Newsflash

Bank of England launches the first scenario of the System-Wide Exploratory Scenario

This communication is intended for insurers, reinsurers, asset managers and banks only. It is published for informational purposes only, and does not constitute advice.

14 November 2023

Chee Lim
Senior Consultant
chee.lim@hymans.co.uk

Diane Duan
Consultant
diane.duan@hymans.co.uk

Megan Clarke
Associate Consultant
megan.clarke@hymans.co.uk

On 10 November 2023, the Bank of England (BoE) initiated the scenario phase of the System-Wide Exploratory Scenario (SWES). The SWES is designed to enhance understanding of how UK financial markets behave under stressed conditions and to assess the impact of these behaviours on the overall financial stability of the UK.

Background and timeline

The SWES was launched by the BoE in June 2023 to improve understanding of the behaviours of banks and non-bank financial institutions ("NBFI") under stress, and the impact of those behaviours on UK financial stability. There are more than 50 participants, such as large banks, insurers, central counterparties ("CCPs") and a variety of funds (including pension funds, hedge funds and asset management funds).

The timeline for the BoE's SWES is shown below:

In June 2023, the BoE gathered information from participants to help design the scenarios. Information focussed on; their business and outstanding exposures in the SWES markets of focus, market risk sensitivities, and their liquidity sourcing actions during market stress. This information gathering phase has now completed and the BoE has launched the first hypothetical stress scenario for the participants to model. This scenario incorporates severe, but plausible, 10-day shocks to interest rates and risky asset prices. In 2024, the BoE will provide another hypothetical scenario for participants to model, which will be designed based on the results from the first scenario and the collective actions participants would have taken in response to the first scenario. The exercise targets specific markets including the gilt, repo, sterling corporate bond and associated derivative markets (e.g. gilt and SONIA futures; and interest rate, cross-currency and inflation swaps).

Round 1: A focus on liquidity

Round 1 focuses on understanding NBFIs liquidity needs and the actions they would take in response. The BoE asks SWES participants to provide information relevant to the drivers of their liquidity needs, their actions to improve liquidity and their risk management actions for their portfolios under market stress.

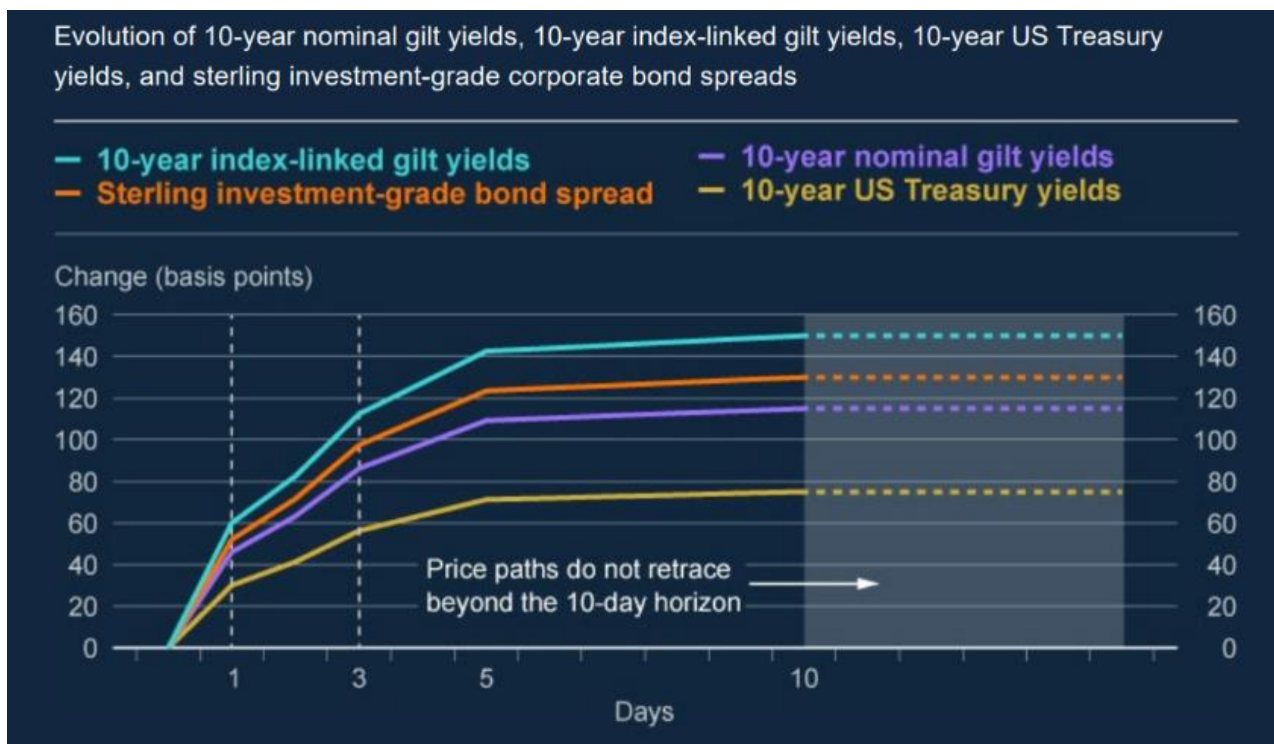
Based on the data received during the information gathering phase, the BoE expects the main drivers of participants' liquidity needs arise from:

- **Increases in collateral calls,** through additional variation margin calls and/or increases in initial margin.
- **Revaluations of collateral**, for example collateral that is posted for securities which are financing transactions, resulting in a need to post additional collateral.
- **Funds facing redemptions** from other market participants who are seeking to meet their own liquidity needs.

The SWES will also examine the role that banks and CCPs play in both demanding liquidity from, and supplying it to, other SWES participants.

A closer look at the round 1 scenario

The shocks in the hypothetical SWES scenario incorporate elements from recent market events. The aggregate shock is more severe than observed in the March 2020 'dash for cash' and the September/October 2022 LDI episodes as the shock is faster, wider ranging, and more persistent than observed in these events. The scenario affects a wide range of market prices and indicators over 10 business days, with the majority of market movements occurring in the first three days. The 10-day shocks are summarised in the graph below.



Source: [The Bank of England has launched the scenario phase of the system-wide exploratory scenario. | Bank of England]

The BoE also provided [context] to illustrate how the shocks shown above compared to both recent market events and the most significant 10-day move observed historically.

Further details on each day of the scenario are outlined below.

Day 1 – 40% of 10-day shock is realised: Markets are surprised by a significant geopolitical shock. Markets begin de-risking, risky asset prices fall, volatility sharply increases, and the overall economic outlook deteriorates. There are significant sales of advanced-economy government debt, resulting in a 45bps and 60 bps increase in yields on 10-year gilts and index-linked gilts respectively. Consequently, repo rates also rise. Volatility increases in foreign exchange ("FX") markets. Many of the day 1 movements are roughly in line with, or more severe than, the largest one-day observed historical movements.

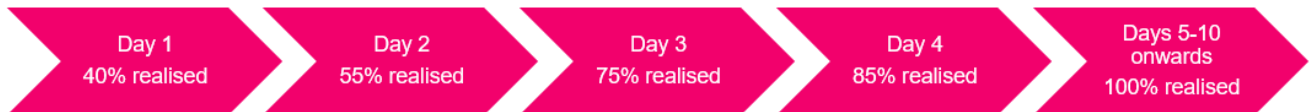
Day 2 – 55% of 10-day shock is realised: Asset prices fall further, exacerbated by hedge funds de-risking and unexpected sovereign bond sales by some wealth funds. As the geopolitical event worsens, credit rating agencies place several jurisdictions, including the UK, and various financial institutions and corporates on negative watch. Sharp declines in risky asset prices and higher government bond yields increase pressure on hedge funds employing relative-value strategies. There are emerging expectations of a severe and persistent deterioration in the global economic outlook, and materially tighter financing conditions for advanced economies as a result of the pressure on yields.

