Global Financial Crisis, India and Insurance & Pension Industry: Why and What Next

Dilip Chakraborty

Executive Summary:

In last decade India, though still a distant second to China, has emerged as a major political & economic power in the world. Global power is slowly passing from the West to the East. The financial crisis that engulfed the world in 2008 needed G20 countries to lead the rescue and recovery, instead of G7 westerns countries who dealt with such crisis in the past. A new global financial architecture is being discussed and negotiated amongst G20 countries. The outcome will affect the relevant industries in India and hence it is a public interest issue for the actuarial profession in the country. Increased and more intrusive and costly regulations and red tapes are likely to be a part of the new deal. This will not be in the interest of India who has only recently emerged from a license-control-inspection Raj. Though the crisis was caused by the banks, insurance industry will be caught in the net by association. The crisis happened not because there was not enough regulation, but because there was too many bad and useless regulations. The West caused the crisis and has agenda and priorities that are different from the East. Their governments, regulators, professional advisors and other authorities do not own up their share of blame in causing the crisis. Any solution offered by them must be dealt with great caution and be rigorously tested for benefit and cost.

The article described the regulatory culture and the outcomes in the UK. There is an obsession with minor details, a focus on the relatively unimportant and a refusal to embrace the big picture: I call them "the gods of small things". This obsession diverts management energy and attention from what matters most. While talking of light touch regulation for public consumption, the government design regulations that overwhelm the regulated with waves of paper work. UK regulators do not consider themselves having any responsibility for the growth, progress and well being of the industry or institutions they regulate. There are no effective checks on the ever increasing cost burden they impose. The Government will not promote good practices if there is even a small risk of things going wrong. The outcome has been disastrous for UK Insurance and Pension Industry. UK Regulation, FSA in particular, is a negative example that should not be followed by India if the country wishes to promote good insurance and pension industry.

The article describes briefly the analysis of the crisis and remedy offered by FSA. There is nothing much to disagree on the analysis, many important questions were not properly dealt with or answered, particularly anything that may pin responsibility to the government and the regulator. A good number of such questions were raised in the article to trigger discussions. Western governments not only ignored the growth of massive credit and asset bubbles, they actively promoted and caused these bubbles, with disastrous consequences for rest of the world. The role of market, hedge funds, International Accounting Standard and various economic theories and models that rely upon efficient market and rational conduct were questioned.

The condition prevailing now and the threats were discussed. It was noted that west has no meaningful proposal to deal with the fundamental imbalance in global economy- the East saves and the West borrows & spend. With unprecedented stimulus like Quantitative Easing (money printing), lowest ever interest rate and other coordinated actions the West is coming out of recession. The asset bubbles were reflated in the process. What will happen once the stimulus stops and then reversed? West must make deep spending cuts to bring back structural budget deficit to a normal level. There is no sign of politicians taking such unpopular steps. Instead West, the borrower is making demands and sacrifices from the East, the lenders

Finally other impacts on the insurances and pension industry were touched upon.

A: Introduction and background:

Global Financial Crisis: It's so yesterday's news, boring and stale. Papers worth a subcontinent of rain forest were written by all and sundry over couple of years and that's without even counting the cyberspace. Then why write another paper for 2010 GCA and why should it be of interest to you? Though strong secondary effects were felt (e.g. recession in the West slowed growth in India), nothing serious happened to the banks and other financial institutions in India and some other countries in the East. Even the latest Dubai debt crisis had little impact on Indian banks. I should explain why. Intensive negotiations and discussions are happening in global level, amongst politicians, regulators as well as technical experts, on designing a new global financial architecture that will prevent similar crisis in the future. As a member of G20, India is an important player in these negotiations. The new set up that may emerge is likely to apply to the industry in India and so will directly and indirectly affect many in today's audience. Though the crisis was essentially in the banking industry, the insurance industry will be affected by association. Some of you may be in a position to influence the forthcoming events. Right lessons should be learnt to ensure that internationally agreed solutions are fit for purpose, both politically and technically, and are not worse than the problems.

I thought it's worth sharing my views on a wide range of issues on the subject with the actuarial profession in India and the GCA, as I am tasked by the Institute of Actuaries of India for country reports in the European Union. This is also a public interest matter; the actuaries in India should articulate their views on issues that fall in our area of expertise.

India emerges in the world: it has global responsibility

When I first arrived in the UK office of LICI in London in 1991, India was going through possibly the worst financial crisis after Independence. Such was the fear of a sovereign debt default that the Govt. of India sent abroad some of its gold reserve as collateral to calm down the international market. With the sudden collapse of Soviet and East European Communism in 1989-91, the economic and political model dear to the Indian political class and mass was in disrepute. Western media and governments bracketed India with Pakistan and that too in less favourable light. With ASEAN tigers and China growing by leaps and bound, 3-4% 'Hindu' growth rate over many years put India in the category of a failing state. Entered Mr. Rao with his Dr. Singh -as described in an editorial in The Times- with their bitter medicine of economic reform. The ride out of Licence-Control-Inspection Raj was slow and bumpy, one step forward and two steps backward. Finally the IT revolution happening silently in Mumbai and Bangalore burst into the wider world with Indian boys and girls 'saving the world' from the non-event called Y2K problem. With gradual easing of foreign exchange control Indian visitors, outsourcers, businessmen became more visible in the global market place. So did the 'foreigners' in India. Year 2000 also witnessed the long awaited liberalisation of the Insurance market in India. A healthy foreign currency reserve (though a pittance compared to China) built up over the decade Noughties was sufficient to withstand sudden shocks. Hindu Growth rate leaped to Dragon Growth rate. By the time crisis arrived in late 2007, the west was bracketing India with China (though as a distant second) as emerging economic superpowers of the 21st century. In the past, global economic/financial decisions were taken by the G7 group of countries (sometimes with Russia); what ever they decided was dished out to the rest of the world. Not so in 2008/09. Some suggested G2 (USA and China) but most agreed on G7 plus BRIC (Brazil, Russia, India, China) to cure the ills of the world. To rope in Middle East petro-dollar and ASEAN tigers, the world finally settled for G20 to deliver a new post-crisis global financial architecture. *From an also run a decade back, India has finally arrived at the centre stage of world economic leadership.* It is flattering to read in a recent review of the decade Noughties (2000-09): "World leaders told us to stay calm while we went to war on terror, but the architecture that held everything together-the financial system- was coming apart. While the developed world wobbled, China and India rose….As we (the West) wandered, the slow, quiet

shift of power to the East continued. Led by the man who may come to be seen as the great politician of our age, Manmohan Singh, India rose steadily in influence and authority through the Noughties" (Bryan Appleyard, The Sunday Times Magazine, 27.12.09). It is important that the newly acquired influence and authority of the country is used and used wisely.

I will also quote a long term perspective on India and China from the Engaged Investor, September/ October 2008, a magazine for pension funds Trustees: What do India and China offer investors: Eastern promise, Western pension. Key points were: (1) China and India are expected to be the biggest economies of the world by 2050. (2) India is behind China because it opened to trade later. (3) If the value of their stock markets reflected their contribution to global GDP their value would shoot up. (4) India and China still have mass poverty and volatile markets but can provide big investment returns in the long run. A number of pitfalls were mentioned: India's economy is a third of the size of UK's. If the factors that have hindered growth there in the past continue, its potential may never be realized. It took India's economy 50 years to double in size. The current sizes of China and India's economy are not reflected in their stock markets. Institutional investment in India is complicated by the notoriously bureaucratic Indian state.

