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What is systemic risk?

- The risk that the failure of a participant to meet its contractual obligations may in turn cause other participants to default, with the chain reaction leading to broader financial difficulties

- The role of confidence and trust

CONT'D

- The probability that cumulative losses will occur from an event that ignites a series of successive losses along a chain of institutions or markets comprising a system
  - Interdependence, interrelatedness, interconnectedness

Why the fear of systemic risk?

- Financial crises
  - 1994 - Mexico crisis and Tequila effect
  - 1997 – Asian crisis
  - 1998 – Russian debt restructuring
  - 1998 – Collapse of LTCM
  - Current flashpoints: Turkey, Argentina, Enron, telecoms, accounting, others

Cont’d

- Fear of contagion: a financial crisis virus?
  - The cross-country transmission of shocks as a result of:
    - Financial links
    - “Real economy” links
    - Political links
- Result: search for systemic weaknesses throughout the financial sector

Why insurance as a source of systemic risk?

- Banking as the initial source of concern for systemic risks
  - Banking has some unique characteristics
    - High leverage
    - High potential for a run
    - High liquidity needs
    - High interdependence: lending, deposit balances, and payments clearing system
    - Last resort, safety nets, and moral hazard

Cont’d

  - Banks as key participants in large-value payment systems
- Securities firms as key participants in clearing and settlement systems for globally-traded securities
- From banking, securities, and insurance firms to financial services firms
- All financial institutions are potential sources of systemic risks: Insurance and reinsurance as sources of systemic risk

TOP FINANCIAL FIRMS BY MARKET CAPITALIZATION

(Source: The Economist, May 18, 2002, Survey of international finance, p.6)

1990		2001	
Industrial Bank of Japan	57.1$bn	Citigroup	259.7$bn
Fuji Bank	52.0	American International Group	207.4
Mitsui Taiyo Kobe Bank	46.3	HSBC Group	109.7
Sumitomo Bank	46.0	Berkshire Hathaway	100.2
Dai-Ichi Kangyo Bank	44.8	Bank of America	99.0
Mitsubishi Bank	44.0	Fannie Mae	79.5
Sanwa Bank	41.2	Wells Fargo	73.7
Nomura Securities	25.5	J.P.Morgan Chase	71.7
Long-Term Credit Bank	24.8	Royal Bank of Scotland	69.4
Allianz	24.6	UBS	67.1
Tokai Bank	21.3	Allianz	62.9
Mitsubishi Trust & Banking	17.2	Morgan Stanley Dean Witter	61.4
Deutsche Bank	16.4	Lloyds TSB	60.3
American International Group	16.3	Barclays	55.2
Bank of Tokyo	15.9	Credit Suisse	51.3

- Convergence and the passing of risks around the financial system: reinsurers and credit risk
  - Are they as skilled at diversifying and transferring as they think?
  - Are they capable of managing the risks transferred to them?
  - Do they understand the new risks?

Cont’d

- The “too big to fail” situation
- Exposure to extreme events, legal risks, and the settlement process
- Retrocession spirals
- Investment portfolios: derivatives, leverage, and liquidity
- Off-balance sheet transactions
- Importance of intangible assets

Guarding against systemic risks

- Capital requirements
- Crisis prevention policies
  - Coordination and exchange of information
  - Improve incentive structures
  - Minimization of moral hazard
  - Transparency and disclosure
  - Liquidity backstop facilities
- Reforms

But remember…

- "When you hear the government talking about systemic risk, hold on to your wallet! It means that they want you to pay more taxes for more regulations, which are likely to create systemic risk by interfering with private contracting…In sum, when you think about systemic risks, you'll be close to the truth if you think of the government as causing them rather than protecting us from them." Fisher Black, (1995) Hedging, speculation, and systemic risk. Journal of Derivatives 2:6-8.