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International Association for the
Study of Insurance Economics

PROGRES

Research Programme on the Service Economy

Geneva Association Information Newsletter

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The Geneva Association

The International Association for the Study of Insurance Economics, or by its short name "The Geneva Association", is a unique world organisation formed by a maximum of 80 chief executive officers from the most important insurance companies in the world (Europe, North and South America, Asia, Africa and Australia). Our main goal is to research the growing importance of worldwide insurance activities in all sectors of the economy. We try to identify fundamental trends and strategic issues where insurance plays a substantial role or which influence the insurance sector. In parallel, we develop and encourage various initiatives concerning the evolution – in economic and cultural terms – of risk management and the notion of uncertainty in the modern economy.

The Geneva Association also acts as a forum for its members, providing a worldwide unique platform for the top insurance CEOs. We organise the framework for our members in order that they may exchange ideas and discuss key strategic issues, especially at the General Assembly where once per year over 50 of the top insurance CEOs gather. The Geneva Association serves as a catalyst for progress in this unprecedented period of fundamental change in the insurance industry and its growing importance for the further development of the modern economy. It is a non-profit organisation.

The PROGRES Research Programme

The PROGRES name stands for research **PROG**ramme on **RE**gulation, **S**upervision and legal issues in insurance. It focuses on questions related to regulation, supervision and international co-operation of insurance and financial services as well as other legal issues of importance. The research programme manages The Geneva Association's co-operation with the supervisory authorities around the world and in particular with the International Association of Insurance Supervisors.

The annual PROGRES seminars address on advancing the regulatory and legal debates as well as trade and international co-operation issues. They provide since 1983 an annual forum and focal point for up to 60 specialist inter-disciplinary participants – private-sector practitioners and experts from representative organisations, academics, officials from governments and intergovernmental organisations – to discuss and debate in an informal way.

The PROGRES Newsletter is distributed worldwide twice annually on a complimentary basis to about 5000 organisations and individuals to raise awareness of selected service-sector research activities, conferences and publications. Anyone wishing to be included on the Newsletter mailing list should visit our webpage at www.genevaassociation.org or contact the Geneva Association Secretariat at:

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The Geneva Association Information Newsletter – PROGRES, No. 39, June 2004
Newsletter for the European Group of Risk and Insurance Economists

This bulletin of the Research Programme on the Service Economy is meant to contribute to the exchange of information on studies and initiatives aimed at better understanding the challenges advising in the fields of insurance regulation, supervision as well as other legal aspects. It is published biannually by the Geneva Association. Any suggestions concerning the content or layout of the newsletter are welcome. Please notify us if you are interested in receiving this publication regularly.

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I. EDITORIAL - NEW ORIENTATION OF PROGRES

By Dr Knut Hohlfeld

The research programme PROGRES now exists 20 years. The 20th PROGRES Seminar will take place in Geneva on 4-5 November 2004, not in the middle of September as you are used to. This has to do with the new orientation of PROGRES. PROGRES now stands for research **PROG**ramme on **RE**gulation, **S**upervision and legal issues in insurance. It takes into account the growing importance of cooperation between insurance supervisors and the supervised entities.

The former supervisory system with prior approval of conditions and tariffs has been replaced by mainly financial and risk based supervision. This new supervisory regime is more company related and requests an intensified dialogue between the supervisor and the supervised industry. The tendency will be further reinforced by the new accounting system according to IAS/IFRS as envisaged by the IASB and the EU Solvency II project. Considering this development PROGRES will focus primarily on regulatory issues that are of special relevance to both the insurance industry and insurance supervisors. Regulatory interlocutors should be prominent representatives of the IAIS, the international standard setting body for insurance supervision.

The IAIS holds its annual conference usually in the last week of September or the first week in October. This makes it nearly impossible for the chairs of important IAIS working parties to participate in the PROGRES Seminar at its traditional date in the middle of September. This year's seminar will therefore be held in the first week of November, i.e. one month after the IAIS Annual Conference. This will give the opportunity to discuss the latest standard setting work of the IAIS. The chairs of the IAIS Accounting, Solvency and Reinsurance Subcommittees have already agreed to participate in the seminar and discuss the ongoing work of their working parties. The insurance industry will hopefully make use of the chance to learn from top regulators about recent regulatory developments and to raise critical questions where there are concerns about the trends.

As from 2005 the PROGRES Seminar will take place in spring of each year. This will enable the participants to have a discussion on the ongoing standard setting work about six months in advance of the IAIS Annual Conference, i.e. at a time when the IAIS papers to be presented at the IAIS Annual Conference for approval by the membership are in the decisive drafting phase. At this time the contents of the papers can still be influenced. It also will be possible to bring forward new ideas for better insurance regulation. PROGRES should thus be developed as a useful connecting link between the insurance industry and insurance supervisors.

PROGRES will not be limited yet to discussions on IAIS activities. It will encompass any topical items that are of relevance to both insurers and insurance supervisors. Part of these items, in particular, are the GATS negotiations and financial services liberalisation. They will remain on the agenda of PROGRES and the PROGRES Seminar.

About the editor: Dr. Knut Holhfeld is the former President of the German Insurance Supervisory Authority and former Secretary General of the IAIS. He now heads The Geneva Association's PROGRES research programme as its Director.

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II. DO INTERNATIONAL STANDARDS HELP PREVENT FINANCIAL CRISIS?

By Dr René Weber

The contagious effects of financial crises in the 1990s has, at an international level and under the guidance of the G7 countries, led to a consensus on strengthening the global financial architecture. As part of this consensus, the development of internationally recognized standards and their widespread implementation were made a priority. This standards initiative is also highly relevant for regulation at the national level.

As a consequence of the financial crises in the emerging markets in the 1990s, which were not confined to national boundaries and rocked the international financial system in its entirety, global awareness of the importance of effective financial market regulation has grown. Such regulation fulfils an important function in the prevention of market excesses and imbalances, as well as structural inefficiencies in the financial sector. In addition, as a result of the high degree of international capital mobility, the need for closer coordination of financial market regulation and implementation practices has become apparent. It is a case of reducing the danger of contagion and avoiding unwanted regulatory arbitrage (i.e. the acquisition of market share through insufficient regulation) between competing financial centers.

Global initiatives on a broad front

With the initiative to further develop and implement internationally recognized standards in the financial sector, the international community has acknowledged these findings. The initiative sets new benchmarks in that it disseminates key standards for financial system stability (amongst others principles concerning financial market infrastructures and market transparency) and strengthens the mandates of international bodies in monitoring their implementation (as opposed to countries conducting self-assessments). The approach taken is based on uniform guiding principles and a standard reporting format for the respective country examinations. Whereas standard setting remains the domain of a disparate group of international financial institutions and private organizations, the task of monitoring progress in implementing the most important standards at the national level (standard implementation) has primarily been assigned to the International Monetary Fund (IMF) and the World Bank. The Financial Sector Assessment Program (FSAP) and the Reports on the Observance of Standards and Codes (ROSC) were created in 1999 as their main tools to fulfill this mandate. Coordination and setting priorities for the work carried out internationally in this area is the responsibility of the Financial Stability Forum (FSF) established in 1999.