Unfortunately India is not quite in the same league as China, who now "leads the global economy. Without it's huge pump-primed domestic demand, there would not even be hints of economic recovery in Europe and the US. Every substantial industrial manufacturer in the West is looking to China for salvation. While car sales this year collapsed in the West, they doubled in China…China did not threaten the world financial system with junk bonds…If Mr. Obama can still sanction a military surge in Afghanistan, it is because China has lent him the money. China is the biggest holder of US Treasury bills, some $800 billion and America's emergence from its financial black hole is contingent on continuing Chinese willingness to underwrite spendthrift America." (Carl Mortished, World Business Briefing, the Times, London, 23 December 2009) Even this article, mainly about climate change talk in Copenhagen, mentioned Delhi and Beijing in the same breath, pointing out that no global deal, whether about trade or climate, war or peace, will progress without China and India agreeing. "Jairam Ramesh, the Indian Environment Minister, boasted that he had thwarted attempts to impose binding targets on carbon reduction on India…..In the selfish world inhabited by the NGOs who cavorted in Copenhagen, growth is a problem, but China and India did low growth thing. It was a world of disease, hunger and early death." India has many problems to overcome: hundreds of millions still living in poverty, increasing income and regional inequality, corruption, pollution, terrorism and civil war. And there is an immediate problem of taming inflation, particularly of basic items like food and oil. But the country can't afford to go back to the bad old days of low growth and inward looking policies.

East and West have different interests and agenda:

I also wish to emphasize a point here: *solutions to a problem offered by the West are not necessarily right for India. They don't have the same agenda and objectives,* though there are many things that India can learn from the west. I notice a danger of America and Europe falling to protectionism and building a form of Licence-Control-Inspection Raj by way of increased and harmful Regulations and Red Tapes. I have mentioned often in the past that the UK regulators in general do not perceive themselves having much responsibility for the growth, well-being and progress of the industry they regulate and there is no effective check on the cost burden they impose on the industry. They have strong incentive to rubbish the regulated industry and extract more and more money from the industry by ever increasing fees or worse still by fines. Please be clear on one lesson: *the global crisis happened not because there were not enough regulations in the West, but because they had too many bad and useless regulations.* If India now passively follows UK, EU or US lead in regulations, it may undo the progress made in the last decade. *Indian policy makers and their advisors (including actuaries working for them) should not agree to regulatory and other structural changes proposed by the West, the UK in particular, if these are based on wrong lessons from the crisis*. Western Governments and Regulators caused the global financial crisis and

they are not coming clean on their role in making it. Consider the UK Government and Regulators (FSA in particular); Gordon Brown, who became the Prime Minister a couple of years back,, was the Chancellor of Exchequer (equivalent to India's Finance Minister) from 1997. He claimed for past ten years that he had abolished 'Tory' boom and bust in the UK economy. In reality, his policies and actions/inactions as the Chancellor hugely contributed in creating the biggest asset and credit bubbles in the country. These were not accidents or unintended outcomes; I would say these were deliberate. Though the process started in Margaret Thatcher's time, Gordon Brown effectively killed pension and other personal savings in the country. The savings ratio came down from already low 12% in 1997 to negative by first quarter of 2008. General outcome of most 'reforms' introduced by him and his predecessor Tony Blair (PM from 1997) was lots of money spent without any impact or sometime making the problems worse. None of them uttered a word of apology; instead Gordon Brown & his government boasts of 'leading the world' to recovery with his responses (print enormous amount of money to spend and spend) to the crisis.

History of regulations in the UK

Similarly, if you go by the 'outcome' the UK financial services regulations produced in last couple of decades, particularly in last 10 years, they could not have done any worse for the industry and the consumers. I will call them 'the gods of small things' obsessed with trivial and form, but oblivious of the big picture and the content. In the last two decades they have grown enormously in size, shape and cost, entirely financed by the industry, yet delivered mostly wrong outcomes. FSA talked about principle based regulation but in reality had very intrusive tick-box style regulations all along. The massive sized rule books remained, a layer of principle were added on top.

This is fairly typical of all UK regulators. Take a headline from the business page of The Times, 31 December 2009: "Regulators light touch that unleashed an overwhelming wave of paper work". This was about Ofcom, the telecom and media regulator. It keeps on pledging light touch regulation, but produced 88 consultative papers in the year 2009- every three working days. A senior mobile phone executive was quoted: "the feeling is that Ofcom tends to get bogged down in the details and covering its back for legal reasons, rather than proactively deal with the big issues" An Ofcom spokesman said: "Ofcom is a creature from parliamentary statute… quite a lot of what we publish is required by the legislation". Ofcom bosses also pay themselves very well. It has become a general feature; while the industry shrinks due to recession, the regulators expand, give themselves pay rise and increased budget. The Tory leader recently criticized Ofcom pay and has promised to make a bonfire of such quangoes. Their record while in office however does not inspire confidence. .

Another quote: "The complex, tedious, demoralizing regulations we now have doesn't seem to work very well…an obsession with what is of little or no importance diverts people's time and energy and money from what matters most." (Minette Marrin, The Sunday Times, 27 December 09)

One more quote from an article in Pension World magazine, October 09 issue: (pension fund) investment committees are so transfixed by regulation that they are missing the bigger picture, says Anthony Hilton of The Evening Standard… the common complaint one hears from members of investment committees is that (big issues) rarely get onto the agenda.. rather investment committees, like much else in the pension world, are now dominated by process and compliance… there is an obsession with details, a focus on the relatively unimportant and a refusal to embrace the big picture.. " The regulators prescribe a process. The process is not changed until things go wrong; then the regulators respond by adding to the process, ostensibly to reduce risk. The process becomes more complex and people become buried in procedures to the detriment of outcomes. The article pleads for trusting common sense.

Some of the regulatory burden in UK originates from the EU but UK tends to 'gold plate' EU regulations with extra layers and goes for vigorous implementation. Some EU counties, including France, Italy, and

Greece take a relaxed view on implementation. Germany and France has blatantly interfered to change rules retrospectively if they harmed their national interest.

What has been the outcome for insurance and pension industry in last two decades? As mentioned, savings have disappeared, direct sales force is gone, with-profit policies are no longer sold, the surviving mutuals and friendly societies are under pressure from FSA to merge or stop writing business, and many household names are lost. With Solvency II threat on annuity and other business and Retail Distribution Review future does not look bright to me. Personal Account (PA) will not bring any benefit to the pension business, though may increase annuity business of the insurance companies in the long term.

KPMG has branded Noughties as a 'lost decade for pensions' (Professional Pensions, 22/12/09)The average pension scheme only managed to grow its assets by just over 2.25% a year before cost while pension pot purchasing power fell from a £100,000 fund being able to buy an annuity of around £9000 in Y2000 to £7,000 in 2009. A disastrous outcome for savers and pensioners.

Barnett Waddington, the largest independent actuarial consultancy firm in the UK, celebrated their 20th birthday this year. While rejoicing over excellent growth from a modest beginning in 1990, their senior partner Adrian Waddingham wrote in recent Annual Review 2008/09: "Our growth is also a reflection on how interventionist governments (of both colours) have made all aspects pf pension provision so unnecessarily complicated. Too much of our work has been driven by regulations. Not only has most of these been over-complicated, but it had had the unintended (I hope it was unintended but one wonders) consequence of seriously damaging workplace pension provision. During over twenty years there has been no legislation with even the slightest encouragement for good pensions-a damning indictment on governments… Government remains reluctant to promote good pension practice if there is even a tiny risk of things not always working. And has concentrated only on trying to stop bad things happening with the result that good pensions have become unaffordable" He went on to criticize the government's recent refusal to remove ban on risk sharing pension schemes (it remains illegal to DB pension unless they are increasing with inflation), leaving only the stark choice between old-style DB with employer taking all risks and simple money purchase DC with all risks with the employee.

