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- Key takeaways from the roundtable

Evolution of Systemic Risk in Light of Recent Banking Failures and Emerging Risk Drivers

June 21, 2023

Participating banks

5 participants from UK's top 5 banks, 7 participants from 7 Global international banks, 4 participants from UK niche banks, 2 participants from UK's top insurers, 2 participants from 2 global asset managers, 1 participant from a stock exchange, 1 participant from UK government, 5 participants from 3 global consulting firms.

Hosted by

European Risk Management Council

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Summary of Discussion

In light of the recent banking failures and emerging risk drivers, it is imperative systemic risk is well understood. Specifically, the various components of systemic risk and the measures needed to better prepare for the future, including:

- The existing systemic risk definition,
- The prevailing economic conditions and steps required to address challenges,
- The current liquidity policy
- The risks associated with new frontiers – Artificial Intelligence (AI), Machine Learning (ML), and Crypto Assets

Revising Definition of Systemic Risk

- The definition of systemic risk needs to be revisited to better assess systemic risk.
- The recent banking failures (Silicon Valley Bank, Signature Bank, Silvergate Bank, First Republic, and Credit Suisse), the current economic conditions (high inflation, rising interest rates, low productivity, etc.), and the emergence of new risks (Artificial Intelligence and Crypto Assets) call for looking at systemic risk with a wider lens.
- The current economic situation is more representative of a "polycrisis," characterized by COVID-19, climate crisis, geopolitical crisis (Russia-Ukraine War), etc. The definition of systemic risk should be revised to include this polycrisis.
- The current banking failures coincide more with confidence risk than systemic risk. Loss of public confidence can prove to be catastrophic for banks. For example, the Northern Bank crisis of 2008 was saved by Richard Branson's announcement of taking over the bank. The announcement helped in calming down sentiments and easing the situation.
- Another reason to reconsider the definition is the change in the velocity of systemic risks. Owing to the technological advancements, the velocity of systemic risks has increased greatly.

Current Economic Conditions

- It is to be understood that if the current banking failures and the increase in systemic risk represent a "Minsky Moment". A Minsky Moment refers to the onset of a market collapse brought on by reckless speculative activity that defines an unsustainable bullish period. The absence of a particular speculative event, the lack of huge expansion in bank credit, and better capitalization of the banking sector signal against the occurrence of a Minsky Moment.
- The possibility of a recession/stagflation, however, cannot be ignored completely. The UK economy is experiencing a period of dismal productivity marked by massive supply shocks, COVID-19, inflation, Brexit, weak growth, and strong labor markets. It is a period of high wages leading to inflation. To curb inflation, the UK must cut wages at a faster rate, which is yet to be seen.

- A major challenge that the authorities are facing is high inflation. Historically, reducing inflation from double figures to less than 3% has taken more than 10 years, which the authorities are trying to achieve currently.
- The current risks to the economy are created by excessive governmental spending financed by higher debts and taxes. On the other hand, private debt has reduced. Additionally, firms have reduced commercial property exposure post COVID-19.
- Despite multiple interest rate hikes, inflation has not reduced as expected. This can be attributed to the fact that the UK is experiencing consumer resilience towards monetary policy due to fixed rate mortgages.
- In response to the high inflation, the Bank of England (BoE) must increase interest rates at a pace that shall lead to a decline in inflation. Also, clarity needs to be provided on the monetary policy post the tightening. Additionally, the UK government needs to provide its support via appropriate fiscal policy measures.

Changes Required in Liquidity Policy and Other Regulations

- In addition to monetary and fiscal measures, the authorities need to evaluate the liquidity policy again.
- There are substantial differences in the UK and the US regime. The US has many more regional banks than the UK. Also, the UK government focuses on ensuring liquidity, and it is well-supervised.
- An area of concern is the Financial Services Compensation Scheme (FCSC) limit. As compared to the US's $250,000, the FCSC limit for the UK is set at £85,000. The BoE needs to reassess and probably increase the limit to increase consumer confidence. Additionally, more clarity should be provided to consumers regarding how the £85,000 limit works. Along with the limit amount, an assessment of the speed at which compensations are paid out should also be made.
- Additionally, the regulators should consider if a relaxation in the 2008 crisis regulations is required.

Impact of New Risks Frontiers – AI/ML and Crypto Assets

- The emergence of AI/ML and Crypto Assets has created both new opportunities and new risks.
- Certain risk-related areas where AI/ML can contribute significantly are as follows:
  - Insurance Underwriting
  - ESG
  - Model Documentation
  - Cyber Security
  - Credit Scoring
  - Credit Application
  - High Frequency Trading
  - Firewall Protection

- Though AI/ML provide multiple growth opportunities, they do present new/hidden risks that are not covered by the current model risk management structures. Banks/financial institutions should ensure the enhancement of MRM to include risks posed by the use of AI/ML.
- As far as Crypto Assets are concerned, regulations should ensure the right balance between ensuring consumer protection and promoting competitive innovation.

Conclusion

Key takeaways from the discussion:

- We must assess if the definition of systemic risk needs to be revisited to include polycrisis, permacrisis, increased payment velocity, interconnections in financial systems, etc.
- The current UK/EU economy is characterized by low growth, high unemployment, and low productivity. To curb inflation, faster interest rate hikes need to be combined with appropriate fiscal policy measures.
- Authorities must revisit the liquidity policy and understand the appropriateness of the £85,000 FCSC limit. Also, an assessment of the regulation put forward in 2008 needs to be made.
- The emergence of new frontiers like AI/ML and Crypto Assets creates opportunities as well as risks for banks/financial institutions. The current MRM frameworks need to be enhanced to incorporate these new risks.

For any questions or details regarding the round table topics, please contact us at: **MRMsolutions@evalueserve.com**

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