The increasing acceptance on the part of the countries (in terms of participation in country assessments) proves that the standards initiative has, within a relatively short period of time, made considerable progress. This is due to various reasons, including that of promoting the image of the countries taking part. However, the use of information related to standards is still not particularly widespread in the private sector. Only a few specific applications have so far ensued, the most well known being the “Opacity Index” from PriceWaterhouseCoopers, the “E-Standards Forum” (www.estandardsforum.com), and the use of standards as investment criteria by CalPERS (California Public Employees Retirement System). To promote the use of standards assessments in the financial sector, incentives such as improving the user-friendliness of such assessments will need to be increased. What is being sought, amongst other things, is a means of improving the information content of the assessments to increase their value for country risk evaluations, investment decisions, or setting interest terms for loans. It is worth noting that the increasing

acceptance of standards improves policy and data transparency, as well as the comparability of national rules. Transparency of this nature is at the same time a prerequisite for achieving the goals of the standards initiative. To this extent, progress in this direction should be self-reinforcing.

Are standards effective?

In order to be able to make an assessment as to whether the standards initiative achieves its goals, i.e. if it contributes to reinforcing the international financial architecture, empirical analyses of the linkages between international standards and financial stability and growth are called for. However, the existing theoretical and empirical literature does not (yet) allow generally accepted conclusions to be drawn. The current patchy and specific case-related evidence is due to a number of caveats. A judgment is rendered particularly difficult by inconsistent and incomplete data and methodological problems which complicate isolating the influence of standards, or of elements thereof (in particular the indirect effects via improvements to the legal framework and macroeconomic stability). A further reservation relates to incomplete evidence as to the status of actual standards implementation in individual countries. Thus, the standards initiative has yet to pass the empirical test on achieving its objectives. The increasing number of standards assessments should, however, contribute to a rapid improvement of the data on national financial market regulations. The research will then be in a position to find better-founded indications on the macroeconomic effects of implementing standards.

Differentiated harmonisation of national law

Standards, even as legally non-binding “soft” laws, restrict the leeway of countries in determining national regulatory framework conditions. National politics, faced with a bundle of goals, must therefore balance them carefully. On the one hand, the aim is to achieve maximum national and global stability and gains in efficiency (tied in with a minimum loss of sovereignty) and on the other, to reinforce the competitiveness of the domestic financial services industry. Accordingly, the current embodiment of international finance relations can be termed as "differentiated harmonization". This common approach recognizes the necessity and desirability of specific, mutually binding rules on the international level, while at the same time not fully eliminating international competition between national economic and locational policies. This enables the financial centers to continue specializing and to pursue niche-market policies. It appears that positioning of this nature by countries and financial centers is current practice today. Standards have therefore become an integral part of international financial relations, both as recognized principles to be striven for and at the same time as the cornerstones of an international level playing field.

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This brief summary is based on the following recent study by the author: “Finanzstabilität und Krisenprävention: Die Rolle internationaler Standards”. Swiss Banking School, Band 282, Bern: Haupt, 2004.

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III. INTERNATIONAL FINANCIAL REPORTING STANDARDS AND IMPLICATIONS ON SOLVENCY

By Dr Joachim Kölschbach

Introduction

After seven years of discussion, on 31 March 2004 the International Accounting Standards Board (IASB) has published a first International Financial Reporting Standard on Insurance Contracts (IFRS 4). This standard was published just in time for application for annual periods beginning on or after 1 January 2005. At the latest for this financial year listed companies, and for this reason listed insurance companies as well, have to publish their consolidated accounts in accordance with the IFRS adopted. For non-listed companies the relevant EU-regulation published in July 2002[1] provides a member state option to allow or require the use of IFRSs for consolidated accounts. Furthermore, it provides member states with an option to allow or require the use of IFRSs also for the annual accounts. Due to another member state option companies which only have issued debt securities on a regulated market must apply IFRSs earliest on or after 1 January 2007. This applies accordingly to those companies using US GAAP because of a listing in the United States.

In 1999 the Steering Committee of the IASC, the predecessor organisation of IASB, published an issues paper on accounting for insurance contracts; at the end of 2001/beginning 2002 it published a Draft Statement of Principles (DSOP) considering the comments on the issues paper. Both papers proposed fair value accounting for assets and liabilities arising from insurance contracts. The issues paper and the DSOP did not find broad support within the insurance industry: There were serious doubts whether the fair value is capable to reflect the insurance business appropriately. In addition numerous questions with respect to a reliable implementation are not yet answered. In May 2002, the IASB recognized that a change towards fair value accounting for insurance companies before 2005 would not be realistic. Therefore the project was divided into two phases: “Phase I” (IFRS 4), considered as a transitional standard, which permits – more or less – companies to continue with their existing accounting policies, until the final standard (phase II) is published. A minimum of transparency and comparability within phase I shall be achieved via disclosures referring to the recognized amount, timing and uncertainty of future cash flows.

IFRS 4

IFRS 4 is applicable to all insurance contracts issued by an insurer as well as ceded reinsurance business. The definition of insurance contracts requires the transfer of significant insurance risk. The standard does not apply to other assets and liabilities within an insurance company, e.g. investments which are covered mainly by IAS 39 (financial instruments) or IASs 40 and 16 (properties).

A lot of financial instruments issued by insurers share certain characteristics with life-insurance contracts, e.g. participating features or long duration. Due to the absence of a clear conceptual view on accounting for participating features they are covered by IFRS 4.

Even before IFRS 4 had been issued the Board had decided to propose a change with respect to the scope: In order to achieve a consistent treatment of financial guarantees issued by banks and credit insurance contracts, the latter shall be excluded again from the scope of IFRS 4 for financial years on or after 2006. As a consequence insurance business will be divided in different classes and be treated unequally.

For the interim solution the IASB has refrained from prescribing a specific accounting policy. Within a given framework the insurers shall continue their current accounting policy for insurance contracts and financial instruments with participating features. A change in accounting policies is only permitted if it leads to more relevant or/and more reliable financial statements. The IASB believes that equalization and catastrophe provisions are without any doubt not in accordance with

1 Regulation (EC) No 1606/2002 of 19 July 2002 on the Application of International Accounting Standards.

the IASB framework and must not be recognized even in phase I. With that the IASB takes away a well proved instrument to reflect the pooling of risks, beyond one accounting period, over the time in the financial statements.

If an insurer's existing accounting policy does not already require it, the insurer has to test the adequacy of the liabilities as well as the recoverability of assets arising from ceded reinsurance business. Discounting of provisions or reduction of the level of prudence are not required, but permitted. IFRS 4 keeps silent with respect to the recognition of deferred acquisition costs.

The insurance industry insisted on its view that insurers should not be required to measure financial instruments that are held to back insurance liabilities with their fair value, as required by IAS 39. For example, an increase of interest rates would be reflected by a decrease in fair values of bonds, whereas the insurance liability would remain measured with a higher value because of discounting with rates prescribed by supervisors. Claims provisions are frequently not discounted at all. Conceptionally it would certainly be right to discount the technical provisions also with market interest rates. IFRS 4 gives an option in this respect. However, IFRS 4 does not give any guidance on how to determine the market interest rate. Furthermore it may require substantial changes of systems to introduce different discount rates depending on the duration of cash flows.

