**EUROFI VIEWS MAGAZINE** - ZAGREB APRIL 2020

## Cyril Roux

Chief Financial Officer, Groupama

# Will the financial center hold in the current economic sudden stop?

After the Great Financial Crisis of 2008, the Financial Stability Forum turned into the Financial Stability Board, established as a permanent organization with a broadened focus reporting to the G20. In the European Union, the Barnier agenda was meant to address the multifaceted weaknesses of financial markets, infrastructures and intermediaries.

Dozens of directives and regulations were established, in an alphabet soup of acronyms: BRRD, MAD/MAR, SFTR, MiFID, EDIS, MMF, and many more. The ESRB worked with ESAs, Central Banks, national supervisors and the European Commission to measure financial stability risks, to design supervisory tools to address them, such as stress testing and remediation plans, and to develop macroprudential supervision.

In the US, the 2010 Dodd-Frank act introduced new federal agencies (CFPB, OFR, FIO and the FOSC) and a great many new financial regulations. The latter part of the decade saw a concurrent effort to roll back in part this recently increased regulatory burden.

In Europe, this was the avowed focus of Commissioner Hill, while in the US, the impetus was given by the Trump administration and Republican Congress. This didn't prevent the completion of Basel III, however. All the while, low interest rates combined with the capital and liquidity requirements imposed on banks led to an increase of the indebtedness of public and private actors, and that of the size of non-bank financing over the decade. Although much was feared about the concentration of risk in CCPs, the strains and imbalances of the market and regulatory structures manifested themselves in the repo market from September 2019, especially in the US.

Then came the sudden economic and financial freefall which started in March 2020 after a decade of growth. It is a very stern test of the sufficiency, or otherwise, of the microprudential and macroprudential regulations and monetary instruments developed since the GFC. As in the GFC, money-market funds are among the very first to be hit by severe liquidity strains – but for reasons affecting the other side of their balance sheets. In the US, the SEC has moved swiftly to relax the prohibition of sponsor financing to enable money market funds to meet the large redemptions they face. In Europe, the ability to deploy swing pricing and redemption gates may be used, despite the stigma which may be attached to these measures.

The current crisis will also test the appropriateness of the CNAV and VNAV bifurcation of money market funds. So will the promise of liquidity underlying the growth of ETFs. ETF redemptions may be met with payment in kind, especially in credit, to the surprise of some subscribers. As in 2008, the CP market has seized, which is only natural when a wave of delinquencies is expected. The rise of counterparty risk in most of the economy, and accompanying credit downgrades, will stress fixed income funds, trigger loan covenants and increase margin calls. Banks would naturally be under critical stress were it not for the unlimited support of Central Banks, together with regulatory relaxation embedded in CRD IV – a relaxation that the European Union singularly failed to provide for under Solvency 2.

More generally, the sudden stop of large swathes of the economy is likely to strain most markets and market participants, including corporates and governments. The least and last affected among financials are likely to be mainstream insurers. Provided they haven't invested unduly in riskier assets, nor taken aberrant underwriting risks (such as guaranteed investment returns or failed to exclude pandemic in their casualty coverage), mainstream insurers should weather the economic and financial storm, as long as governments do not default, notwithstanding broken measures of their solvency ratios based on point-in-time volatilities that say precious little about their financial standing. Should that be the case, as it was during the GFC, this would prove once again the futility of EIOPA and IAIS insistence to try to develop for and impose on the insurance sector an additional layer of systemic regulatory burden. ●