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“New Developments in the Regulation and
Supervision of Financial Services”**

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“New developments in the regulation and supervision of financial services”

by Julian Arkell

Good morning, and welcome. What are the key issues on the programme?

This year we are going to focus mainly on the regulation and supervision of financial services, which is becoming progressively more complex and extends to reinsurance, while the systems are becoming more global. Sound regulation involves setting appropriate standards to assure solvency and capital adequacy. Last year we considered various dimensions of risk and volatility, and now we will discuss the reflection of those elements in financial statements, which involves the nearly global application of capital and accounting standards. Tomorrow afternoon we will hear about the negotiations on trade in financial services under the General Agreement on Trade in Services (GATS) of the World Trade Organisation (WTO), and consider the aims of the trade policy makers and the prudential regulators expressed in the context of the Doha Development Agenda ‘round’ involving 148 member nations, and others in the process of acceding.

In these opening remarks I would like to dwell briefly on some root causes of uncertainty, as a backdrop for today’s discussions on financial stability in our inter-related commercial systems and inter-dependent nations, before we concentrate on the challenging specifics.

A noted physicist wrote “The effort to understand the universe is one of the very few things that lifts human life a little above the level of farce, and gives it some of the grace of tragedy.”¹ This gem forms a good starting point for my reflections today on our evolving world.

The late Belgian chemist, Ilya Prigogine, who spoke at early Geneva Association events, studied how life first evolved on Earth and noted that: “Characteristic of such self-organising systems is their tendency to reach critical ‘bifurcation’ or indecision points, where their behaviour is unpredictable. They may leap abruptly to a new state of greater complexity and stabilise, or descend into chaos.”² When contemplating this basic reality, one recalls the dictum “that the absence of evidence is not the same as evidence of absence” !

The key issue, if I have understood this message correctly, is that the further we climb up the mountain of inter-linked system complexity, using ever more effort to scale higher, the closer we approach the possibility of an unpredictable and sudden chaotic fall backwards. Furthermore, the underlying mathematics that model most closely such systems, predict that “you do not need a large trigger in order to set off a large event”³, or put another way, “even a small trigger can, on occasions, produce a very large change in the system as a whole. Life really is like that.”

¹ “The First Three Minutes” by Steven Weinberg, quoted in “A Matter of Degrees”, Gino Segrè, p 226.

² Extract from “The Fifth Miracle”, Paul Davis, Penguin, 1999, summarising the conclusions of his research on “chemical mixtures that behave in a lifelike manner.”

³ “Deep Simplicity – chaos, complexity and the emergence of life”, John Gribbin, Penguin/Allen Lane, 2004 (pages 157 and 198).

The Club of Rome in its statement last year “Towards a New Age of Information and Knowledge for All” warned on the subject of “Stability and Security” that:

“The stronger (and faster) interactions between people in a more intensely networked society and economy will generate new risks of instability, as well as new growth and creativity. These risks of instability from positive feedback and ‘fashionable’ over-enthusiasms or recessions, whether in financial markets, in internet ‘virus’ propagation, or in social movements, must be addressed. They must be addressed at the international level. New mechanisms must be found to dampen ‘run-away’ trends, to contain them, and to re-channel them. The analytical tools for risk analysis in complex systems are becoming available, but the institutional arrangements to mitigate risks are not yet in place.”

(Section 3.2, page 18)

Although this Club of Rome report was targeted at the World Summit on the Information Society, it is very apposite for our seminar. Much of our time will be spent looking at institutional issues, both national and multilateral, their standards and how they will be implemented and enforced. They in turn are aimed at protecting the financial systems, and peoples’ assets from new risks of all sorts, and the tendency for growing financial volatility propagated instantaneously across the globe.

As I see it, the conundrum is whether the greater the attempts we make to protect the systems from chaotic breakdown, the closer we predictably push the complexity towards the precipice we wish to avoid, while being unable in advance to identify the proverbial last straw.

When we consider the wider social setting of our discussion today on risk arising from such volatility in the global financial markets, it might be apt to recall that the journalist Robert D Kaplan postulated, in his book “The ends of the Earth – a journey to the frontiers of anarchy”, how “a second Cold War might be upon us – a protracted struggle between ourselves and the demons of crime, population pressure, environmental degradation, disease, and culture conflict.”⁴ In his travels in Africa and Asia, most graphically described, he quoted the telling phrase of the Nigerian poet Ben Okry “We are the miracles that God made to taste the bitter fruit of Time”, which I find overly depressing.

Kaplan had seen the results of overpopulation, land degradation, the move into overgrown cities, which are slums acting as a magnet for emptying the countryside, leading to the collapse of facilities and loss of stabilised customs and values, and where there is no work, a rise in the use of drugs and crime, and also of violence from strife and feuds over land, beliefs, religions, cultural values and ethnicity, coupled with growing disparities in wealth. These results are magnified by disease, weak nation states, crumbling and porous national borders, corruption that prevents economic growth, and the swallowing up of aid, aid which is reducing as ageing wealthier societies face lower state pensions.

⁴ Vintage Books, 1997.

