

The EU's Banking and Insurance Market Is Trying to Solve Serious Financial Problems without the Support of Theory

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Abstract

This article was written as a contribution to the research project of the Faculty of Finance and Accounting at the University of Economics, Prague, Czech Republic, which was carried out within the framework of the institutional support of the University (IP 100040). Its authors deal with the low level of theoretical support for attempts to resolve the current serious problems of the world economy, eg. the continuing effects of the high level of debt of the leading world economies and heterogeneous integration groupings. The unresolved methodological grounding of economic theory makes it harder to find ways out of the debt trap and increasing social conflicts, and is reflected in some negative aspects of the situation in the main segments of the financial markets – banking and insurance, which, under political pressure, accompanied by inappropriate regulation, are losing their effectiveness.

Keywords: complexity of globalized world, current economic problems, absence of theoretical support, empirical approaches to economic research, banking and insurance market, effectiveness of the financial service branch

INTRODUCTION

During the course of the deep financial and economic crisis affecting both the global and national economies in the last decade, we have been unable to avoid the conclusion that, in the complex globalised era, the current economic model and existing economic paradigms are clearly failing. If we look at the problem from both extremes of the spectrum of opinions, we have to conclude that neither the liberal nor the Keynesian approach to economic policy has been able to identify in time the growth of serious imbalances in the economic world, and therefore to prevent the gradual increase in crisis phenomena, or, at least, to limit their destructive power. It is becoming increasingly clear that present-day economic science does not possess the necessary theoretical tools to recognize and cognitively comprehend the complexity¹ of a complicated economic world with significant elements of randomness.

It is against this background that, with a strong force of argument, Hayek's question once again poses itself; whether it is not necessary in scientific economics to start again from the very beginning,

from the level of determinism of the current world and the basic philosophical and methodological categories and to set off from Descartes' most fundamental and incontrovertible axiom "I think, therefore I am."

In a situation with limited possibilities for using tools based on economic forecasting grounded in expertise, fear of chaos is leading to an increase in political activity involving unsystematic, discretionary intervention in the economy and a resulting increase in regulation. Theoretical economists must accept the incontrovertibility of the general axiom that the external world is unpredictable, and the illusion that we understand economic events is confronted by the fact that the emerging conditions in the world are increasingly complex and random.

An important factor in this is the fact that in recent decades there has been a significant shift towards the formalization and mathematization of economic science in an attempt to achieve greater rigour (maximization or optimization) leading to the greater effectiveness of normative prediction. The American professor Samuelson is regarded by methodologists as the chief representative and guru of this tendency. Unfortunately, the economists who promote mathematization have required the nondialectical discipline of mathematics to operate in social science in a way which is alien to its basic nature. Moreover, the supporters of that tendency evidently did not know how to apply a mathematical apparatus to

¹ At a seminar at the University of Economics on March 27th 2012 on the topic of "the Vicious Circle of European Integration" the philosopher and political scientist Petr Robejšek referred to the failure of the political, power and also scientific elites and their role in the difficulties of integration. He then identified the most serious current problem as the failure to manage the complexity of the current globalized world.

economic reality. However, what the authors of this article regard as being of exceptional importance is the fact that the “mathematizing” economists have completely left the ethical dimension of economics out of their mathematical models. A result of this is the current low ethical level of economic transactions. Negative selection and moral hazard are today among the most pressing problems in practice. Seen from this viewpoint, one of the most important tasks facing theoretical economists is to introduce (or reintroduce) an ethical dimension to economic categories and to strengthen their methodological basis.

Attempts to Resolve the Most Pressing Economic Problems Have no Theoretical Support

Although a relatively long period of time has elapsed since the start of the global economic and financial crisis, economists have not yet come to a consensus regarding the origin and course of the crisis, a possibly remedy or the consequences for the paradigms of economic science and, above all, for the future of economic policy. One reason for this among others is certainly the fact that the crisis has had several completely new, specific features: a run on the banks, the role of innovative structured instruments and the failure of the ratings agencies. The recession has also been “different”, with low interest rates, a non-functioning credit market and the non-functioning currency stabilization of aggregate demand. It has not yet been possible to absorb these new aspects properly, and it remains to be seen whether theory can ever manage to do so.

