



## On Risk, Rescue and Hazards – The Global Crisis

by Patrick M. Liedtke

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This article was published in Insurance and Finance No. 4, February 2009

Any economic and financial crisis the size of the current one leads to a series of reactions that outlast the crisis itself in a substantial way. We can already see how many different aspects of our modern economies are affected by the crisis and how this has provoked a serious shift in vulnerability awareness, risk aversion and priority setting. This comprises different dimensions and translates into specific actions:

- a) Actions that are intended to cope with the original and constituting elements of the crisis. Directly affected institutions are those that to a large part provoked the current malaise and are mainly part of the financial services sector, foremost in banking.

The crisis led to a fall-out in the mortgage sector, the seizing up of the credit markets, almost a general liquidity freeze and several bankruptcies, near-bankruptcies and nationalisations. Many official actions have tried to counter the immediate negative effects of the crisis which undermined primarily the functioning of credit markets and the solvency (expectations) of important parts of the financial sector. The efforts to actively pump liquidity into the banking system as well as the relaxation of liquidity and solvency constraints were and are meant to solve the deadlock.

- b) Actions that are intended to limit the further impact of the crisis and/or to contain its spreading. Affected institutions range from governments through the business sector right down to the individual level.

While at first it was the financial sector, led by the banking institutions directly involved in the subprime lending and then the financial guarantee business, the impact has spread to the wider economy. At this stage, the crisis has started to impair the “normal” functioning also of non-financial institutions which have run into severe difficulties in refinancing their operations as well as beginning to suffer from the fall-out in demand that the current world recession has triggered. Concerned with this development, governments and central banks have reacted to mitigate the impact. This has triggered a series of direct interventions, using mostly Keynesian instruments, to stabilize demand. The idea is to prevent the world economy from suffering a sharp and potentially longer-lasting downturn, which could turn into a depression.

- c) Actions that are intended to improve the future resilience of our financial and economic systems. Affected institutions are primarily those operating in the areas that triggered the original crisis. In addition, however, there is a discussion going on about how to make the financial system in general more resilient to potential hazards, improving its vulnerability characteristics in the process.

As in traditional engineering, any accident suffered by a system provides most valuable insights as to its unique behaviour in the real world rather than the theoretical concepts and original intentions that lead to its creation. And so it happens in financial engineering as well. The systems that were meant to provide better access to housing in the U.S., that were designed to spread risks more evenly and efficiently throughout the financial world, and that were supposed

to actually strengthen the financial system, turned out to do just the opposite. Uncontrolled risk-taking, unchecked risk accumulation and incompetent and naïve risk management were the consequence. The efforts of the guardians of the world's financial health – including supranational organisations like the IMF, the Bank of International Settlement or the World Bank, intergovernmental organisations like the Financial Stability Forum or the G-8 and G-20, as well as private sector institutions with an interest in financial stability – endeavour to create a less vulnerable setup for the future.

One would suppose that all of the actions that are either already executed, about to be implemented or expected to materialise over the coming months have been designed with utmost good intentions in mind. However, as the saying goes, the road to hell is paved with good intentions. Most certainly we will come to regret some of the rasher and less well thought-through initiatives. In this respect a series of concerns can already be formulated:

- *Will policy action result in more protectionism, more cost, and less efficiency in the markets?*  
It seems unlikely that policy makers would easily risk the benefits of moving towards global markets for goods and services when these have been a major cause for the increase in wealth and welfare of many nations over the past decades. However, local pressure could build up to such an extent that some negative reactions could be triggered, resulting in more protectionism. These reactions will be difficult to fight as the case for free, open and efficient markets on a transnational scale is often more technical and difficult to make, especially in the face of job losses and local hardship.
- *Will future regulation target the right objects?*  
It is all too easy to confound cause and consequence, suddenly turning the victims of a crisis into the recipients of more regulatory action. A thorough analysis as to who and what caused the greatest and most dangerous threats to the financial and economic system as well as a measured approach to deal with them in an appropriate way is required. Very problematic seem two possible dangers when devising new regulation: a) unnecessary spill-over effects, i.e. when one specific aspect is meant to be the object of new regulation while others – which were never meant to be affected – are also concerned, thus undermining the efficiency of the system or even leading to adverse incentives; and b) ample targeting when precision is required, i.e. adopting a shotgun approach to regulation that would put bystanders at risk when a silver bullet solution would be called for.
- *How can governments avoid that subsidies to certain players (in the financial markets as much as in the wider economy) will result in market distortions?*  
Unfortunately, the answer is, they cannot. As we have already seen, some players who received government rescue packages have at the same time been bidding for new acquisitions, which amounts to a serious market impact as *de facto* public money is in direct competition with private funds. Similarly, rescuing operations to the benefit of one sector or one country, which might offer comparable goods and services to those of another sector or country (which did not need special help) skews the level playing ground for everybody. Likewise, the need to keep in business and to satisfy the cash-flow requirements of government help packages leads to an impact on the behaviour (including the risk taking) of firms and the proposed rates at which they price their products and services. While such behaviour is bad for any industry, in insurance it could turn out to be particularly dangerous. Pressure to underwrite any business at too low a rate undermines the necessity of building enough reserves, thus potentially impairing many years hence the ability to meet claims. In financial services, the banking and insurance supervisors will have to act early and decisively to avoid the worst.
- *Will the new order in financial markets be able to avoid the problems of having too many institutions that are systemically too relevant to be allowed to fail?*  
During the current crisis we saw quite a number of rescue operations that centred on institutions that were considered to be “too big to fail” or “too interconnected to fail”. A key hallmark of a free market economy has always been that an enterprise should be allowed to fail in order to avoid the moral hazards and inefficient incentives that are produced by an implicit rescue guarantee. This has also been important in order to allow more efficient firms to prosper and contribute to the mechanism that Schumpeter called in his book *Capitalism, Socialism and Democracy* in 1942 the

“creative destruction”. What if the implicit and explicit guarantees that are being given now undermine this source of possible future advancement as the potential destruction of inefficient firms will no longer give way to the rise of more efficient ones? It seems counter-intuitive that many financial firms who had to be rescued were merged into larger institutions, thus contributing to the problem of possible risk accumulation rather than solving it. It seems the new order in the financial markets will have to be seriously revisited in this respect once the crisis is over.

- *Will the enormous wave of liquidity that is currently being pumped into the system be put to good use or will it result in an upsurge of future inflation?*

While it is relatively easy to turn on the tap of liquidity in times of stress, it is almost impossible to get the dosage right and politically extremely difficult to find the right moment to turn it off again. The consequences for the financial system and to the millions of savers that would see a serious erosion of their real asset values could be dire indeed.

The current crisis is far from over and the real work to prepare better systems for the future has barely begun. That requires careful, conscientious and prudent action. A lot of the confidence in the banking sector and the financial system in general that has been lost over the past months can only be restored if the resulting structure will be efficient, fair and sustainable. As insurance is a long-term business that depends like few others on efficient markets, prudent risk taking by all (including governments!) and the availability to diversify across regions and sectors, it has more at stake than many other industries. A direct and visible involvement in the public debates and the global decision-making is called for.

**About the author:** *Patrick M. Liedtke is Editor of the Insurance and Finance Newsletter and Secretary General and Managing Director of The Geneva Association.*

*This article was published by The International Association for the Study of Insurance Economics (The Geneva Association). Articles, documents and recent publications of the Association can be found on its website, at [www.genevaassociation.org](http://www.genevaassociation.org)*