Of course Kaplan pointed out that utopianism is out of reach and there could be no return to pastoral beatitude. I wonder whether it was certain that the latter was a reality in any case - Human kind has long had the myth of the Phoenix arising out of the ashes. But Kaplan also mused on whether there is, or not, any pattern in current history, and a sequence of events that fits into a thematic order. Are we, he asked “beyond history, because too much has happened and there is no longer a theme? Or is the theme hidden, and we are at the beginning of a passage to a new phase of history, when much of what now seems like mere chaos will become clear?” Having observed how “economic and social development is generally cruel, painful, violent and uneven”,⁵ he asks, will this be so as humanity develops “more dramatically than ever before?” This follows on from his observation that “if the past is any guide, in too many places there will be a time lag between extreme social deterioration and strategies which might have prevented it. The long range future may be bright, but the next few decades will be tumultuous.” Recall that Kaplan made these comments four years or so before the Iraq war and its current violent aftermath.

He is echoed by Carlos Fuentes the Mexican writer, who asks what will be the implications of the pressure by those who, while accepting the market economy, fight against a market society. They seek competent democratic social institutions to work at greater velocity with keener perspectives and programmes. Or, as a reaction, will more countries opt for authoritarian one-party capitalism, as in China and Vietnam, which Fuentes decries as negating the soul of man.⁶ What risk patterns are likely here, I wonder? Are they stepping closer to chaos, or away from it?

However, Kaplan did not refer to the insights of the counterfactual historians who point to the results of randomness that rules out determinism, and the crucial importance of the personal choice of those powerful individuals living at the fulcrum of turning points in history - though one asks whether they themselves can always see they are indeed acting at such switching moments.

Returning to the global financial system, a Financial Times correspondent reported in June how the Bank for International Settlements considered that: “Leading economies will need ‘an unusual degree’ of tightening of both monetary and fiscal policy to give themselves room to manoeuvre in response to future shocks [and] the challenge for the Fed and its counterparts worldwide was how to tighten policy without destabilising the global economy.”⁷

Earlier in June, Sir Samuel Brittan, of the Financial Times, had written in his article “The hidden threat of extreme events”: “There are weaknesses in the world economy that have a high rather than a low probability of doing damage but to an uncertain extent and over uncertain time horizons.” He referred to the work of Kenneth Rogoff who “believes that we underrate the long-term threat to price stability posed by the steady deterioration in budget positions forecast over the OECD area in the next 30 years, due mainly to ageing populations. Central banks will thus need to strengthen their independence so that ‘irresistible spendthrift governments’ meet ‘immovable anti-inflation monetary authorities’.”⁸ Indeed, another

⁵ No wonder that economics is dubbed the dismal science!

⁶ Speaking on BBC Radio on 24 October 04

⁷ “BIS warns big economies of ‘future shocks’”, Ed. Crooks, FT 29 June 04

⁸ “The hidden threat of extreme events”, FT 18 June 04

observer went so far as to say that there is a “need for global macroeconomic stability to complement the continued lowering of trade barriers. [] However politically difficult the goal, we need to move toward a global central bank.”⁹

As you know, Joseph Stiglitz, a nobel prize winner and former chief economist of the World Bank, referring to the IMF said “many of its policies – from the capital market liberalisation to the massive bail outs – almost surely contributed to global instability.”¹⁰ Indeed in pursuing its policies on credit contracts and the blind pursuit of fiscal austerity “the IMF was willing to tear apart the even more important social contract.”¹¹

An acute observer of financial services (who spoke to us two years ago), says that it seems the “number of large and unexpected economic and financial shocks” has been increasing and also “There is evidence that the adoption of risk-management practices in institutional investment in the 1990s has increased, not reduced, volatility in financial markets.”¹² He argues that: “capital charges and financial regulation should reward those best able to shoulder risk”, and that the “current course of regulation threatens to put a straightjacket on those who know what they are doing, and force risk on to those who do not. This cannot be right. By ignoring the fluidity of risk and adopting a piece-meal approach we are in danger of unleashing a plague of hidden risks on those least able to withstand them.”

Well my time for this eclectic beating of the bounds is up. As we have attempted to do in the past few years in these PROGRES Seminars, can we today discern what is coming over the horizon as the pace of globalisation intensifies and its reach extends, driven by entrepreneurs using ever more powerful communications and information processing tools? You are gathered together on neutral ground with experts of different skills and sector experience, and the speakers who have generously offered to contribute this year comprise a strong group from a wide range of organisations and backgrounds. Hopefully, we stand a good chance of correctly assessing how to handle the major challenges faced, and I hope our discussions can continue the conceptual bridge building between us.

Our warm welcome and thanks to each of you for travelling here today to support this modest venture in furthering understanding between national and international institutions and private sector associations and corporations, so that together we can strive to make the world a better place in which to live and work. I trust there will be value for you arising from our discussions following the brief presentations of key issues, and from your informal contacts made over the two days – and that you all will also enjoy and this 20th PROGRES Seminar.

Thank you.

⁹ “Why we need to move to a global central bank”, Professor J Stodder, FT 3 August 04

¹⁰ “Globalisation and its discontents”, Penguin, 2002, page 211

¹¹ Ibid, page 209

¹² “The dangers of being risk-averse”, John Nugee and Avinash Persaud, FT 17 September 04