A few years back the government arranged legal protection of DB scheme members (PPF), paid for by the ever declining pool of DB Schemes i.e. employers. The government took immense pride and credit but made no contribution to the cost. This has been the pattern for past 20/30 years; government makes regular changes & improvements of company DB pensions and the employer mostly takes the extra unanticipated cost. This is not what the employer bargained for when he set up the pension scheme. As this is a voluntary arrangement, no wonder employers are running away from DB pension. There is of course no such safety net or protection for the members of rapidly increasing DC Schemes. The matter will become worse when DC based PA comes into operation in 2012, when the government expects that many more, mainly low earners, will join the pension scheme.

Insurance and Pension

Finally I will briefly deal with a few Insurance and Pension industry related issues flowing from the crisis. I give *two examples* to start with..

The FSA boss Lord Turner has recently said that some of the 'products' sold by the investment banks are 'socially useless'. For a change, I agree with him. Though he did not name any particular product, we may assume that he knew all along what was useless and still decided to do nothing when these were (and possibly still are) being 'peddled' by the banks. This statement effectively concedes the case for product approval by the regulator before a product is allowed to be sold. The UK government and regulators always resisted such product regulations, in spite of serous trouble for the life insurance industry

beginning with pension mis-selling reviews in early 1990s. Recently the US authorities have also started investigation on some of the complex derivative products designed and sold by investment banks like Goldman Sachs. Were these suitable/ fit for purpose? Class action suits have also started against banks regarding suitability of products sold/ advices given. I am a supporter of pre-approval of products, though I too once was in favour of 'freedom with publicity' model which was supposed to encourage innovation and competition. I changed my mind a decade back after I started running pension and other mis-selling reviews for my employers in late 1990s. With pre-approved product and efficient monitoring that the product is reaching the target market only and is performing as designed, the mis-selling risk will greatly reduce. The current crisis offers another opportunity to investigate the products we sell. *Are you, working in the industry in India, confident that all 'products' sold by Life and General Insurance companies here are socially useful and of reasonable value compared to the cost?* Please ask yourself: Are you designing and selling products suitable for meeting clearly identified needs of the end consumer? Is the product reaching the target customer? Does he understand or capable of understanding the risks of the product not performing as desired or expected? Is he capable of bearing the consequences of such failure? As insurance industry are you giving him the risk protection he needs? For de-risking the provider company, are you leaving too much risk on the shoulder of the customer, thereby negating the basic purpose of protection provision and risk mitigation? I suspect you may find a few products that do not pass these (or similar) tests.

The second example is on corporate governance role of institutional investors: Insurance and Pension companies operating in India are also major institutional investors in Indian stock market. Their importance will only grow in future. As shareholder representative of your customers and owners, are you playing the ownership role effectively? Some Indian insurance companies must have investment in Satyam and Mr. Raju's companies. Is there any lesson to be learnt from the biggest corporate scandal of India in last decade? But for the global crisis, the fraud might have gone on undetected. I am aware that this is a difficult task for individual actuaries in India, as there is hardly any actuary in CEO or Investment Director positions. With family ownership the task is even more difficult. But you should ponder the issue at professional level.

B: What caused the crisis?

"Yavat Jivet Sukham Jivet
Rinam Kritva Ghritam Pibet
Bhasmi Bhutasya Dehasya
Punaragamanam Kutah.

(A Sanskrit sloka ascribed to Charbaka, meaning: Live happily while you are alive, borrow in order to drink ghee, your body will turn into ashes, who say there is life after death?)

I will not give a blow by blow account of the crisis in September/ October 2008. I will also avoid going into details of how the crisis brewed in last two decades, except making references where appropriate. I assume you know the general story line.

To my mind, the 'population' that together gave rise to the crisis can be 'segmented' into four broad categories: *The financial institutions, the governments, the regulators and Joe the public.* It is difficult to fit political, social and cultural conditions in the West into the mix, but they too played major roles in shaping the crisis. For example, the existence of welfare state, many benefits & entitlements and human rights indirectly encourage a culture of consumption, even if fueled by debt. Social Security safety net protects people from the consequences of their irresponsible behaviour. Though it was an ancient Indian sage Charbaka of 800 BC who first proclaimed the materialistic and pleasure seeking philosophy of

borrowing, its true practitioners are in modern day west. The East has very little or no welfare state. As a result the East saves while the West borrows and spends.

Joe the common man

I will start with Joe the public, as no one has pinned any blame on him. Every body in the West agrees that poor Joe is the victim of the crisis. He lost his home, his job and his wife. He is the Main Street against the greedy bankers of the Wall Street. The crisis began with sub-prime mortgage defaults in the USA. The poor man; the Wall Street bankers put guns on his head to buy the home on the mortgage he could not afford. The credit card companies forced him to buy the holiday or the car or the latest electronic gadget though he did not have the income to repay. Many Joes are what can be called tax eaters; either they live on benefits or earn low salaries and get more out of the state in benefits than they will ever pay in tax. It will appear that he has no responsibility for his financial conducts and decisions. It is always some body else's fault. A nineteenth century Joe knew that he would go to jail if he did not pay back loan; they still do in Dubai and some countries in the Middle East. Threat of punishment focuses the mind of even the dumbest. For a modern Joe, debt restructuring is not difficult; bankruptcy laws are a lot relaxed; there is nothing much to loose by defaulting. He can simply walk out, Freddie Mac and Fannie Mae will take care of the loan.Most will be re-housed by the government; food and beer will be provided. Any stigma associated with bankruptcy and indebtedness has reduced greatly. In my opinion Joe is one of the main culprits responsible for causing the crisis. Fortunately for India, it still has not many Joes. Most of our Amar Akbar and Anthony behave more responsibly. Unfortunately credit card and loan based consumption is increasing amongst the young generation. Please take care that they don't become Joes or start following Charbaka, the ancient sage.

FSA Analysis of the Crisis:

Global banking crisis was of course caused by the banks and I have no disagreement in calling them the main culprit. The banks, in their arrogance and pursuit of super-profit gave easy loan to those who can not afford, passed on the 'trash' to the capital market by designing products that hide the risks. The Turner Review and the FSA Discussion Paper (DP) 09/2 dated March 2009 but published simultaneously in April spell out the UK Government's analysis of the causes of the global banking crisis and its regulatory response respectively.. A subsequent DP09/4 (October 2009) deals with two further issues: "how to offset the moral hazard created by the existence of large systemically important banks which can be either 'too-big-to-fail', 'too-inter-connected-to fail' or 'too-big-to-rescue'?" And "how should the cumulative impact of various capital and liquidity regime changes be assessed, and what can we say about optimal levels of capital and liquidity in the global banking system?" I will recommend all to read these documents in full to get a clear idea of FSA's thought process.