In Europe, the financial and economic crisis has ultimately developed into a fatal debt crisis. This is both the result of crisis therapy, with the subsequent need for consolidation, and the choice of a particular model for the economic and social system in the European Union. The outlook for a solution is rather pessimistic. According to the rating agency Fitch, Europe has already been through the worst stage of the debt crisis. However, a complete recovery will require most of the next decade². The cause of the long-term crisis is the fact that the affected economies are trapped in a vicious circle: the banking crisis cannot be solved fiscally, because public finances are also in crisis: the crisis of public finances could be solved by fiscal restrictions, but they would lead to a deepening of the recession: one way out of the recession would be monetary expansion, but that cannot be implemented because of the banking crisis etc.etc. This cocktail, consisting of a mixture of a banking crisis, a public finance crisis and trade or currency imbalances, still represents a systemic risk for the whole economic, and by extension, financial

system, which cannot be solved by the traditional tools of currency and fiscal policy. The changes caused by the crisis to the socio-economic environment are even eroding the trend towards globalization, which, until recently, appeared to be irreversible. The current symptoms suggest, at the least, that the trend is fragmenting.

The period of mass over-consumption in the world's core economies, which led to an imbalance of such a scale that it could only be rectified by a massive financial and economic crisis, was ideologically supported by the ideas of the welfare state promoting short-term goals³ in the spirit of Keynes's quip that, “In the long run, we are all dead”. As a consequence, indebtedness was regarded more or less positively, leading to a crisis of public finances linked to an overgrown welfare state. In this respect, the attempt in the EU to institute central management with significant bureaucratic features appears to be disproportionately costly. Some steps of the European Commission carried out in that spirit, arouse, to put it mildly, feelings of unease. The first decade of the new millennium in the Eurozone was characterized by constantly rising government expenditure compared with income. The fall into the debt trap was, therefore, the logical consequence of these highly controversial trends.

The negative phenomena of the current globalized world are increasingly reflected at the political level. In the absence of appropriate recommendations based on economic theory, the bureaucratic apparatus is pushing for greater intervention by state administration in the life of society, especially in economic matters. Increasing income polarization and fiscal consolidation are disrupting social harmony, radicalizing a section of the political spectrum, and, to a certain extent, calling into question the democratic social model itself and eroding the ideas of international and inter-sectoral integration. E.Kislingerová (2013), with regard to this phenomenon, refers to the general increase in hostility in the societies of the developed economies towards financiers, especially bankers, who are labeled by politicians as some of the principal culprits responsible for the crisis and who are therefore the chief victims of the extension of state regulation, the concrete manifestations of which, often in the form of legally enforced norms, are frequently detrimental to

² According to the agency Fitch, Europe should gradually recover from the crisis, Finanční noviny (newspaper) and the Economic and Financial Server of ČTK (Czech Press Agency) 14.1.2012

³ P.Vooley, in a contribution at the European Banking and Financial Forum, Prague, March 26th 2013, entitled “The Dream and Drama of Financially Sustainable Growth”, believes that, for the stable development and growth of financial markets, it is necessary to set a “standard” of responsibility for politicians, managers and investors when following long-term goals, and that the preference for short-term goals was a cause of the current crisis. According to this contribution, it is significant that the economic paradigm is unable to explain the concept of the short term.

business itself; we are thinking of the inappropriate strengthening of consumer protection measures, anti-discrimination measures in the insurance trade etc. This leads to an almost insoluble conflict. Regulatory measures introduced to promote the safety of the client exceed reasonable limits, make financial services more expensive for the client and render them less effective. In other words, they have completely the opposite effect to the one they were meant to have.

Methodologists point out an important aspect of this situation: In the new environment, some well-established definitions of economic categories no longer fully encompass the meanings of terms as they are understood in the completely different conditions of today. One example of this are the basic concepts of economic crisis and recession. The “different” form they have assumed in recent times is clearly the result of the failure of human cognitive abilities, and their new comprehensive definition should therefore apparently go beyond the dimensions of economic science and become a category of the general methodology of science. The definition should reflect the fact that when the world economy experiences a crisis, there is a new quality to the spontaneous rectification of imbalances through the spontaneous fragmentation of the economic and financial system, allowing it to rise again from the ashes and ruins of the previous order. Of course, to reach such a conclusion, we must clearly use different approaches to those we have used hitherto.