On the other hand it is understandable that from the IASB´s point of view insurers may not be exempted from the application of IAS 39, as it would mean that current practices would be continued for both, most parts of the assets as well as for the liabilities without any harmonization at all. Furthermore those insurers already applying IFRS and using US GAAP for the technical items are already faced with this problem. There is no doubt that this has to be solved within phase II: For the transition period of phase I insurers have the option to use market interest rates for discounting of technical provisions. In addition IFRS 4 allows the introduction of the concept of "shadow adjustments" which may reduce volatility at least for participating life insurance business.

Apart from that IFRS 4 addresses most of the concerns raised in response to the Exposure Draft: especially the requirement to disclose the fair value of insurance contracts in the notes for 2006 was not maintained in IFRS 4.

The IASB has announced to restart the work on phase II within the near future. However, an Exposure Draft may not be expected before mid of 2005; as a consequence the final standard may not be published before mid of 2006. Assuming a two year transition period until the first obligatory application, at the earliest financial statements in 2009 will be effected by phase II. It is expected that fair value accounting will be the basis for the upcoming discussions.

Possible consequences for Solvency II

This leads to the question whether, if phase II ends up with a fair value approach, IFRS financial statements can form the basis for solvency measurement requirements. Papers issued by the EU Commission Services do propose so. Solvency II will, probably, allow an insurer referring to internal models for the determination of solvency. The basis for these internal models is the determination of economic capital based on market values. The substantial constituent parts of economic capital for the purposes of risk and capital management are:

- application of market values or corresponding models,
- risk adjustments,
- the limitation to closed books, i.e. only those contracts that are in force currently,
- separation between underwriting activities and asset management activities.

There is no doubt that for external reporting purposes the reliability of fair value accounting is an issue of concern. However, a fair value approach shares more characteristics with economic capital than most of the current accounting policies do. Therefore, in the case phase II ends up with a fair value approach, the necessary accounting systems would have a common basis, both for external and internal reporting purposes.

Additional interrelations between IFRS and Solvency II result from the so called "pillar 3": By extensive disclosures insurers shall be obliged to provide transparency. This transparency shall

result in market discipline, forcing insurers to introduce proper risk management systems and provide sufficient capital to cover the risks incurred.

Conclusion

Fair value accounting, Solvency II and the resulting transparency will have an impact on the design of insurance products; how in detail, will be subject to market forces. For guarantees and options provided in insurance contracts an insurer has to hold adequate own funds. The resulting costs will be transferred to the policyholders, if they are not excluded from the products in advance.

As far as can be seen, no research has been done so far on the macro-economic impact, as for example the stability of financial markets and the role of the insurance industry in old age provisioning. In further discussions on an appropriate reflection of the insurance business in the financial statements this fact should also be taken into account.

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The European Centre of Tort and Insurance Law (ECTIL) was founded in Vienna in 1999 with a two-fold purpose: on the one hand, to create a secure institutional basis for the drafting of the Principles of European Tort Law (Principles) which is undertaken by the European Group on Tort Law and, on the other hand, to undertake research projects in the field of tort and insurance law.

The drafting of the Principles is the most extensive project of ECTIL. Academics were called together to discuss the fundamental questions relating to tort law on a comparative basis, the aim of the research being to create the foundation for discussing a future harmonisation of tort law in the EU. The work of the European Group has already led to concrete results in the form of publications dealing with the issues of Wrongfulness, Causation, Damages, Strict Liability, Liability for Damage caused by Others and Contributory Negligence which are published by Kluwer Law International in the Unification of Tort Law series. Forthcoming publications (2004) will deal with the issues of Multiple Tortfeasors and Fault. The results of the General Part of the Principles were completed in April 2004 and are available on ECTIL's website (www.ectil.org). The Commentary to the Principles will appear at the beginning of 2005.

The work of ECTIL also encompasses comparative legal research studies, the results of which are published in the Tort and Insurance Law series by Springer Publishing House. Detailed information on these publications, which, among others, deal with the topics of Terror, No-Fault Compensation, Environmental Liability, Medical Malpractice, Non-Pecuniary Loss, Pure Economic Loss, and Personal Injury can be accessed at the website of ECTIL. The subjects of the research, which deal with relevant issues for the insurance industry, are chosen due to their current significance and are often embarked upon on the initiation of institutions who have a particular interest in a topic at the European level. ECTIL also publishes a Yearbook on the developments of tort law in Europe in cooperation with the Research Unit on European Tort Law of the Austrian Academy of Sciences (www.etl.oeaw.ac.at). The highlights of the reports are presented and discussed at the Annual Conference on European Tort Law in Vienna.

The next conference will take place on 31 March and 1 April 2005.

IV. INSURANCE AND THE LIABILITY CHALLENGE

By Patrick M. Liedtke

Tackling Liability Concerns in the Insurance Industry

In October 2003, a group of European and U.S. claims professionals and lawyers from the insurance industry conferred for two days about liability regimes. The event was hosted by Swiss Re and co-organised by The Geneva Association. The aim was to discuss how far the developments in the liability area pose a danger to the insurance industry and whether there was a need to increase the understanding about the issue and possible consequences through a specific project.

After much discussion, a central question and a division into almost diametrically opposed responses came to the fore. Conference participants broadly agreed that a revolution of sorts had occurred or is occurring in the United States with respect to liability regimes and further agreed that this phenomenon poses issues of consequence for insurers writing business in the United States. In particular, fairly compelling data led participants to agree that the US tort system was continuing to evolve and appeared either to have already shifted or to be in the process of shifting toward a liability regime where insurers increasingly were being made responsible for losses and for punitive damages not only where there was no fault, but also even in cases where there was no real harm to the insured, or more commonly, no evident connection between the fact or the scope of the loss and the policy at issue. Additionally, the participants agreed about what is all too obvious, namely the rising costs of the U.S. tort system, associated inefficiencies and the rising dominance of a small, privileged class of plaintiffs' lawyers.

Conference attendees were uncertain, however, on the question of as to which extent this current (arguably U.S.) problem was likely to extend into liability regimes in Europe, Asia or other parts of the world. A better understanding of the driving forces and transmission mechanisms would be needed in order to answer the question: What could and what should insurers and reinsurers plan for in connection with their business outside the United States? Business as usual or radical increases in claims?

A first modest proposal resulted, developed in accordance with simple logic. It pushed off from a two-column sheet headed “what we know” and “what we don’t know”. Among other things, we *know* that

(i) time lags are profitable for insurers,

(ii) real-world liabilities tend to be specifically geographically (and jurisdictionally) bounded, and

(iii) we have a fairly obviously problematic set of US developments.

We *don’t know*, however, whether those developments are, in fact, extensible, what the likelihood is that they will go beyond US borders and, if so, at what pace.

Thus, the proposal argued – much in line with the general dictum of the precautionary principle – that claims professionals ought to write an option now to limit the downside if the problem ever crosses borders. Pending further evidence, claims professionals should, arguably even are required to, behave as though the U.S. trend is extensible. They should do this even, perhaps especially, if underwriters feel compelled to proceed on the opposite tack for competitive reasons. Of course this behaviour has to be balanced by the search for efficiency, but it might appear that the price to pay for the drafting of some limiting clauses would not create much impact, especially if all other market participants think that the liability problem will not manifest itself in other parts of the world. The “safety clause” would become more valuable, of course, as the perceived (and later real) impact of the changes in the liability regimes and their effects on insurance markets become apparent.

