



SC6 Insurance and Finance

Research on Finance Issues in Insurance

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Everything you wanted to know about the crisis ... but were afraid to ask

by Denis Kessler

In this article Denis Kessler looks at the credit crisis and contrasts our limited knowledge and negligence with the key characteristics of the crisis.

1. Everything I thought we should have known and I discovered that many of us did not know, or acted as if they did not know about it.
2. Everything we did not know but have discovered with the crisis, so that we have to take this knowledge into account in the future, from now on.
3. Everything we did not know, we still do not know, but we cannot ignore.

1/ Everything I thought we should have known and I discovered that many of us did not know or acted as if they did not know about it.

<i>I thought that it was common knowledge that... 5 examples</i>	<i>I discovered that some smart people had bet on the fact that...</i>
<i>(1) the economy is intrinsically <u>cyclical</u>;</i>	...they could pursue their business without a buffer for distressed times and were surprised when the crisis happened and they became short of liquidity;
<i>(2) <u>credit made to liquidity-constrained households is often not repaid</u>;</i>	...the best investment was to buy sophisticated securitised schemes pooling housing credits made to liquidity-constrained households and complained that they had been fooled by the banks who sold them these schemes when they discovered that a lot of this credit would not be repaid;
<i>(3) no one should take <u>risks that he/she does not understand</u>;</i>	...the trend had been to ignore good old equities and acquire new unknown risky financial products called “structured products” on the basis of an awarded rating, without any track record. The end of the story is well known: structured products dropped 85 per cent when equities dropped less than 50 per cent from the beginning of the crisis;

<i>(4) economic agents knew that business never develops in a linear fashion and that there are always negative, as well as positive <u>crosswinds</u> affecting the economic activity;</i>	...a lot of people ignored these crosswinds and were surprised by events such as the U.S. housing market crash, the Madoff fraud or the Obama changeover of political power;
<i>(5) investors were always taking complex calculations and sophisticated model results with caution and prudence.</i>	...investors made huge arbitrage on the basis of tiny differences that were not statistically significant (+ 40 Bps) and became angry when they were informed of model errors that dramatically reversed the positive result (- 40,000Bps)!!!
<i>Having re-read my good old economic textbooks, I thought that educated experts were aware of the following 6 facts ... How naïve of me!</i>	<i>I discovered the following practices among the smartest experts....</i>
<i>(1) I believed that experts knew that a <u>lax monetary policy</u> always fuels a credit cycle beginning with an excess of debt, often accompanied by a housing bubble, and ending in a financial mess and a contraction of the real economy...;</i>	...the trend was to lend credence to a new economic theory “that this time it’s different!”, and arguing that the excess of debt when fuelled by a U.S. lax monetary policy was a good cholesterol supporting long-term growth;
<i>(2) I believed that experts were convinced that some financial institutions were “too big to fail”;</i>	...experts did not know what to do in case of a major bankruptcy, did not anticipate it, and even became angry when they discovered that there was no other solution than to save a bank in great distress;
<i>(3) I believed that experts were always fearing the moral hazard consequences of public puts, such as the famous Greenspan put, etc.;</i>	...experts were supportive of these so-called public puts that were supposed to help fine-tune the economic fluctuations. They did not realise how much banks had bet on public support in case of distress when they exposed themselves to too much risk;
<i>(4) I believed that enlightened governments, in their role of protecting consumers and investors, would refrain from giving any incentive to transfer a risk from an institution who knows this risk well to an investor who does not know or understand it and who has little expertise;</i>	... the opposite happened, as supervisory authorities encouraged banks to throw out of their balance sheets the most risky credit, i.e. mortgages, and to transfer them, by way of securitisation, to investors who did not know the risk;
<i>(5) I believed that governments that were for years preaching in favour of precautionary behaviours and in favour of risk management, had contingency plans for times of crisis, notably systemic crisis;</i>	... many governments were not ready at all, did not prepare anything between August 2007 and September 2008 and were caught by surprise, muddling through emergency plans under pressure;
<i>(6) I believed that supervisors knew that most extreme risks are not isolated risks but that these risks re-correlate when their severity increases. This hypothesis would also be true for expectations that tend to re-correlate at a time of severe crisis. “When it rains, it pours” says the English proverb!</i>	...these facts, these phenomena were largely ignored and many observers seemed surprised when the crisis worsened at an incredible speed.

2/ Everything we did not know but have discovered with the crisis, so that we have to take this knowledge into account in the future, from now on