Why should the insurance companies be concerned by the regulatory developments in the banking world? The FSA highlights the following at the outset: "Who should read this DP (09/2)? Although the focus of this DP is on banking and investment banking activities, elements of the DP are much broader in their potential application and will be of interest to other types of regulated firms, including insurance firms. Section 11, concerning the FSA's supervisory approach is relevant for all regulated firms." I remember a large insurance company boss commenting soon thereafter: my neighbour's house caught fire due to his negligence; as a result the fire brigade is imposing fine, cost and restrictions on me! Insurance industry will be caught in the avalanche of regulations that will surely follow from FSA and other regulators. Who knows what would have happened if, unlike FSA, the Insurance and Banking Regulators were different in the UK, as in India and many counties in the world. Except AIG, no insurance company of any significance has gone bust or was seriously affected by the global banking crisis. FSA accepts that AIG was a special case; it was brought down by its non-insurance activities. "AIG Inc, although widely regarded as one of the world's largest insurance companies, was a conglomerate whose activities go well

beyond insurance. Below the top holding company there are four business units, each made up of complex structure of subsidiary companies: Property and Casualty, Life and Retirement, Asset Management and Financial Products (FP). While the trigger for AIG Inc's bailout by the US authorities was the FP business, its liquidity problems have since worsened as a result of investment activities using (but not on) the balance sheets of the insurance companies." (Box 2D: Case Study-AIG, page 58, DP09/02 mentioned above). Obviously other insurance companies and pension funds as stock market investors suffered asset defaults/ impairments/ losses arising from recession, corporate bankruptcy and increased market risks. But these were secondary effects. Their role as share holders in corporate governance of banks and other financial institutions (for example in setting banker's bonus and top management remuneration) has however come under heavy criticism.

Coming back to Turner Review and DP09/2, the causes of the crisis were analysed in three sections;

- The global story: macro imbalances meet financial innovation;
- The UK specific story: rapid credit growth, significant whole sale and overseas funding;
- Global finance without global government: fault lines in the regulation of cross-border banks.

The financial system and the real economy implications: the essence of what happened *globally* is:

1. Characteristics of the new global financial system, combining with macroeconomic imbalances, helped create unsustainable credit boom and asset price inflation.
2. Those characteristics then played a crucial role in reinforcing the severity of the financial crisis and in transforming financial system problems into real economy effects.
3. The shock to the banking system has been so great that its impaired ability to extend credit to the real economy has played and is still playing a major role in exacerbating the economic downturn, which in turn undermines banking system strength in a self-enforcing feedback loop.

According to FSA, *globally* the factors which drove the initial over-extension of credit, and the factors which have played a crucial role in extending the length and severity of the crisis include:

- **The massive growth and increasing complexity of the securitized credit model**, underpinned by inadequate capital requirements against trading books, which facilitated unsustainable growth in credit extension to households and to some parts of the corporate sector.
- **Extensive commercial bank involvements in trading activities,** which meant that falling asset prices have had a large and rapid effect on bank profitability, and in turn on perception of their credit worthiness, creating a collapse in banking liquidity.
- **High leverage in multiple forms,** which helped drive the rapid growth in credit extension and asset prices and which increased the vulnerability of the system, since asset price falls had an amplified impact on system capital adequacy.
- **Extended maturity transformation dependent on the marketability of assets**, making the system more vulnerable.
- **Complexity and opacity of the structured credit and derivative system**, built upon a misplaced reliance on sophisticated mathematics. Once irrational exuberance disappeared, it contributed to a collapse of confidence in credit ratings, huge uncertainty about appropriate prices, and a lack of trusts that published accounting figures captured the reality of emerging problems.
- **Hard-wired procyclicality**, which exacerbated the scale of the downturn, with credit rating, margin calls, CDS spreads and general market confidence, interacting to create self-reinforcing feedback loops.
- **Lack of adequate capital buffer,** impairing the ability of the banking system to extend credit, and creating a powerful feedback loop between banking system and downturn in the real economy.

Next FSA analysed *UK specific developments*. There were many common features between UK and USA (so-called Anglo-Saxon economies blamed by Franco- German EU economies for the crisis) there were some special features for the UK economy. I am skipping this part of the analysis.

Finally FSA analysed the problem of *Global finance without global government: fault lines in regulatory approach*. This part mainly deals with the operation of cross-border banks, though the crisis raised important questions on capital adequacy, liquidity, remuneration, bank-like institutions and credit agencies, which are relevant for all banks across the world even if they entirely operate within national markets. Three case studies were made: Lessons from the Icelandic Banking Crisis, Case Study AIG and Case Study Lehman Brothers. I quote a few observations:

- Rapid mortgage credit expansion and property price bubbles were more prevalent in English speaking counties, though other countries like Spain too had these.
- The purchase of securitized credit assets was widely spread across the world, with some German Banks being big purchasers.
- The crisis followed a period of significant globalization of banking activities, both whole sale and retail. Major European banks (UBS, Deutsche Bank) expanded in London and New York; major UK banks (RBS, Barclays and HSBC) expanded in the USA; Icelandic, Irish banks and a few EU banks like ING went into cross border retail activities within EU (particularly in the UK). As a result they got badly burnt by the crisis in USA and UK.
- The crisis revealed fault lines in the global regulation and supervision of some of the cross border firms. This must be addressed collectively by global regulators in future. The essence of the problem- as the governor of the Bank of England has put it- is that *global banking institutions are global in life, but national in death.* When crisis occurs, it is national central banks which have to provide lender-of-last-resort (LOLR) support and the national government that provide fiscal support and that, if there is a failure, bankruptcy procedures are national and it matters with which specific legal entity a creditor has their claim. The failures of Lehman Brothers and Landsbanki threw these fault lines into sharp relief. (my note: There was considerable bitterness in the UK and Europe over Lehman's action of siphoning of £8 billion liquid assets from London to New York one day before the company filed for the bankruptcy in USA, taking advantage of a weekend).

Banker's remuneration, Bankers bonus is of course a highly publicized cause of the crisis. The bankers got enormous amounts of money (though not quite like the footballers in UK premier league), their incentives were mis-aligned, based on short term measurement of performance, these encouraged excessive risk taking as there was no down side penalty for failure. While I agree with much of this criticism on stand-alone basis, I believe it is wrong to pretend that an 'ideal' bonus and remuneration scheme would have prevented the crisis. Lehman for example mostly paid bonus by share, thereby offering long-term incentive. As the bank collapsed, its bankers lost their entire wealth.

FSA has come out with a number of recommendations. Their ambitions are global and they are seeking global solutions. Some of the proposals may adversely affect the insurance industry who is protesting for being penalized for the recklessness of a few banks who were previously feted by the FSA and the UK government. FSA has also promised intensive supervision model which will apply across the board for all sectors, including Insurance. More and heavier fines will no doubt be imposed, some for small errors, increasing FSA's coffer in the process. There are threats of criminal prosecution, but FSA's success in this area is rather poor.

As you read these documents you may however, like me, get the surreal feeling that these are written by detached economic historians who had no role in causing the crisis. Neither the UK Government nor the UK regulator take much responsibility for the outcomes in last decade; it's all global and hence not their fault.

The Questions that need better and fuller answer:

I will list some questions on the crisis that I have heard being asked in different quarters. As far as I know the UK and US authorities have not provided full, credible or reasonable answers, at least in public, to many of the questions, particularly if that involves admission on guilt or fault.