A modern guide to the new way of thinking, with a veritable fount of inspiration, is the bestselling book “The Black Swan” by N.N.Taleb. Most of the book consists of essays of a philosophical or methodological nature dealing with basic epistemological, gnosiological and ontological questions. Nevertheless, their applicability to the search for new economic paradigms is plain to see.

The inappropriate emphasis on the excessive formalization of economic theory has another, negative aspect. The intensive implementation of mathematical approaches, especially to the models of market regulation, with the aim of limiting volatility and maintaining greater market stability was, in the last two decades, based on the concept of the risk based approach, which is based on the idea that it is possible to manage the significant impact of randomness on world economic conditions. According to this approach, the appropriate weapon to use was a well-stocked database of historical data and a wide portfolio of sophisticated models. The hectic state of the current world economy is clear proof of the ineffectiveness of that kind of “exact” approach to managing, or even eliminating risk. A “safeguard” against economic uncertainty and instability simply does not exist. Combining the

reduction of market volatility with the reduction of risk was shown to be completely defective during the first phase of the economic crisis. All that happened was that risk was transferred from the individual participants of economic interactions to the system as a whole.

The truth and validity of the basic methodological ambivalences about the unpredictability of the external world are repeatedly confirmed, as are, by extension, the highly limited possibilities of humans to make predictions and the basic methodological dilemma, which resembles an axiom: How can we make the future the object of scientific research, when it does not yet exist as an object? These are the realities that must be discussed, and, from that viewpoint, fluid economic categories must be amended.

The enormously complicated and globalized world of today is characterized by the occurrence of highly improbable and unpredictable events of all kinds. The mathematical models of formalization do not deal with these events, because they are so improbable, and do not, therefore, take their consequences into account. The role of scientists and researchers, as well as the way their contributions are received, is closely connected with unfettered randomness. This particularly applies to the social sciences, markets, politics and society as a whole, which are, according to Taleb, fundamentally unpredictable, despite the debatable, if tenacious attempts of economists, forecasters, mathematicians, statisticians and other academic specialists and theoreticians. This basic idea of Taleb’s book should, perhaps, become a credo for the creation of paradigms for economic science in the future.

The Practical Consequences of Insufficient Theoretical Support for the Principal Segments of the Financial Markets

1. Banking

Especially in the first phase of the crisis, the banks were pilloried as some of the chief culprits responsible for the crisis events, and for their excessive greed. They were, and still are, “punished” for this by stricter state regulation and supervision, including the regulation of bankers’ remuneration. This attitude of politicians towards the banks is reflected by a strengthening of public opinion against the bankers. The current feelings of the public can be seen in the campaign being waged by some bank clients in some countries against bank charges. In some countries, the problem has even led to litigation.

A separate chapter is the “punishment” for bankers that goes by the name of “bank tax”. The introduction of this tax was approved at an EU summit. The

revenue raised by it is meant to cover the costs of any future crises. Some EU countries have already started to levy the tax. One of those countries in Central Europe is Slovakia, whereas the Czech Republic has negotiated an opt-out, allowing it not to introduce the tax. According to the politicians, the tax should ensure that citizens do not have to bear the costs of a crisis for which they are not responsible. Even if we ignore the highly controversial nature of this assertion, we can assume that the bankers will pass the new tax on in the form of higher bank charges, and that, in the end it will be borne by bank clients, or taxpayers.

EU institutions have approached the problem with an appropriately graded variation on the theme by presenting key initiatives for the banking market, and, by extension, the financial markets in the form of a proposal for a European directive setting the framework for the recovery and restructuring of the sick banking sector of the EU countries, and, above all, a proposal to create a banking union. The EU summit in June approved the establishment, in stages, of a banking union during the course of 2013. Final acceptance of the proposal requires, however, the approval of all the member states, and the Czech Republic is one of the few countries to oppose the adoption of the proposal.

