.3bn	Governance,mispricing
CLICO,BAICO	???	Governance, asset mismatch
Financial sector,Jamaica	$3bn	Governance, asset mismatch

Macro vs Micro Prudential Policy

- Micro level policy
  - Limits distress of individual entities
  - Focus on protection of investor & policyholder
  - Manages riskiness of the entity’s behaviour
  - Limited attention on linkages across entities
- Macro level policy
  - Limits financial instability
  - Focus on protection of real economy
  - Manages riskiness of collective behaviour
  - Attention on linkages across entities
- Limited empiricism on effectiveness of macro prudential tools

Micro/Macro Prudential Tools

- Capital based
  - Regulatory Capital
  - Collateral rules
  - Profit distribution rules
  - Investment rules
- Disclosure
  - Financial reporting
- Compensation schemes
- Resolution Plans

Financial Stability

- No common definition
  - Robustness of financial system to exogenous shocks
  - Robustness of financial system to endogenous shocks
  - Stable provision of financial intermediation services
    - Payment services
    - Credit
    - Insurance
    - Capital
  - Viewed through the concept of systemic risk
  - Negative externality that no entity prices
- Two dimensions
  - Evolution of risk over time i.e. procyclicality
  - Distribution of risk at a point in time i.e. contribution of each entity to systemic risk
- Limited theoretical and empirical knowledge of interaction between financial system and macro economy

Systemic Risk Challenges

- Definitional challenge but three common factors
  - Risk of an event
  - Impact of the event
  - Cause of the event
- Measurement challenge
  - Balance Sheet and Market Indicators
    - Backward looking and micro in nature
  - Early warning indicators
    - No reflection on how the real economy and financial sector interact
  - VAR models
    - Forward looking and tracks transmission of shocks
  - Macro stress tests
    - Forward looking

Systemic Risk

- IAIS, FSB definition
- Size
- Interconnectedness
- Availability of substitutes
- Time

Idiosyncratic Caribbean Risks

- Limited fiscal buffers
  - Primary deficits
  - High debt stocks
- Limited external buffers
  - Balance of payments deficits
  - Low foreign reserves
- Sclerosis
  - Anaemic economic growth
  - Reluctance to engage in fiscal, debt and exchange rate adjustment unless mandated by external party or crisis
  - Large off balance sheet age related and interest sensitive liabilities for pensions and health

Idiosyncratic Caribbean Risks

- Regulation should not amplify capital risks
  - Capital controls compel entities to buy domestic assets
  - Capital standards provide significant reward to buying sovereign bonds
  - Recent debt restructurings have reduced supply and increased cost of capital
  - Localisation of capital in pending regulations have created the need for more capital in markets with low growth
  - Tradeoff in capital required at micro and macro prudential level to avoid capital raising
  - Suggest more disclosure as the first policy option

Idiosyncratic Caribbean Risks

- Fiscal and monetary policy should not amplify risks
  - Capital controls create a duty on policymakers to have responsible fiscal and monetary policies
  - Pattern of debt restructurings, modes of intervention in failed entities, reluctance to chart paths quickly adds to uncertainty
- Disorderly resolution of systemic risks
- No transparency and standardisation of data for common exposures

Interconnectedness

- Classification
  - product
  - counterparty
  - maturity
  - credit rating (standard required for unrated)
- Size
  - Gross
  - net of collateral
  - fair value
  - Currency
- Potential capital calls by stressing net exposures
- Concentration

Current Endogenous Risks

- Sovereign debt
  - Double whammy
  - Loss on assets
  - Increase in liabilities unlike banking sector
- Micro prudential policy
  - Limited securities to match assets
  - Large haircuts on equities, 20-25%
  - Large haircuts on real estate,10-15%
  - Large haircuts on foreign currency,8%

Resolution Models

- Transparency, Speed (weekend) and Certainty
  - Identifying distressed entities
  - Counterparty risk
  - Illiquid assets
  - Core Liability Management
    - Suspension of termination rights
- Internalise systemic risk
  - Resolution fund
  - price explicitly for taxpayer guarantee
  - premium is A+B
  - A= expected losses of entity on default
  - B=expected systemic costs in a crisis x contribution of the entity
- Manage systemic risk
  - Living Will : tranches of debt converted into equity until defaults are cured
  - Contingent Capital: Convertible debt that converts to equity
  - Regulatory Forebearance
  - Good company/Bad company
  - Taxpayer bailout

Summary

- Governance must include industry experts
- Measure cost of each entity
- Assess total capital impact because industry is capital constrained
- Responsible governments
- Predefined resolution model
- Monitor interconnectedness
- Transparency helps better pricing of risks and risk controls