- What were the government authorities, the policy makers, the regulators in USA, UK or Europe doing to prevent the asset, property and credit bubbles from growing out of control? While stock market actually fell between 2000 and 2009, UK house prices gained 117% in the decade. This 'macro-prudential' failure did not happen unnoticed. How could Gordon Brown make the claim that he has abolished boom and bust without the UK regulators and other policy makers challenging him? It was not a party politics issue; it was a pure technical economic question. What did his civil servants in the treasury and regulators expect to happen when the bubbles eventually burst?
- How the world should deal with, in the short, medium and long term, the fundamental imbalances of world economy: west borrows and spends while east saves and lives frugally? In a TV panel discussion at the height of the crisis, US, EU and UK politicians & officials were making various demands on rest of the world (mainly Chinese and other creditors from the east) in order to control the crisis. One participant Lord Desai, a well known economist, finally commented, expressing surprise that all that was suggested was a charter of demands from the borrowers to the lenders, so that the borrowers can keep borrowing! What about creditors' demands to the defaulting borrowers?
- The savings were massively regulated (from 1988 in UK) but loans/ credits were not. Why? Was it not deliberate? In UK tied agents selling savings products for Insurance Companies were regulated out of existence. Why there was hardly any control on selling of loans by the banks and mortgage houses? The insurance industry relentlessly objected to this discrimination but the authorities simply ignored such protests. You can borrow hundreds of thousands of pound on self-certified mortgage loans (so-called liars loan) without a question asked, but you needed 50 pages of form filling and hours of fact finding, knowing the customer etc for buying £50 per month savings.
- Did the action and inactions of government actively helped in propping up the bubbles? Many like me think so. Did the governments of the day derive short term political and fiscal benefits from the consumption boom driven by borrowing on the back of highly inflated house prices?
- Why some developed countries could avoid the global credit crisis (though not the recession that followed)? For example, Canadian Banks and financial institutions did escape loss from US sub-prime loan and toxic derivatives/ securitization market. Even the Germans did not. Was it by chance or due to better control and regulation in Canada?
- How did the Banks in Far East, China and India escape the banking crisis? Obviously most were not in western markets buying securitized loans, synthetic CDOs and exotic derivatives. Many are owned by the governments. Were these markets also regulated better?
- Is nationalization the answer to 'too-big-to-fail' bank question? If not why not? When the free market was facing self-destruction, the most right wing US government in recent past nationalized Freddie Mac, Fannie Mae, AIG and provided state protections to many more banks and industrial corporations. Many in the left parties questioned: if the loss is borne by the state why not the profit? Full or part nationalistion is back as an option that can not be dismissed off hand.

- A thorough review is called for on the rise and rise of hedge funds and private equity funds in last two decades. The Hedge Fund industry hardly existed in 1990. They grew rapidly by 2000, but were still worth $500 billion. Then they grew spectacularly till 2008 to a few trillion. Germany

and France were always apprehensive of Hedge funds and Private Equities creating massive distortion in financial markets. One respected industry figure called derivatives as 'weapon of mass destruction'. Why they were left largely unregulated, thereby creating a regulatory arbitrage in their favour? UK and USA were strongly opposed to tougher regulation of hedge funds and Private Equity funds. How much of hedge fund activities were really hedging (which may be socially useful) and how much trading was pure speculation and insider dealing? How could many hedge funds offer 'absolute return' all the time unless they were indulging in unfair practice? USA has now started investigating a few cases.

- While the hedge funds/ private equities backed by easy credit earned massive fees and still gave fabulous returns to their investors and managers, why did the equity market from 2000 to 2008 perform so poorly, draining wealth from retail investors in pension, insurance and mutual funds? In fact equity is the worst performing asset class for a regular saver over past 15 years in the UK. Is there a correlation? There has been a historical transfer of wealth from many small savers to a few rich speculators, all financed by easy credit. Was there a deliberate regulatory arbitrage favouring hedge funds and private equities? Did the regulators drive Insurance companies and Pension funds to sell equity at the bottom of market (2003) so that Hedge funds could buy cheap? No insurance company or pension fund sold equity when markets collapsed in 1987. They knew it was temporary and market would recover for a long term investor. Why did then Standard Life 'de-risked' and sold equity in 2003? Who forced their hands? Recently FSA told UK Life offices not to sell equity at the bottom of the market in simply for technical solvency reasons. Why they did not do so in 2003?
- Is market rational and efficient? Is mark-to-market valuation the 'fair value' and fit for all purpose? Many actuaries said that MV was not a suitable measure for decision making in most circumstances for a long term investor with long term liabilities. Some economists too said so. In an article "Flawed theories that have brought disastrous results" (The Times, Business Section, 9 November 2009) two professors of economics in USA wrote: "a much deeper debate is required about the flawed theories of market 'efficiency' and 'rationality', which have led economics and policy astray in the past decade, with recent disastrous results. Although financial market practitioners now largely deride or ignore these concepts, they continue to shape the debate about fiscal stimulus, financial reform and more broadly, the future of capitalism-which means that they remain danger to all concerned." The professors questioned the Rational Expectation Hypothesis (REH) which is the centre piece of all economic model building. "Most reputable investment banks and credit-rating agencies used REH finance models to 'price' new derivatives products. But new derivatives are not engineering breakthroughs. The use of mechanical REH models to price them assumed away the ultimate source of uncertainty in markets. Far from providing a 'scientific' rationale, the valuations and ratings that they yielded were bound to have little connection to reality. The unreasonableness of REH also helps to explain why macroeconomists of all camps and finance theorists find it so hard to account for swings and risks in asset prices. Even more pernicious, despite these difficulties, their models supposedly provide a scientific basis for judging the proper role of the market and the State in a modern economy." The professors also ridiculed the efficient market hypothesis which "made the crisis more likely, if not inevitable".
- It was always clear that no 'financial model' could have predicted asset prices and equity market behavior of past two decades. Based on various models, every year government authorities, banks, financial institutions, investment advisors make predictions for GDP growth, inflation, current account surplus/deficit, bank rates, unemployment, stock market indices etc. I am not aware of any institution who was consistently successful in such predictions. Many failed very badly. Still the bankers and regulators relied heavily on such mathematical models. Even more incomprehensible is mark-to-model pricing for exotic derivative products.

- The Market Consistent Embedded Value (MCEV) principles and guidelines propagated by European Insurance CFO Forum improve consistency of financial reporting, reduce the scope for management discretion and align the methodology with likely approaches of Solvency II. However, is “market consistent” really market consistent? This is what the UBS Equity Research said: “The intention of the MCEV principles is to provide a shareholder’s perspective of value. It is some what ironic in our view, therefore, that it appears to fail in providing a basis for valuation that is consistent with the market prices of life insurance companies.” (UBS presentation to KPMG Actuate Dining Club, September 2008). As MCEV is now a hot issue in India, this message has strong relevance. As I don’t have data on the market condition in India, I refrain from making further comment. Canadians are doing fine without MCEV.
- What was the role of market value fundamentalists of International Accountancy Profession in creating and worsening the market volatility? Under pressure from G20 they reluctantly agreed to temporary suspension of a few rules at the peak of the crisis. FRS 17, IAS 19 contributed to the death of DB pension in the west. There should be full and proper debate on MV, possible alternatives and what is suitable under what circumstances. The entire IFRS and IASB debate should be revisited. Unfortunately recent developments in IASB on pension fund accounting show no sign of weakening of grip of the entrenched ideology. At present the ‘actuarial gains and losses’ in a year (recently big losses) do not go through the profit and loss account. In spite of serious opposition from pension actuarial profession and the industry, in a change proposed for IAS 19, IASB is insisting that such losses should go through annual profit and loss accounts. This will significantly increase the volatility of reported profits for companies with any defined benefit pension liability. The accountants (and the actuaries) exist for the business and not other way around.
- Every company whose share prices collapsed in 2007/08 complained of speculation and short selling. Bear Stern, Citicorp, Lehman Brothers, Barclays, RBS, Llyods, US Motor Giants- all made the same complaint when their share prices collapsed. Except for a temporary ban, why forward trading, particularly ‘naked’ short trading is not banned completely? What great social goods are delivered by short sellers?
- Last 20 years saw gradual weakening or destruction of mutual companies (banks and insurance companies) in major western countries. Greed was one reason, Joe the public was greedy for a few hundred pounds wind fall and the top managers were greedy for share options that brought quick wealth. Was it good for the society and the industry? Quite a few large building societies that demutualised in last two decades were destroyed in the current crisis. Did regulation create unfavourable and un-level playing field for mutuals? Why Standard Life did finally give up its battle to remain mutual? Was it not forced by the FSA’s unreasonable and untimely demand for massive increase in capital? What steps UK (and other countries) took to protect mutual from extinctions?
- How much capital is enough for a bank (or an insurance company) to avoid ruin i.e. to withstand ‘tail risks’? If 6% is not enough, why should 12% be? What is the trade off between cost and security? Do you have the luxury of massive capital injection for the sake of cast-iron security? As capital does not fall from the sky who will supply the capital? The private sector in the West has run out of savings and money, but governments are printing money and can supply the capital. In past few years, Western banks and financial institutions went to the East (China, Far East, Middle East) for raising capital. The East ‘rescued’ them in 2007, but US and UK government confiscated their investments in Freddie Mac, Fannie Mae, RBS etc, all in the name of punishing the shareholders for the wrong doing of their managers. Punishing Chen for the crimes of Charlie. Will the East still supply capital to the West? What about currency risk? UK and USA are debasing their currencies by running a printing press economy with no serous plan for recovery and rebalancing of structural budget deficits.