Insurers and reinsurers need to invoke and improve a number of sound practices that have been introduced in response to runaway liability regimes; e.g., earlier intervention in claims, more proactive claims management (in stark contrast to former insurance practice, where companies in our business tended to be content to "follow the fortunes" of either big clients or cedants), and better contractual provisions on several fronts, including things that limit liability, such as more precise definitions of the scope and duration of covered risks, as well as things that make clear that these improved claims practices are within the insurer's and reinsurer's remit, such as strong claims cooperation clauses.

One also might want to get ready to prevent the worst case border crossing scenarios by working early and often with governments and regulators, trying to understand, and make understand other stakeholders, what the consequences of a US-style liability regime are. It is not so much a question of lobbying to preserve the features of the current Eurasian liability regimes. There seem to be developments that emanate from far beyond the insurance industry and in greater parts of our modern economic systems and societies themselves that shape our expectations as to what constitutes an efficient and fair distribution of responsibilities, and thus liabilities. These are the developments we have to understand first, before entering in more detail into the specific insurance issues. Plus, insurance will have to "go with the flow" of developments (at least in part), if it is to keep a meaningful position as risk transfer partner in the future.

However, even at this stage of limited understanding, there are the above methods to behave prudently. Then, whatever the eventual outcome of our unknowable question, insurers and reinsurers will have put themselves in sustainable positions that safeguard the functioning of markets over a longer period of time than otherwise.

Establishment of a Liability Regimes Conference Series and Planning Board

Following The Geneva Association's initial co-operation with Swiss Re in October 2003 on the challenges that developments in the liability field pose to the insurance industry, a new conference series on liability regimes is being established. The initiative is led by a Planning Board consisting of senior managers from the following companies: Munich Re, Royal & Sun Alliance, SCOR, Swiss Re, Zurich Financial Services, and The Geneva Association. The key aims of the conference series and the work of the Planning Board are to:

- Improve our understanding of the evolving global liability conditions.
- Develop better understanding and tools for liability management that is appropriate and responsive to these changing conditions.
- Engage the insurance market as a whole in these issues and developments.
- Assist insurers in meeting obligations to policyholders.

The co-operation between the six parties mentioned above takes place on the understanding that Munich Re and Swiss Re will alternate as the hosts of the first two conferences, with Swiss Re hosting in 2004 and Munich Re in 2005. The six parties will share responsibility for planning and implementing each conference. The series is meant to gather senior managers that want to discuss liability assessment and management for the insurance and reinsurance industries and their strategic implications for the business.

The first conference in October 2004 in Zurich will focus on Europe. In 2005, the conference series will expand the central theme to gain a more global view and embark on an international analysis and discussion. Further developments will depend on the outcome of the first conferences and the accompanying work in the Planning Board.

Author: Patrick M. Liedtke is Secretary General and Managing Director of The Geneva Association

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V. IAIS ACTIVITIES

The International Association of Insurance Supervisors (IAIS) continued with a very busy agenda for 2004.

It is generally recognised today that good **corporate governance** is one of the keys for economic success. This is also true for the insurance sector. The IAIS therefore included a core principle on corporate governance in its revised Insurance Core Principles (ICP). As is said in the explanatory note to this ICP 9, corporate governance refers to the manner in which boards of directors and senior management oversee the insurers' business. Besides ICP 9 several more ICP and also other IAIS papers are related to various corporate governance aspects. The IAIS therefore produced a compilation of the ICP related to corporate governance supplemented by a list of other relevant IAIS papers. The compilation contains the full text including the explanatory notes as well as the essential and advanced criteria of ICP 9 and six additional ICP. Further listed are one principles, six standards and four guidance papers which the IAIS has developed on issues related to corporate governance. The compilation provides a good overview on best practice in corporate governance from a regulatory and supervisory view. The compilation is available on the IAIS website (www.iaisweb.org).

The various IAIS working parties continue being very active. The **Accounting Subcommittee** closely follows the work of the IASB. It is preparing a paper on the valuation of insurance liabilities examining which methodologies or models would be acceptable for prudential insurance supervision. The Subcommittee is further preparing comments to the IASB on the IFRS exposure drafts that are related to insurance, to the IAA on their draft papers related to insurance accounting and reporting, and to other organisations like IFAC on accounting related documents. There is a move towards closer liaison between the IAIS and the IASB, in particular with a joint meeting back to back to the IAIS committee meetings in Oslo in June 2004.

The **Solvency Subcommittee** has drafted a Supervisory Standard on Suitable Forms of Capital for Insurers. The purpose of the paper is to set standards for the assessment of suitable forms of capital that can apply within a capital adequacy and solvency regime. IAIS members and observers has been given the opportunity to comments. The standard will be finalised in time to be approved by the IAIS membership at the IAIS Annual Conference in October 2004. The Subcommittee is also developing a Supervisory Standard on Adequacy Requirements, to be finalised in 2005.

The **Investments Subcommittee** is currently dealing with the comments it received on the draft Guidance Paper on Investment Risk Management. The paper shall also be ready for approval at the IAIS Annual Conference in October 2004.

The **Reinsurance Subcommittee** aims at moving towards mutual recognition of the supervision of reinsurers and looks for areas of commonalities for that purpose. It started this work with a survey on the meaning of mutual recognition. At its last meeting a representative of the NAIC explained the financial regulation standards and accreditation programme of the NAIC as one possibility how mutual recognition could be organised. A representative of the European Commission reported on the envisaged EU directive on reinsurance supervision which shall be based on harmonisation and mutual recognition and abolish collateralisation requirements in the EU.

The Task Force on Enhancing Transparency and Disclosure in the Reinsurance Sector (**Task Force Re**) has finalised and delivered its report to the Financial Stability Forum (FSF) on how to enhance the transparency of the global reinsurance market. In cooperation with the reinsurance industry it developed a framework for collecting, processing and publishing global reinsurance market statistics in order to improve the understanding of aggregate reinsurance risks and produce data and analysis on the global reinsurance market at regular intervals. The 40 largest reinsurance

companies will participate in the statistics thus covering a significant part of the reinsurance market. The Task Force Re's report is available on the IAIS website at www.iaisweb.org. After completion of its work the Task Force Re has been dissolved. Instead an IAIS Steering Group on Transparency in the Reinsurance Sector was set up which will focus on the annual production of global reinsurance market statistics and reports and the development of the framework to include further areas.

The **Enhanced Disclosure Subcommittee** finalised the draft Standard on Disclosures Concerning Technical Performance and Risks for Non-life Insurers and Reinsurers, which will be presented to the IAIS membership at the IAIS Annual Conference in October 2004 for approval. The Subcommittee now started developing a Standard on Disclosure of Investment Performance and Risks which should be ready for approval at the IAIS Annual Conference in October 2005.

The **Working Group on E-Commerce/Internet** reviewed the Principles on the Supervision of Insurance Activities on the Internet issued in 2000. The revised version, in particular, includes some advice on the management of the risks posed by electronic commerce. It will be on the agenda at the IAIS Annual Conference in October 2004 for approval by the IAIS membership.