<i>All of us (financial institutions, investors, supervisors, analysts, rating agencies) should have known quite a few facts (7) but were not fully aware or ignored that...</i>	<i>From now on, we have to be aware of the fact that...</i>
<i>(1) our economies, our financial systems, were already largely globalised, interconnected, despite the fact that experts have been discussing globalisation for years;</i>	...the crisis is a global shock—affecting all players, all countries, etc.—that requires a global medicine; it is therefore surprising how many and how much governments are preferring the old inefficient national policies of supporting the domestic demand and the declining industries, helping their own financial institutions;
<i>(2) credit protections (credit derivatives, credit enhancement, etc.) have clear limits;</i>	...we now know that all investors around the world cannot simultaneously be credibly covered against all counterparty risk (when everyone thinks that he or she is protected against counterparty risk, then no one is probably protected);
<i>(3) off balance sheet exposures are dangerous because they require softer reporting, and are therefore more opaque, and escape prudential requirements;</i>	...we cannot ignore any longer that “off balance sheet exposures” should be better regulated and controlled, internally and externally;
<i>(4) a non-identified counterparty is by definition dangerous: first, it is by nature an unknown and a misunderstood risk, second, opacity always protects hidden risks;</i>	...we have to acknowledge that non-identified counterparty cannot be considered anymore as normal average risks;
<i>(5) IFRS mark-to-market accounting standards and new prudential standards had been demonstrated to be largely pro-cyclical;</i>	...the demonstration has now been made that IFRS and Solvency II, as well as most internal models, are too pro-cyclical and have to be corrected;
<i>(6) the fluctuations of the liquidity provided by securitisation over the last decade provided up to 30-35 per cent of the liquidity of the U.S. market and 10-15 per cent of the liquidity of the European market—that was before the crisis happened;</i>	...we all know that securitisation, by nature, is a discontinuous and therefore unstable source of liquidity for the market, which can be interrupted in time of crisis;
<i>(7) financial conglomerates are dangerous because of their size and contagion risk: double gearing risk was underestimated and firewall protection overestimated;</i>	... diversification is only one dimension of conglomerates, which is more or less counterbalanced in times of extreme financial stress by the risks related to their size and their interconnections.
<i>All of us erroneously thought that...</i>	<i>At the time of the crisis, we learned that...</i>
<i>(1) we controlled the behaviour of the new sophisticated financial products;</i>	...structured products have non-continuous, non-normal behaviours;

<i>(2) internal models and their ESGs were powerful instruments for exploring most virtual situations;</i>	...most internal models and their ESGs were unable to anticipate a shock similar to the current crisis and have to be revisited;
<i>(3) downgrades by rating agencies had no significant macro-economic consequences;</i>	...the dramatic downgrade of some U.S. mortgage vehicles has fuelled the loss of confidence by investors in the overall market of securitised vehicles;
<i>(4) an investment bank or a credit enhancer could fail without macro-economic major damages;</i>	...an orderly failure of either a big investment bank (Lehman Brothers) or a big credit enhancer (“monoliner”) is not possible to control;
<i>(5) insurance and reinsurance business was riskier than banking, following the lessons of the 2001-2003 period;</i>	...by nature, (re)insurance is less risky than banking, especially because it is less exposed to liquidity risk, except in very exceptional situations (in cases combining shocks on the assets and on the liabilities or in cases of insurance doing quasi-banking business);
<i>(6) public money infusion was the right solution for bailing out distressed banks;</i>	...caution is probably more efficient because it gives a better incentive to managers, it reduces moral hazard effects and it is less expensive;
<i>(7) systemic risk had disappeared in advanced economies thanks to Keynesian macro-economic policies and sophisticated financial supervision of banks and insurance;</i>	...systemic risk is persistent in our advanced economies because of the limited efficiency of the traditional instruments of Keynesian macro-economic policies and of sophisticated financial regulation;
<i>(8) small countries (mainly islands...) were internationally attractive because of their low taxation and their light regulation.</i>	...since 2008, we know that in time of distress small countries are no more attractive because they are too small to provide the large amount of support needed by those worldwide companies that are based in these countries... it is the small country syndrome: the risk pooling base is too narrow...

3/ Everything we did not know, we still don't know but we cannot ignore

<i>We all would like to have news on 5 key issues...</i>	<i>This knowledge will only be available at the exit of the current crisis.</i>
<i>(1) When will the crisis end? Are we in V or U or W, or L or square root shaped crisis?</i>	I have some personal ideas on the subject but no certitudes: the crisis may be deep and long; despite the vigorous equity market rebound we have observed during the last weeks we nevertheless remain at a depressed level of economic activity.
<i>(2) After deflation, will inflation come back?</i>	There are good arguments in favour of this inflation comeback: the volume of money created to cure the crisis, the unsustainable path of the public debt, globalisation that no longer provides disinflation but inflation (oil, food); at the same time, the prolonged crisis may dampen any inflationary tensions for a long time.

<i>(3) Will the yield curve steepen? And will real interest rates skyrocket?</i>	I personally think that the yield curve will steepen, indeed, this movement has already started. When the market fully reopens the yield structure will be definitely different than the one we knew before the crisis. As governments will need to finance their huge deficit they will be forced to offer better yield. And central banks will be led to increase short-term interest rates to fight against mounting inflationary pressures.
<i>(4) Will business models evolve?</i>	Yes, very likely. The era of the business model characterised by zero cash, maximum leverage, large off-balance sheet exposure, unrealistic ROE targets has come to an end. Each company—be it an insurance company, a bank or an industrial company—is thinking today about its next business model.
<i>(5) What kind of regulations are going to emerge at the end of the crisis?</i>	It is too early to say. But it is very likely that regulations will be stricter and heavier, capital requirements more stringent, monitoring more pressing, reporting more detailed, but we still do not know if there will be global or regional supervisors and we still do not know if there will be a true federal insurance and banking supervisor in the U.S.
<i>We all would like to know...</i>	<i>This knowledge will likely not be available before the next crisis...</i>
<i>(6) Is the European Monetary Union at risk in case of a prolonged crisis?</i>	The probability of such a risk is still very low. At the same time it is no longer zero and it is increasing. The risk is that, if the crisis lasts much longer than anticipated, public debt might explode in some Euro-countries and become all the more unsustainable as inflation or devaluation are no longer readily available. Recurring divergences could put unsustainable pressures on the EMU...

The author: Denis Kessler is Chairman and CEO of SCOR, Paris, and Board Member of The Geneva Association. This text is based on his contribution to the Insurance Forum jointly organised by The Geneva Association with AXA/MPS and ANIA in Rome on 16 October 2009.

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