- How much profit the UK and US government are making from 'rescuing' the banks? We are relentlessly fed with the propaganda that these governments have spent enormous amounts of money to save the banking industry and the world economy. This may be false unless you count the money printed by them as a part of government loss. These governments dramatically increased the capital requirements for banks with a short notice, knowing well that capital would not be available from a market gripped by panic. They claimed (whether rightly or wrongly is a different matter) this was necessary to restore market confidence and forced the banks to take government funds at exorbitant rates of interest (12% for UK and 6% for USA when bank rates were 0.5%), acquired equity shares at a rock bottom price in a panic driven irrational and disorderly market. Was there no other means to restore order and confidence? They will make hugh profit when order returns in the market. Bank of England has already made biggest ever profit in 2009 from fees it collected from the 'rescue' operation. US too have already made tidy profits from Goldman Sachs, Citicorp, and Wall Fargo in the mean time. The share holders (pensioners, ordinary employees with share options, savers in insurance and mutual funds, sovereign funds in China and the East) will nurture the loss and watch helplessly the great bank robbery of Anglo-Saxon governments. The point was further proved by Barclays Bank in the UK. At the height of the crisis it decided to reject the UK govt rescue plan and instead borrowed money from a Middle East government fund to provide the extra capital suddenly demanded by the FSA with a very short notice. Barclays first sounded UK institutional investors who did not show much interest. There was a lot of bad blood between the two after these institutions backed RBS against Barclays in ABN Amro take-over battle. Quataris charged 14% interest with option to convert into equity. And what happened after one year? Barclay's share price of course recovered sufficiently for the Quataris to encash and make a hugh profit. The UK institutional investors had once again eggs on their face and the UK government was furious for loosing the profit they anticipated when designing the rescue plan.
- How much transparency can the financial systems, particularly the banks, withstand? In internet, mobile phone, 24 hour TV news channels, rumours and speculations travel fast. Fed by rumours and TV pictures, the first run in recent time on a UK bank (Northern Rock) developed very quickly. In the crises of 1970s most UK banks were technically bankrupt. Except Bank of England no body knew that. There was no short selling. All bank debts were in the balance sheet. The Bank of England exercised its power *behind close doors* and the banking industry and the stock market were saved. Every body later on applauded the collusion. Why it was so different in 2008? Why this cult of extreme transparency coupled with a cynical distrust of professionals and central banks?
- As actions and inactions of US authorities triggered the calamity in September/October 2008 and affected the rest of the world badly, US owes a thorough explanation. Sub-prime mortgages were very actively encouraged and promoted by US government of the day. The default crisis first erupted in late 2007, though even earlier US authorities ignored warnings of moral hazard created by the guarantees offered by Freddie Mac and Fannie Mae. These two semi-nationalised mortgage banks survived 2007 crisis due to fresh capital injected by the Chinese and other sovereign funds. In September 2008 as a result of an avalanche of sub-prime mortgage defaults, US government fully nationalized these two mortgage institutions and confiscated the money pumped in by overseas investors a year back in the name of punishing the negligent shareholders. Very next week Henry Paulson, the Treasury Secretary and ex-boss of Goldman Sachs in his wisdom decided to let Lehman Brothers fall. The financial world across the globe was shell-shocked and started collapsing like a pack of cards. Within 24 hours, inundated by calls from foreign government it is said, Mr. Paulson rescued AIG, the biggest insurance company in the world, due to its Lehman CDS and other FP exposures. Was it a failure of anticipation or a vindictive act by ex-Goldman boss against a prime and hated rival? Market fundamentalist one day and communist nationaliser next day?

There will be other questions too not listed by me. The western politicians, authorities, regulators and institutions must honestly explain to the rest of the world their roles in creating the banking crisis that led to recessions in many countries that played no role in causing the problem. Only then a global response will emerge.

C: What happened next?

There was massive coordinated response by the global leaders during and soon after the crisis peaked. The first priority was of course to save the banks and stop the panic. Next was to open up the credit market which went into long freeze. Then Main Street was hit by recession. The car industry was in deep trouble and needed to be rescued. Cash bribes were given to consumers to buy new cars (even though they may still be in debt). The specter of depression, mass unemployment and social unrest led to old text book remedies of John Maynard Keynes adopted by Barack Obama and Gordon Brown, followed with different degrees of enthusiasm by other world leaders. Interest rates in western countries were cut to the lowest level in last 300 years. Savers, mainly pensioners, continue to be punished to rescue the borrowers. The money printing press (Quantitative Easing) went in full drive in US and UK, but less so in EU. A government spending spree followed. Taxes were cut temporarily, to be followed by big rise from 2010 onwards. The idealist US president promised to build a new green capitalism which would save the world from global warming and also create millions of new jobs and wealth. Slowly the west started coming out of recession. Gordon Brown previously said UK was best placed to deal with a recession; we expected Britain to be the first to return to growth. The Euro gained great deal compared to the dollar and pound sterling during the crisis and the German economy is still very much export driven. Yet it was Germany who first returned to growth, even though the dour physicist female leader from ex-communist East Germany, Angela Merkel, was the least enthusiastic amongst world leaders to the money printing remedy. The rest of Europe (barring Spain) and US too came out of recession by Q3 2009. Not Gordon Brown's UK; we will be out only in year end, the very last amongst G7 countries. After an across the board fall of about 15% from the peak, UK house process started rising from the middle of 2009 and regained half of the loss by year end. Though UK house prices are still hugely overvalued by any historical standard, the housing bubble got reflated, bringing grief to millions of young first time buyers who can't leave parental home and start family. US housing market too recovered. The governments are delighted. The UK government is relentlessly cajoling the banks (particularly ones partly owned by the state) to keep lending at the level of 2007 (peak of the credit boom). 'Unfortunately' the savings ratio in UK in Q3 2009 improved to 8%, causing hysterical headlines that the thrifty savers are acting against national interest and prolonging the recession! People were not actually saving though, they were just repaying some of their loans instead of buying cars on more loan. The consumer spending in 2009 Christmas increased beyond expectation. Unemployment rose but not as fast as was feared. Gradually optimism is returning. The stock market recovered and has now touched the 2008 peak.