At its last meeting the **Insurance Fraud Subcommittee** discussed the cooperation with the Financial Action Task Force (FATF) and agreed that the IAIS neither should interfere in the work of the FATF nor duplicate its work. The AML/CFT Guidance Paper is being reviewed and shall be based on the revised FATF recommendations. It will draw conclusions that are specifically important for the insurance sector. It is intended to finalise the new guidance paper in time to get it approved at the IAIS Annual Conference in October 2004. Taking into account the full agenda of the Insurance Fraud Subcommittee and the fact that so far selling of insurance via the internet is still not very common the Subcommittee decided to postpone its joint work with the Working Group on E-Commerce/Internet regarding a survey on the use and risks of e-insurance and of the internet in relation to supervision for at least one year.

The **Emerging Markets Committee**, in particular, discussed training issues. The IAIS will continue supporting regional and executive training seminars for insurance supervisors. It is intended to develop regional three-year strategic plans for training courses based on a survey on training needs in the different regions. The Committee emphasised the importance of input also from the insurance industry about training needs in the different regions. It also stressed the successful cooperation with the Financial Stability Institute (FSI), which will be further reinforced.

Last year the IAIS in partnership with the World Bank and the FSI established a **Task Force on the Core Curriculum** with the mandate to develop a comprehensive learning curriculum for insurance supervisors based on the Insurance Core Principles and the additional IAIS principles, standards and guidance papers. 56 learning modules are planned over a three-year period, 2004–2006. At its last meeting the Task Force decided on the authors and reviewers of the 15 modules to be developed in 2004, all volunteers and most of them current or retired senior insurance supervisors.

It is only four months until the next **IAIS Annual Conference,** which will take place in Amman, Jordan, on 5-7 October 2004. The main IAIS committees will meet in Oslo at the end of June and make the final preparations for the Conference. It will be held under the theme of "Globalised Insurance Markets – Challenges & Opportunities" being of great interest to all who deal with insurance. The Conference offers an excellent opportunity to meet the heads and senior representatives of insurance supervisory authorities worldwide. IAIS members and observers as well as others who are interested in insurance and insurance regulation are invited. Detailed information and registration forms are available on the website of the conference at www.iais2004.com.

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VI. LEGAL PREDICTABILITY AND RISK MANAGEMENT: WHAT PRICE THE GATS?

HOW PREDICTABLE ARE THE LEGAL EFFECTS OF THE GATS BINDINGS OF SPECIFIC COMMITMENTS?

By Julian Arkell

Private sector advocates of the benefits of legally binding undertakings at the General Agreement on Tariffs and Trade (GATT) and its successor the World Trade Organisation, or WTO, have long pointed to the value of the clarity and predictability obtained when governments make specific commitments attached to the framework of principles and rules. This is a significant factor influencing business decisions and risk management strategies on whether to invest and trade in a particular jurisdiction.

These WTO obligations are underpinned by a far stronger dispute settlement system than was deployed under the GATT: it makes the WTO rules binding and therefore predictable, or so the argument goes. The eminent legal expert, John Jackson, in reference to the WTO, said:

> " […] it has been argued that a chief value of a dispute settlement system is **enhancing the predictability and stability of the obligation norms of the system**. This better enables the millions of non-government entrepreneurs to make business decisions of a wide variety of types […]Thus, the dispute settlement system could be seen as reducing [risk] […] and thereby enhancing world welfare through better allocation of investment flows and better business decisions by millions of entrepreneurs."[2] (Emphasis added).

WTO Members have both a duty to submit to the existing body of its charter rules and a right to contribute to their modification and development - indeed these rules cannot be altered by unilateral declaration by one state, however powerful. The essential basis of international law is common consent where decisions are adopted from emerging consensus.

There is no central law-making authority lying above the WTO in its specific domain, though in general there are superior rules under the Members' obligations to the UN Charter that may be relevant. The WTO cannot, however, over-ride norms of international law from which no derogation is permissible (ie rules of a *jus cogens* nature[3]). For instance the WTO has no powers in relation to basic human rights, and it cannot enforce one general international law against another, should the one violate the other. Neither, of course, can the WTO redress the extreme unfairness of the present economic divergence between peoples.

It seems that given a fair wind the decisions of the WTO dispute settlement mechanism will become an important node in the development of international law, as long as its decisions are consistent and its reasoning accessible, and the panels abide by the general principles of equity and good faith between the parties.

The General Agreement on Trade in Services (GATS) as an integral part of the WTO is placed at a fascinating conjuncture where some of the faster developments of international law may be possible.[4] Securely grounded in an international organisation by binding international treaty, and operating by consensus in the interests of a wide international community, it is capable of developing specific rules for new situations within the conceptually complete international legal system for trade, such that conflicting situations can be determined as a matter of law.

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[2] - "Dispute settlement and the WTO", John Jackson in "Seattle, the WTO, and the future of the multilateral trading system", Porter/Sauvé, Eds., The Center for Business and Government, Harvard University, June 2000

[3] *Jus cogens* is the only real category of 'superior' rules in that treaty law cannot derogate from them. They include, for instance, anti-slavery, human rights, genocide, and so on.

[4] Such developments reflect principally innovation at the regional and national level, rather than that created in the GATS 'from above', in the view of Professor Razeen Sally, who is an associate professor in international political economy at the London School of Economics and Political Science. See his article "Whither the WTO? A progress report on the Doha Round", No.23, CATO Institute, 3 March 2003.

In 1984 a former GATT Director General wrote that: " the founding countries of GATT […] created a trade system designed to bring stability and transparency to the conditions in which trade takes place and to promote progressive trade liberalisation."[5]

A senior Canadian trade official has stated that: "Good economic governance, by providing transparency, objectivity, and predictability of regulation, provides the certainty necessary for business to have confidence to engage in trade in services. […] today's trade negotiations are about good governance and democratic development: the creation of stable and transparent supervisory structures that ultimately provide a non-corrupt and predictable environment for traders, investors and consumers [for] a system of international governance geared to sustainable growth and sustainable development."[6] Let us hope the GATS will play a central role in this.

Ultimately, however, "It is a truism that a treaty is only worth what its members make of it. If respect for rules and commitments is eroded, if member countries hesitate to intervene when there is a breach of the legal rule simply to keep open the possibility of circumventing the rule themselves, the means of constraint must lose a great part of their force and effectiveness."[7]

At the back of our minds we think that predictability is what the most tested laws of science provide: there is a hypothesis on out-turns, and measurements consistently come up with exactly the same answer in confirmation.

Some economists feel the same can be said about one or two 'laws' of economics, such as comparative advantage and allocative and distributive efficiencies,[8] but since theories in this domain attempt to capture the outcome of human systems and interactions, the certainty of basic science is left far behind – after all, economics is the 'dismal science'![9]

International law could be "characterised by the image of a fungible high-water positive tide wrack resulting from political cooperation."[10] It will stay the same shape until the next extreme high tide changes it once more.

Already international law recognises that states will choose different legal techniques to implement treaty obligations and that this does not constitute lack of reciprocity - in the EU it is called mutual recognition of equivalence, a practical substitute for impossible degrees of harmonisation. In certain cases, though, treaties may provide for uniformity for some matters of private law. Whichever it happens to be, it is important to realise that failure to implement such treaty obligations cannot be justified in international law on legal, practical or political grounds.[11]

As a legal construct, the GATS in effect must keep afloat in a sea of social legitimacy, which is even more fungible and even less predictable. The political scientist Professor Robert Wolfe describes the normative setting in which he sees the WTO "as a site for the elaboration of a system of 'law' that arises from and provides a framework for self-directed human interaction."[12] "The purpose (telos) of any system of law is not merely to have a system of law for itself, it is to create a framework to guide the future interaction of the parties. […] The goal for global governance is pluralism, therefore, rather than the imposition of any one governing model." The "pluralist view stresses law as guidelines and expects to see a continuous process of social interaction in which the parties adjust their expectations of each other." It is the predictability of such expectations that business seeks.