The creation of a banking union in the form proposed in current discussions would mean several very significant changes to the way the banking sector is currently organized. In particular, it would mean the complete transfer of supervision of the banking sector from the national level to Brussels. The common insurance of deposit accounts, a common system for restructuring the banking sector and common (stricter) rules for behaviour would be introduced across the whole of the EU. This, however, raises the delicate question of increased moral hazard and negative selection in the banking sector.

Decision-making about monetary transfers would be taken away from national authorities and handed over to “independent” experts. The newly created channel for bank transfers would have a “technical” character. The transfer of financial resources would take place less more surreptitiously. According to current thinking, this change would affect not only members of the Eurozone, but all member states of the EU. States outside the Eurozone would then be forced by the transfer mechanism to support the European currency union if necessary.

Such an environment poses a dilemma which resembles the search for a suitable relationship between a foreign parent company and a domestic subsidiary. There is a latent possibility that quality resources will be pumped out, and “bids” made to purchase toxic risk assets. This could potentially lead

to conflict between the leading European banking companies and the national regulatory body, whose duty it is to ensure the safety of the deposits of domestic clients. The proposed banking union would lead to a shift in power away from the national central banks and national supervisory bodies.

The proposal to create a banking union is certainly not the principal way to resolve the current debt problems in the EU. For national economies, it could mean a disruption of the stability of the banking sector and also the possibility that banks in countries outside the Eurozone might have to support the common currency financially. Even if we leave aside the political aspects of the proposal to make use of the situation to increase the weight of supranational institutions in the integration grouping, which would be a further step towards fiscal union, EU leaders are clearly attempting not to rock the fragile financial markets with a non-invasive solution, and to try to gain time for the southern branch of the Eurozone. So far, it does not appear very realistic that the time gained in this way will be used to increase the cohesion and competitiveness of the integrated countries as a whole. The banking crisis in Cyprus in March this year suggests, rather, the opposite. During that crisis, the bewildered EU institutions continued to mark time, while once again questions are raised about tax havens, the appropriateness of the number of banking institutions in them, and, last but not least, the general ethical problem of utilitarian greed for profit, which, in its present extent, exceeds Joseph Schumpeter’s proverbial “critical framework of the mind of capitalism”.

2. The Insurance Business

The core business in insurance, including reinsurers as the insurers of last recourse, has in recent years been affected by the enormous financial consequences of natural disasters and, in the light of their increased occurrence, the situation in this branch regarding the provision of capital is far from satisfactory. Reinsurers, as a result of the set reinsurance tariffs (whose creators succumbed to the human capacity to ignore extreme values and their negative impact), have been making a loss during that period, but nevertheless realize that the result could have been much worse, as there has not yet been a disaster large enough to cause the collapse of the whole branch of insurance. Because of this, the key challenge for the whole branch, and especially for reinsurers as the integral stabilizing factor for the whole branch of insurance, is to make the business profitable again and to restore its capital provisions so that it is able to fulfill its role in solving the financial consequences of Taleb’s “unfettered” randomness⁴.

⁴ These ideas constituted the paraphrased conclusions of the seminar organized by the London reinsurance broker Guy Carpenter in Prague on March 19th 2013.

The impact of the crisis did not itself threaten the insurance business, nevertheless, insurance companies have to deal with the aftereffects of the crisis in more or less the same problem areas as the banks do. The decreased willingness of economic entities to expend financial resources in a time of crisis has even led the insurance market of Central and Eastern Europe into a price war, especially in the area of vehicle insurance. The impact of a policy of price dumping in the setting of insurance tariffs on the economies of commercial insurance companies becomes clear only after a certain time (several years), but problems may be expected in the future from the payment of indemnities for damage caused to health by accidents, from the payment of remuneration, if it remains at an acceptable level etc. because they are increasing progressively at present.