I am reminded of a cartoon by Laxman in the Times of India many years back when foreign travel was a rare privilege. A khadi clad minister was getting down from an Air India plane in Delhi. He was beaming and he roared to the waiting journalists and bureaucrats: The borrowing mission abroad was a complete failure; I will have to make another trip as soon as possible.

The current issues and prospects:

The biggest worry is the fragile nature of the recovery. What will happen after the massive intervention by the governments come to an end and quantitative easing is reversed? Temporary tax cuts made in 2008/09will be replaced by large tax increases from 2010. Will global economy fall back to a double dip recession? UK is particularly vulnerable, due to market's lack of faith on current government and uncertainty of a general election. Obama magic is also fading and US congress too is due for election in 2010. Deep spending cuts and belt-tightening is absolutely necessary, but the politicians are unwilling.

Smaller countries in EU have started the process or are in danger of their sovereign debts being downgraded. Ireland has made deep cuts in public spending, including 5% cut in public sector salary. Iceland is in deep trouble after negating the commitments made to UK government to pay compensation to UK customers of collapsed Icelandic banks. Greece has credit rating down graded, but its newly elected left party government is unwilling to make unpopular cuts. The Euro as single currency is under great strain. It may not survive if any EU country in the single currency actually defaults and Germany (and possibly France) does not come to the rescue. The fear of further rise in unemployment has not gone away. What will happen when historically lowest ever interest rate (0.5%) returns to 'normal' rates? Consumer spending and housing market may again collapse.

The most talked-about story is of course the Bankers Bonus. The politician and the regulators love it; public attention gets diverted away from them. Backed by easy money and less competition, massive profits were made by US and UK investment banks in 2009 from their trading and investment banking activities. And they (including RBS, over 80% owned by UK) want to pay mega bonus to retain their star performers. This insensitive move created outrage everywhere- right from Barack Obama, Gordon Brown to the men and women on the street. When rest of the world is reeling from recession, the very people who caused the crisis are rewarding themselves with billions. The tax rate was due to go up to 50% any way from April 2010 for income above £150,000. The UK government went further and announced in December 09 a draconian new tax specifically on banker's bonus over £25,000. France has promised to follow. Gordon Brown is also talking of a Tobin tax on banks to curb excess trading. Separation of deposit taking banking from more risky investment banking is being discussed. Bank of England Boss suggested that instead of paying bonus the banks should retain profits to improve capital. He calculated that had the bankers not taken bonus in last decade, the banks would not have needed bailout money. He did not say how much tax the government would have lost (40% of bonus paid went as tax) if these bonuses were not paid. The institutional investors are objecting too, exercising their shareholder rights. Some of them feel the investment banks are charging excessive fees and with the demise of a few large banks in the crisis Goldman etc are having a near monopoly. While London and New York are barking, Singapore and Zurich are said to be wooing bankers from City to relocate. Most surprisingly, Germany is silent and some have seen them lobbying with bankers in London to move to Frankfurt. "Chancellor's coup is a body blow to London" said the Business Editor of The Sunday Times on 13 December 2009, reacting to Alistair Darling's retrospective tax on banker's bonus. He previously introduced 50% tax rate for high earners, already making London the most taxed place amongst major financial centres. The article, while blaming the bankers for not responding to public anger, stated the benefits they bring to London and called the move as "nuclear button on London's continued status as a global financial centre."

The Dubai debt crisis sent a reminder of sub-prime crisis; many UK banks have large exposure to Dubai plc. Had Abu Dhabi not come to the rescue God knows what would have happened? The nerves are still raw. There are talks of double dip recession. UK property and debt bubble was never allowed to burst. "Has the payback been cancelled or merely postponed? Hopes for 2010 are not high.. The fear is that such an injection of taxpayer money has merely blown up the next valuation bubble that will need to be popped in time. The truth is that the excesses of the past are still working slowly through the system. Debt and managing it down will remain at the top of the agenda." (The Sunday Times, 27 December, 2009, Focus)

Is inflation looming? Last three recessions in the UK were unleashed by the Government to curb inflation. This time the priority was to curb deflation. The easiest way (least painful for the government in the short run) to deal with the debt problem is to whittle down debt by inflation. Is this the government policy now?

Is dollar at risk as a reserve currency? US's main creditor China is concerned that its dollar loans will be repaid by a depreciated currency. They have started talking about developing an alternative currency for global trade, say Special Drawing Rights (SDR). Meanwhile US want China to re-value its currency by removing the unofficial policy of pegging Chinese currency with US dollar. China is taking massive steps

to increase internal consumption and demands. India bought gold recently from IMF, annoying US, to drive home the same concern about dollar's status as reserve currency. The critics say it was a wrong decision as current gold price marks the peak of gold market. History will tell who was right. Just to remind, Gordon Brown sold some of UK gold reserve a few years back, for no apparent reason, when gold price was at rock bottom.

If foreign investors start loosing faith in dollar, what chance does the pound sterling has? Who will buy UK government gilts in coming years? The threat of credit rating down grade is already hanging over UK. If Tories are perceived to be loosing 2010 election it may actually happen sooner.

The main global structural issue- imbalance caused by east's savings and west's borrowing- remain unaddressed for the time being.

The 'eastern' economies (non-west G20 countries, mainly BRIC and Asian tigers) are growing nicely. Has the long-awaited decoupling of two sets of economies started happening?

A group of 11 UK economists wrote a letter in The Sunday Times (27 December 09) attacking the UK government for its 'irresponsible' failure to set out "even the rudiments" of a convincing plan to reduce Britain's "structural budget deficit" (current year's budget deficit is £178 billion). "We are concerned about the integrity of fiscal and monetary policy in the UK". One danger is that international investors in UK gilts may see the Bank of England's programme of Quantitative Easing (£200 billion so far) as "driven by a politically motivated desire to ease the government's funding difficulties." In the medium term UK needs spending cut and not higher taxes. By raising marginal tax rates, the government is making UK less competitive and attractive for business, thereby risking long term growth and making the task of reducing public sector borrowing much harder.

Many in UK are concerned that the government of the day is passing a massive loan burden to their children's generation. We have already burdened them with an aging population, declining birth rate, immigration and other sensitive problems. Unfortunately political correctness is preventing full and frank discussions on a full range of such issues.

Finally, some see opportunity in a crisis.

Insurers proffer cash for clout (The Times, 15 December, Business Editor's commentary)
"Britain's insurers have embarked on an unprecedented lobbying campaign in Whitehall to protect themselves from regulatory overreach, particularly in Brussels. In return, they are offering something the Government is extremely short of at the moment-cash. The campaign is being driven by Tim Breedon, the chief executive of Legal & General and Andrew Moss, head of Aviva. If successful, it could see insurers play a more active role in the welfare state, administering pensions and benefits and orchestrating health care provision. It could also see them take the place of capital-constrained banks and lend to projects to build roads, hospitals and prisons…In return the insurers want to be protected from Solvency II, a European Directive that would make then hold greater capital in reserve and could force them to raise up to £50 billion new funding, according to ABI.. Lord Myners, the City Minister, is an outspoken critic of the current well-intentioned but damaging Solvency II proposals…. The industry is also speaking out against investment banking fees and (belatedly) excessive bonuses. It is good to see the industry using its clout against some well-chosen targets."

The insurance industry in UK received relentless beating from the governments of both colours ever since income tax relief on life insurance premium (LAPR) was abolished in 1984. After many a false dawn followed by yet another round of regulation and government driven destructions, we still live in hope.