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[5] "Law and its limitations in the GATT multilateral trade system", Olivier Long, Kluwer, 1985.

[6] "Governance in the global age: a public international law perspective", Jonathan T Fried, DFAIT, Canada, in Porter/Sauvé, Eds.

[7] Long, ibid.

[8] It is differences in resources (factor endowments) that create the potential for mutual gain through trade.

[9] One has to wonder where that leaves 'political science' !

[10] "The liberalisation of international trade in services: looking at issues of competence and legitimacy for the GATS – and the impact of its rules on institutions", Julian Arkell, mimeo, presented to the 10th Annual International Conference of RESER, Bergen, October 2000. This is downloadable from: www.arkell.info/conferences.html.

[11] Some criticise the present construct of international law and the precepts followed by the International Court of Justice for being of purely Western origin and propose that it should be changed to reflect the systems of other civilisations.

[12] This quotation and the following ones are taken from "See you in Geneva? Pluralism and centralism in legal representations of the trading system", Robert Wolfe, Associate Professor, School of Policy Studies, Queen's University, Kingston, Ontario, Canada &7L 2N6 WolfeR@qsilver.queensu.ca

Razeen Sally points to the different nature of such laws that have to be considered: some would limit government action, others could be positive procedural rules to enhance transparency in domestic regulation so as to promote market access, and others still could be prescriptive regulations intended to harmonise standards usually up to developed country levels. He sees that there needs to be a fine balance for multilateral rules which have to be strong enough to have some effect, yet be flexible enough to allow for policy and legal experimentation at lower levels tailored to specific conditions and competitive emulation.[13]

Professor Wolfe argues, however, "that far from being only in Geneva, trade law is everywhere." This approach reminds me of the welcome shift from a reductive - Cartesian - view of the world to holistic constructs, or in his terminology, the move from centralist / positivist / monist assumptions to "implicit and interactional law" and "legal pluralism" founded on cooperation, where the predictability of process and decision making are at issue. Hence we should explain the role of the GATS in this setting. Seeing "social order, good institutional design, and law as a social construction, suggests that the role of institutions in the establishment of a stable and prosperous global order is to create a framework for self-directed human interaction rather than coercion of self-interested individuals." Legal pluralism "is a way to move the state out of the centre of the frame, to develop an overview of world politics that recognizes not merely a multiplicity of issue-areas but multiple sources of normative order. […] The WTO texts work well, but they do not work alone in guiding governments let alone the interactions of millions of traders."

A difficulty "lies in separating the text of an agreement from the purpose sought by the parties, which may or may not have been well expressed in the text, which may or may not be consistent over time, and which is only one indicator of the law in any social context." This must be especially the case in the complex GATS setting with its many constructive ambiguities so loved of realistic negotiators attempting to square sovereign policy circles affecting a wide range of domestic regulations.

"When we see law as 'stabilized interactional expectancies', we then see texts as guidelines not commands, and courts become one of many social institutions for making collective decisions, rather than as a uniquely authoritative site for determining what is 'legal'", and Professor Wolfe refers to the "affinity of this approach with notions of 'customary international law'." Thus the "choice of decision process is not instrumental; it is a reflection of the form of participation desired and the end in view."

Professor Wolfe sees a real benefit of such a reality, because "the logic of legal pluralism is that disputes are more often avoided by law's role in shaping expectations." Predictability is about expectations. This raises the questions: "Are WTO obligations 'binding'? Who can assess compliance? Is the WTO 'enforceable', or predictable?" In turn this raises the role of understanding in predictability. The GATS reaches deeper into domestic law than does the GATT. In this respect he comments: "In effect, the WTO creates a **supply** of rules to be incorporated in national law. Can it affect the **demand** for its rules? […] Creating such demand is a problem when a new WTO obligation requires action not by the trade minister but by other ministers who do not see the domestic value of international trade." The problems arising over the liberalisation of the movement of natural persons, or GATS Mode 4, is a prime example of this, given the role of the authorities responsible for immigration and labour employment conditions.

Even "good faith efforts to comply with new international rules will founder. Norms and principles will be understood differently from country to country. Formal passage of a new law written to WTO specifications will have little impact if the text is incongruent with informal practices and mutual expectations of a given polity." The WTO dispute settlement system is thus "not analogous to a Supreme Court with autonomous power to interpret the contract" but "analogous to the labour arbitrator, who is a creature of the contract, useful for some but by no means all of the interpretative problems that arise. […] Law as 'guidelines for behaviour' rather than as commands of the sovereign sees law as a form of prospective ordering not merely retrospective adjudication. […] The first difficulty with compliance is knowing when the problem arises, since treaty language can be ambiguous", which must especially be the case in the unquantifiable realm of services delivery to which the GATS rules relate.

[13] In correspondence.

Bearing in mind the problems that beset many developing countries both as to governance and negotiating capacity, this pluralist view of law as guidelines has great significance as it "expects to see a continuous process of social interaction in which the parties adjust their expectations of each other." The experience of the failed WTO Ministerial Conference in Cancun bears testimony to the vast divide in expectations that exist in countries at different levels of development, and to which they will have to adjust.

Razeen Sally adds to the analysis, when he states: "Trade policy, like internationalism and charity, begins and ends at home, not in the WTO, nor indeed in the IMF and the World Bank. Credible and sustainable policies towards trade, foreign investment and the cross-border movement of workers emerge bottom-up as part of broader national economic strategies for growth and development. Thus trade policy should be made in the first instance at the *national* level, and it should be consistent with national macro- and microeconomic priorities. Unilateral liberalisation and pro-competitive domestic regulatory reforms, now as in the nineteenth century, should occupy centre-stage. International trade negotiations should then be used to help achieve nationally-set goals."[14]

One device for improving legal risk management in this setting is the requirement to adhere to international standards, and this has been of benefit under the GATT for issues of food safety, where risk "assessment uses science-based probabilistic reasoning [and] risk communication uses safety-orientated deterministic reasoning."[15] However, in the field of services such support to predictable actions by government are not likely to be widely available, partly because they cannot be science-based, and partly because they do not yet exist, and may be a long time in coming, if at all. A positive example is the work of the financial services regulators, cooperating at the multilateral level, to agree on principles, rules and procedures which has already produced much convergence, even though harmonisation is not on the cards.[16] However, as for the WTO, Razeen Sally sees that it "is in danger of regulatory overload and has a creeping *standards harmonisation* agenda. Detailed, prescriptive regulations are intended (at least implicitly) to bring developing country standards up to developed country norms. […] This 'intrusionism' […] in the domestic policies and institutions of the developing world is noxious […] it goes too far in curtailing national regulatory autonomy."[17]

Professor Wolfe then raises the problem that the WTO has no means of enforcement, though some "would say that the WTO is 'enforceable', although it has no enforcement mechanism, because it is embedded in a set of mutually reinforcing obligations." He concludes that "Predictability really comes from law's function of channelling everyday life. If law provides a framework for interaction, then it makes actors (firms as well as states) comprehensible to each other." Where conflicts arise because of "good faith disagreement on the meaning of Members' mutual obligations" rather than from cheating, and "they cannot agree, adjudication may be necessary, although **the outcome could hardly be predictable ex ante, especially to outsiders. Or at least, not predictable in the sense of knowing what a court might do.**" (Emphasis added.)