Another problem area shared with the banking sector is the extension of regulation and its universal enforcement on the financial markets. Another factor which, it appears, will increase the costs of insurance activity in the EU, are the European Commission's measures to improve the protection of the consumers of financial services. Guarantee schemes for insurance services do, indeed, increase the stability of the insurance markets and the security of clients. However, we may wonder if they have not gone beyond a reasonable level. The reason for requiring the creation of sufficient reserves is to increase the protection of clients in the event of the sudden collapse of a financial institution. This measure is being introduced by the European Commission across the whole of the financial market, while one of the standpoints in this process is the harmonization of regulation for all financial market segments. Our reservation about this blanket approach stems from the fact that the insurance business has not, historically, been prone to sudden collapse, unlike the banking sector or investment funds. In the past it has been shown that the insurance business has relatively greater resistance to cyclical fluctuations. In a crisis, when there is a run on the banks, there is not an analogous run on the insurance companies, which is partly due to the technical impossibility of suddenly cancelling an insurance policy, but also predetermined by the stronger motive for taking out insurance; protecting one's family and property against harmful events is attractive even during a trough of the economic cycle. Indeed, proof of the lower sensitivity of the insurance business is the impact on it of the recent crisis, which, apart from a few exceptions which confirm the rule, has not been nearly as fatal as in the banking sector. Despite this fact, the insurance business, in the spirit of "harmonization", must submit to the new, more extensive regulating structures including

"harmonizing" approaches such as guarantee schemes, which mean higher costs for insurance companies, and which do not appear to be worth their presumed benefits.

Although the insurance sector, for the reasons already stated, is struggling both with the problem of a stagnant market and the stagnation of its own effectiveness, it could, in the near future, lose further financial resources. The first option under discussion is the introduction of a controversial tax on financial transactions, or even the introduction of a special, so-called sector tax on commercial insurance companies. Consideration of the topic of how to tax commercial insurance companies appropriately is not new. Unlike banks, where the creation of the economic result is, from that point of view, more transparent, insurance companies can amend their economic results through the creation of so-called insurance technical reserves, which are meant to cover the costs of paying indemnities. The problem lies in the difficulty of proving the objective need for their creation. One of these reserves, which is, from time to time, discussed in connection with taxation issues, is the reserve for damage which has already occurred, but which has not yet been reported to the insurance company and about which there is, therefore, not yet any documentation. The level of these reserves is set (estimated) using mathematical-statistical methods. Commercial insurance companies have always managed to defend the need for these reserves and their recognition for tax purposes. If a sector tax were introduced, theoretical discussion would virtually cease. In our view, the problem of an administrative intervention against commercial insurance companies lies mainly in its timing. It could be another factor militating against the restoration of effectiveness in the branch.

So, the only good news for commercial insurance companies is the fact that the controversial regulatory project Solvency II has been postponed several times, and will not be implemented before 2016 at the earliest. Provided the European Commission does not take another step towards extending the regulation of the insurance market, we can expect that this will be a factor leading to a slowing-down in the decline of the effectiveness of the insurance businesses caused by over-regulation. Another piece of good news in the same vein is that at the March session of the European Council of Ministers one member state managed to promote the topic of active deregulation. This means that in the autumn the European Commission will have to put forward proposals to simplify and reduce the burden of regulation and, at the same time, present a list of legal regulations that should be abolished.

CONCLUSION

The current globalized era in the world's economy is marked by highly volatile markets, especially financial markets, a low ethical level of economic interactions, and a low level of theoretical support for attempts to solve the current serious problems of the global economy, especially the continuing effects of the high level of debt of the leading world economies and heterogeneous integration groupings. In order to solve the problems, which are historically unprecedented, we believe that it is necessary to make more use of N.N.Taleb's system of empirical thought and modify the paradigms of economic science to make them sufficiently cognitive of the current situation so they can enable us to manage positively the economic situation in the world.

The unresolved methodological grounding of economic theory makes it harder to find ways out of the debt trap and increasing social conflicts, and is reflected in some negative aspects of the situation in the main segments of the financial markets – banking and insurance. Both branches must deal with the changed behaviour of their clients and with political pressure to extend regulation, as these factors tend to reduce the effectiveness of those branches. We believe that it is over-regulation in those two branches that represents a virtually insolvable conflict: regulatory measures implemented in the interests of clients' security are exceeding appropriate limits and leading to more expensive services for the clients of banks and insurance companies and lower effectiveness in both branches. In other words, they are having the opposite effect to the one they were intended to have.

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