Day 3 – 75% of 10-day shock is realised: A sovereign wealth fund's decision to continue selling government bonds heightens counterparty credit concerns. Asset prices continue to fall as market activity is sporadic and liquidity is thin. Forced selling behaviour is observed from a number of the distressed funds and there are concerns around the creditworthiness of these funds on meeting their margin payments in full. This results in credit rating agencies placing more corporates on negative watch and a further sharp increase in corporate bond spreads.

Day 4 – 85% of 10-day shock is realised: Amid ongoing media focus on geopolitical tensions, a mid-sized hedge fund defaults, leading to the sale of collateral and further declines in asset prices. Retail fund redemptions remain heightened. This increases concerns around counterparty credit risk, contributing to a significant drop in funding

market activities and further price falls in fixed-income markets. Volatility in equity, FX, and rates markets remain elevated. Sterling begins to depreciate due to a higher risk premium associated with UK assets.

Day 5-10 onwards – 100% of 10-day shock is realised: The geopolitical situation remains unstable with no prospect of resolution in the medium term. There are concerns the situation could evolve into a downturn of similar severity to the 2007/08 global financial crisis. The price movements and volatilities remain elevated in the following months. The sovereigns placed on negative watch, including the UK, are downgraded by a single notch, although markets have mostly already priced in the effect of this. Further downgrades are expected.



Next steps

Participants have been asked to model the impact of the round 1 hypothetical scenario on their business. The BoE has shared scenario documentation, response templates and guidance, for participants to respond by January 2024. Following this, the BoE will review results and publish a second hypothetical scenario for firms to model in Q2 2024. A final report on the SWES results will be published by end-2024, which will summarise system-wide findings. There will also be interim results and updates via standard Bank/Financial Policy Committee communication channels such as Financial Stability Reports.

Implications for firms

Insurance companies should take this opportunity to review and strengthen their risk management framework and stress testing capabilities, based on insights gained from the SWES modelling and results. Areas of focus could include:

- Incorporating system-wide scenarios into their stress-testing and risk assessment may be required to enhance their risk management framework
- Revising liquidity management framework in light of recent events. Firms may want to consider interlinkages between interest rate, liquidity risk and solvency level. Firms may review their collateral management, explore liquidity management tools available to them and monitor liquidity level more frequently.
- Reviewing management actions under stress, reflecting behaviours of other market participants and interactions between markets of focus.

We continue to work with a wide range of insurers across the UK and abroad on scenario modelling, stress-testing, liquidity and risk management framework. If you would like to discuss any of these points further, please get in touch with your usual Hymans Robertson contact or any of the authors of this Newsflash.

This document has been compiled by Hymans Robertson LLP who reserve all rights to it. It should not be used by any third party without reference to "Hymans Robertson LLP". It is based upon our understanding of the subject matter as at the date of publication. It is not a definitive analysis of the subject covered or specific to the circumstances of any particular person, scheme, business or organisation. The information contained is not advice and nor is it a recommendation. It should not be relied on, nor considered to be a substitute for professional advice (including actuarial, investment, legal, tax, audit or accounting advice). We accept no liability for errors or omissions, for results obtained from using the information, or for any reliance you place upon any statement or opinion contained in this document. We also accept no responsibility for how you use the information contained in this document.

This information is not to be interpreted as an offer, solicitation or recommendation to make (or not make) any specific investments or product decisions. All forecasts are based on our reasonable belief. Please note the value of investments, and income from them, may fall as well as rise. You should not make any assumptions about the future performance of any investments or products based on information contained in this document.

Hymans Robertson LLP (registered in England and Wales - One London Wall, London EC2Y 5EA - OC310282) is authorised and regulated by the Financial Conduct Authority and licensed by the Institute and Faculty of Actuaries for a range of investment business activities. A member of Abelica Global. © Hymans Robertson LLP.