Referring at one point to the GATS, Professor Wolfe notes that "Critics begin to fear that the system is so powerful, and so malleable, that soon [it] will make it impossible to regulate health and education in the national interest, not necessarily because such restrictions might be inscribed in WTO agreements, but because generic rules could become weapons in the dispute settlement system." He thus concludes that the ultimate "test of WTO law in the trading system" will be whether "the parties are able to get along with each other, creatively if need be, when unanticipated

[14] "The end of the road for the WTO? A snapshot of international trade policy after Cancun", Razeen Sally, World Economics, Volume 5, Number 1, January-March 2004.

[15] Professor Wolfe, ibid.

[16] However, it can be argued that the 'prudential carve-out' from GATS rules procured by the financial services regulators in the Uruguay Round is too wide – see the present author's article "Should the GATS 'prudential carve-out' for financial services measures be revisited now – rather than left to store up a crisis for the WTO dispute settlement System?" in the PROGRES Newsletter No 37, June 2003

[17] Indeed Professor Sally begins to feel "that the WTO, and with it multilateral reciprocity in trade policy, is fast approaching its limits. Diminishing returns set in a while back. This applies particularly on what is now the bulk of the agenda: non-border domestic regulation. GATS, of course, is right at the heart of this. One cannot expect much from Geneva. One has to expect more from unilateral measures and, in the next instance, intensive bilateral and regional negotiations / agreements." This quotation is in correspondence. The argument is developed in his article referred to above in footnote 3.

situations arise, without interminable conflict. […] The process of discovering new rules to shape future interaction is more important than efforts to discipline past cheating."

We can see in this light that it is not its legally written framework that will make the GATS predictable, but only the extent to which its conceptual principles are lived by both the entrepreneurs who trade, and the domestic regulators of services, the latter often in effect regulating trade in services without knowing it. Once regulators 'think GATS', trading situations will become more predictable, and participants in the normative setting established by the GATS should be able to anticipate better how others will respond in a given set of circumstances. Put another way, law emerges from social interaction because officials write it down, they do not themselves make it. If nothing has happened to advance understanding, further attempts to 'clarify' the texts will not help. Thus, *pace* John Jackson, the dispute settlement system is not the key to "enhancing the predictability and stability of the obligation norms of the system" (in his words quoted at the start).[18]

Viewing the GATS from the political, rather than the legal, angle makes clear the imperative need for the advocates of the GATS liberalisation process not only to keep up, but also to re-invigorate their 'educational' efforts to influence, in addition to the trade negotiators, also the whole broad range of 'stakeholders', whether other government departments, regulators, trade and professional associations, NGOs and academics. Otherwise predictability will elude their grasp.

Author: Julian Arkell is PROGRES Conference Director for The Geneva Association and independent researcher and consultant on global trade issues.

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Conference Announcement

The Geneva Association's

21st PROGRES Seminar on
Regulation, Supervision and Global Trade Issues

7-8 April 2005

Venue: Hotel President Wilson in Geneva

Note:

In the future, PROGRES Seminars will concentrate stronger on regulatory issues in insurance, although the traditional trade discussions shall not be given up. As from 2005, the PROGRES Seminar will take place in spring of each year. This will enable the participants to have a discussion on the ongoing standard setting work about six months in advance of the IAIS Annual Conference, i.e. at a time when the IAIS papers to be presented at the IAIS Annual Conference for approval by the membership are in the decisive drafting phase. At this time the contents of the papers can still be influenced. It also will be possible to bring forward new ideas for better insurance regulation. PROGRES should thus also be developed as a useful connecting link between the insurance industry and insurance supervisors. Any suggestions concerning the 2005 PROGRES Seminar are welcome and should be directed to Dr. Knut Holhfeld (Head of Research – PROGRES) or Julian Arkell (PROGRES Conference Director) via *secretariat@genevaassociation.org*

[18] This paragraph draws on points put to the author by Professor Wolfe in correspondence.

VII. FINANCIAL RISK AND THE PATENTING SYSTEM – A RISK MANAGEMENT APPROACH

By Eskil Ullberg

The use of patents in *financial services* is a new development during the last 2 decades, which today accounts for about 20-50 patents[19] per year (in US). These patents are in the software area, an area that has grown more than10x during the same period, i.e. +12%p.a., to 8000 patents per year in 2001 compared to the total patenting growth rate of 4-5% p.a.[20]. Patents in this area are at present also granted in Europe (EPC). The small part of financial risk management *patenting* – less than 1% of all software patents and 5% of all business related patents – is however dramatic increase from "0" in 1981.

In a business sense these represent innovative ways of *managing risk*[21] in financial services enabled by IT (electronically available information, networks and software). The use of patenting in *business* also changes the way financial institutions look at companies, in particular innovative high growth companies. This article takes a look at the future strategic use of the patenting system to better manage risks and uncertainties in a global service economy and explores the relation between management of financial risk and the patenting system, both from a risk management approach.

The service economy development can be seen in 5 historic steps when it comes to managing business risk and uncertainty[22]. (1) *Products*, with a warranty added to get market access, (2) *finance*, to make products available to the customers usage (ex. capital goods), (3) *technical service*, to make products produce more effectively at the customers site, (4) *information and systems*, to provide tools to monitor performance and usage at the customer's site and (5) *management services*, to relieve the customer of cost in managing business risks and also create an upside based on experience (can be charged for).

Patents affect risks in trade and cost of capital

All these steps contribute to the value in the offering making it more performing by more effectively manage different risks in the customer relationship. Today it's a well-established fact that the services exceed 2/3 of GDP in the west. We live in a "service" economy, which needs new ways of managing risks, which are taken into account when financing that risk.

Most of the *ways* risk is managed is related to the "intellectual capital" of a company: ideas, systems, and information. "Intellectual capital" can, under certain criteria, be turned into "intellectual property", IP, through the IP system where patenting represents the most "aggressive" instrument, since it gives the holder a legal right. That right can be seen as a "tradable commodity". Other frequently used IP are trademarks, copyrights, design, etc.

Today around 85% of market capitalization in S&P 500 companies come from intangibles. Most of these values are in brands (trademarks) but a large part also in other IP rights such as patents. A conservative calculation indicates 15% of market capitalization from patent rights[23]. This is roughly the same as (or more than) the value of the physical assets of these companies.

In the United States, IP industries represent the largest single sector of the economy, accounting for almost 5% of GDP more than 50% of U.S. exports now depend on some form of IP protection[24].

Another aspect is that the *cost of capital* would go down provided that the company's IP is secured and valid. The patenting system thus provides a "service" to the economy in

[19] Number of patents/year for the industry is one way of measuring patent activity.
[20] US PTO statistics of US patents from 1969–2003 + US class 705: *financial* and other data processing
[21] With "risk" is means both "risk" that can be calculated and "uncertainty" that has to be managed.
[22] *Geneva Papers* July 2002. Risk management – from portfolio strategy …, Ullberg et.al.
[23] A work done together with the European Patent Office, EPO, in 2001and confirmed in 2003.
[24] From the "World Intellectual Property Day", 2004, **Jon Dudas**, acting USPTO Director.

absorbing some of the business risks related to the ownership of the intellectual property by granting exclusive usage rights to that IP for in general 20 years. This is however not a monopoly since other products that meet the same need, using other IP could be sold. A unique IP provides instead a competitive advantage to the holder of that technology.