D: Future for Insurance and Pension Industry:

Regulation:

Biggest impact will be regulatory changes-global as well as country-wise. Regulations will become more intense, intrusive and oppressive in the west. For their government and the regulators, there is no down side in going for an over-kill. "The political dynamics and .the bureaucratic mind will tend to produce all-embracing outcomes that are aimed at reducing political and reputational risks for the authorities" (Insight & foresight; Beachcroft Regulatory Consulting). For them it may not be all bad; improvement in overall level of confidence in their markets may benefit all. But I believe this should not be the global remedy; it certainly is not the remedy for the east.

Some FSA proposals will affect Life and General Insurance companies. UK Pension regulators will be further encouraged towards security-at-any-cost regulation. FSA will push the international body of regulators to adopt their new approach. That's where the danger lies for Indian Industry.

The issues highlighted by FSA are:

- **Intensive model of supervision**. To cover all sectors, including Life and GI companies. In non-banking sector the focus will be on *governance* and *risk management.* Attention will be on the role of Board of Directors and whether they provide strong independent oversight of the executive management. Non-Executive Directors (NED) should spend weeks and not days every month to discharge their responsibilities and should have more resources to support them. The pool of NED is to increase to meet the increased demands on time of existing ones. It may imply that NED should have strong sector knowledge, thereby opening more opportunities for the actuarial profession. Risk Committees should not be diluted by including audit functions. An ED in the main board should have sole responsibility for risk function.
- FSA is concerned about **the quality as well as the quantity of regulatory capital** firms must put up. Their concern is probably liquidity and the ability of the business to run off solvently and still remain as a going concern. Danger of increased capital requirement, particularly when capital is so scarce, is a major concern for UK insurance companies. EU regulators may take the opportunity of Solvency II to force more capital in the business simply to cover their back.
- **Bancassurance**: When banks own insurer or insurer owns bank, there is a contagion risk i.e. FSA will view the group as a whole. Nothing new there. Why it was not done well in USA for AIG is a mystery.
- FSA acknowledges that **macro-prudential issues** are mainly for banks. But they have given a general warning that other sectors could come within their view. "This suggests that when more time is available to reflect, the insurance sector will be drawn into a more intrusive and comprehensive approach to regulation bordering on economic management resulting in loss of management freedom." (BeachCroft , as above)
- The poor performance of credit rating agencies has implications for **what classes of assets insurers should invest in**. Some restrictions may not be bad.
- **Cross-border institutions;** the branch structure will be heavily discouraged and local subsidiary structure will be preferred. There will be lot of focus on this subject in international negotiations.

I am afraid regulation driven destruction of DB pension has become irreversible. DC pension will be inadequate, high-risk and of poor value to employees. The best hope is an emergence of risk sharing or DB/DC hybrid pension scheme, but I don't see that happening soon. The west is going back to the era when physical assets (land and buildings) and children were the main forms of retirement provision. As India wants to travel in the opposite direction, moving to financial assets from physical assets for retirement, it should not follow the west in this journey.

I have already given my views on product regulation and pre-approval of products. As a backlash it is possible that some western country will look at the products currently being sold by banks & insurers, find a few as ‘socially useless’ and ban them.

Lessons to be learnt::

- Risks should be fully evaluated, understood and priced. Don’t accept risks that you don’t understand or can’t price.
- Properly priced risks can still be gainfully diversified. For a Life or GI direct insurer, help in appraising risks may be available from the reinsurer. Reinsurance may have become more important now due to capital scarcity and underwriting uncertainties.
- Diversification does not always reduce risk. The insurance industry learnt this bitter lesson in Lloyd’s retrocession crisis in early 1990s. A poisonous risk parceled and passed on to others in the market does not reduce the risk; it only spreads the poison to the entire system. Sub-prime and other mortgage risks in US, UK etc. were under priced on the assumption that these can be cut into smaller pieces, packaged and repackaged and passed on cheaply to third parties (counterparties like other banks, capital markets and insurers). It did not work, just as it failed in Lloyds two decades back.
- Don’t be carried away by euphoria or panic. New paradigm is a dangerous word when used to justify irrational phenomenon like dot com or housing bubble. “The assumption of risk, its estimation and its management require a conservative mindset and disciplined execution to ensure that we can keep the promises we make… insurance is not a business for optimists but for realists who assume and manage risks conservatively.” (Tad Montross, Topics No.17, Gen Re, 2009)
- Extreme Events Risk, Tail Risk, Black Swan Risk: It is the risk of events that are extremely rare (or might never have happened in the relevant historical past) and have extremely high cost. This is the most difficult one to manage. I personally believe only a state, if sufficiently big and rich, or a group of smaller states with sufficient resources can be the banker or insurer of last resort. The amount of capital a private company or industry can realistically hold will always have an upper limit, but the extreme tail risk may cost well above the limit.
- The faith in market or mathematical models will not recover, though many will insist on using these on ‘there is no alternative’ argument. Behavioral Economics will try to fill the gap. I don’t think this philosophical conflict will be easily reconciled. Market will remain irrational, volatile and open to manipulation. The prospect of good and secure investment return is not bright, to the detriment of retail and whole sale investors.
- As western welfare states will face more and more difficulties in keeping the state benefits, there may be new opportunities for the insurance industry.
- Recession, slow growth, debt repayment and unemployment in the short term may see further reduction of premium income for savings products. Insurance fraud increases in difficult times.
- A few big UK banks (RBS, Lloyds/HBOS) owning insurance subsidiaries are trying to sell some of these to raise capital. Similarly a few insurance companies (Pru, Standard Life) that diversified into banking have or are selling those operations. Bancassurance may change as a result.

I am sure some more can be added to the list.

Not one of Charbaka’s original manuscripts survived. What ever little we know about him is only from the works of his critics. Every school of philosophy and religion of ancient India battled with his God-less, re-birth denying and pleasure seeking materialistic ideology. We don’t know whether Charbaka, the Rishi (sage), and his disciples practiced what they preached; unlikely considering that he was only a poor

teacher. The saint was blacked out of India's history and philosophy. But his thoughts survived, with some unpleasant consequences twenty eight centuries later.

The End

7th January, 2010.

About the Author:

Dilip Charan Chakraborty works as Finance Director, Life & Pension Business, Canada Life Limited, UK. He also advices the company on all UK pension related matters, including staff pension scheme, and is a Director of Canada Life Pension Management & Trustee Company.

Before joining CLUK in 1999, Dilip Chakraborty worked in Life Insurance Corporation of India (LICI) in India and the UK. After graduating from the Presidency College and doing post-graduation in theoretical physics from the Calcutta University, he joined LICI as a Direct Recruit Officer in November !969. He started actuarial studies in 1981, was awarded a bursary by the Worshipful Company of Actuaries, London in 1984, and qualified as FASI in 1987 and as FIA in 1990. During this period he mostly worked in sales and marketing assignments in Calcutta and neighboring districts. He joined LICI's UK office as the Chief Manager in 1991 and in addition was the Surrogate Appointed Actuary from 1993 to 98. When he left LICI, he was the Chief (Pension& Group Schemes) of LICI at its Central Office.

Dilip Chakraborty was closely associated with the liberalization process of insurance industry in India since the formation of Malhotra Committee in early 1990s. He assisted the Government of India, IRA and IRDA till 2002/03. He was elected to the EC of ASI in 1999. He has presented a number of papers in previous GCAs and other actuarial conferences in India and abroad.