The patenting aspect has therefore become of primary importance to understand thoroughly for financial risk management by financial institutions like banks and insurance companies.[25].

Patents as an instrument for competitive advantage in financial risk management

A third aspect of the financial risk and the patenting system is to secure *financial* intellectual property. In this way patents become an instrument of competitive advantage for the financial industry as well. Some of this development can be seen in the patenting statistics. Some financial companies claim that they have an Intellectual Property (IP) strategy that now includes patenting as a strategic tool to protect their investments. This is what is seen in other (non-financial) companies *in general* since about 5 years. Patent "portfolios" are also developed just like in other industries (starting about 10 years ago) to be used as instruments in managing market risks. Looking at the "insurance business" patents (US class 705/4) reveals some long-term trends. See figure 1.

These trends replicate the software industry's early patenting practices some 20 years ago. The data provides an *indication* of the interest and value of patenting by the financial industry today. Options provided by the patenting system are: *exclusivity* (providing unique competitive advantage), *licensing out* (for increased return on investment), *cross licensing* (reducing the cash component in licensing *in* a certain technology and/or getting access to competitive technology), *collateral* for borrowing against a patent (portfolio) and *securitization* can be options (just like in the copyright industry today).

With a current growth rate of 22% p.a. in another 10 years there will be more that 1000 patents in the financial area. In15 years finance will pass today's software patenting level. That will provide an effective unique market access for those holding the patent rights; a way to cross-license with other financial companies to provide a wide variety of services to their customers; and create a cost advantage to competition who will have to pay for these licenses if they want to use them.

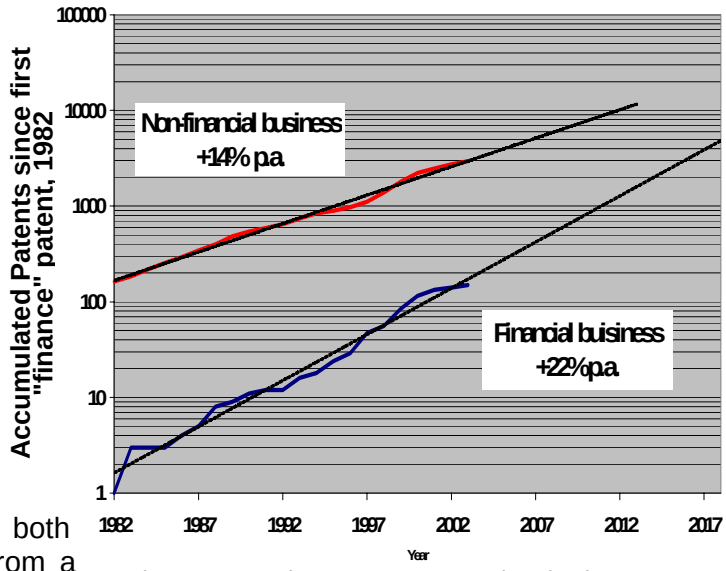

Fig.1 Patents since 1982+10y trend projection. R2 of data = .98-.99. US Class 705: Financial, Business Practice, Management or Cost/Price Determination (Data Processing), International Class G06F 17/60. Top 10 countries: US, Japan, UK, Germany, Canada, France, Israel, Sweden, Australia, Switzerland. Top 5 companies: Citibank (44 patents), Merrill-Lynch (21), VISA

This development is of course uncertain both from a competitive market aspect and from a political "patenting policy" perspective. However as risk management – both financial and business – becomes more complex and demands more and more investment in methods, systems and information, companies will try to secure these investments in one way or the other. Here patenting seem to provide an

[25] Analysis along these lines adds another point to financial risk evaluation – the patent seen as a "corporate asset". These are partly accounting issues. Discussions (US/EU) may lead to putting these assets on the balance sheet creating a definite link between financial risk and the patenting system.

interesting avenue for financial risk by providing a way to secure unique risk management knowledge.

Big debate on the right to patent inventions including software

There is currently a big discussion in US and Europe of granting these patents at all or at least to what extent. In Europe for example the European Commission is "for" software patents but "negative" to "business methods" patents. The European parliaments however have recently proposed to stop software patenting all together in Europe (EPC) after lobbying from the "open source" movement. This has in turn created a lot of opposition from the European industry, both engineering/technical and financial. Software is seen as create a competitive advantage for these companies by combining high tech, software and design features [26]. A washing machine needs software to be able to adapt over time to new detergents. Practically any engineered equipment today includes software to perform its functions, can be monitored remotely over a network for efficient maintenance and performance, etc.

This is another example of the steps in risk management referred to above. Leading companies are trying out step (4) to compete using software as an integral part of the offering to manage risk for the customers by delivering better *performing* products and services combining software with other assets.

An Example

A simple example of a patent application filed along these lines is "Method and system for gather information relating to risk", published 1/4/2004. Here a unique way of gathering information on risk perception is filed. This method is "systematic", should use "networks", and produce decision material as output (claim 1). It is thus an example of securing risk management at level 4 using IT: information and systems. It is classified as "Data Processing: Financial, Business Practice, Management, or Cost/Price Determination/Insurance" (705/4) in the US (G06F 17/60) in the international system. (*SwissRe*, who has 6 published applications in the field, filed this application. *Zürich Insurance* has filed 1 by its American subsidiary[27].)

Summary

The idea has been to draw attention to the ongoing opportunity for financial companies to better make use of their expertise, systems and information in risk management by securing their right to their intellectual property through the patenting system, worldwide. The basic idea has been to be able to *trade* these rights. Trading these rights allows for *specialization* in risk management by companies, ultimately creating increased *productivity* and more efficient risk management in the financial services markets worldwide.

Currently the research is focused on four areas: management of risk and uncertainty in the service economy including IP, Risk management and IP, Economics of patenting, Financial risk and patenting (applied) and finally a commodity market in patenting (applied). Input and dialogue in these areas are welcomed from both business and academic. (For further information please contact the author, eskil.ullberg@euromail.se)

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[26] Article in DI from Ericsson, ABB, Atlas Copco and Scania.
[27] The applications can be found on www.epo.org, by searching on applicants company name.

VIII. LETTER TO THE EDITOR

Financial Services and the Prudential Carve out

Dear Sir:

I read with interest the article on the prudential carve-out published in PROGRES Newsletter No 37 in June 2003. I am not so sure I agree with some of the author's observations insofar as how a panel would interpret the exception. First of all, the Oxford English Dictionary definition of the use of the term, is not the right starting point. As expressed in GATS, it relates to two things, the protection of deposit holders, etc. and to ensure the integrity and stability of the system. I realize it is preceded by the term "includes", but, to borrow from the Vienna Convention, it is hard to expect a panel to relate a defense of the carve out to anything but those more specifically expressed criteria. Nor would it be "prudent" to attach it to the disciplines of Article VI, by reason of its heading under "Domestic Regulation" or otherwise. First of all, the author reads too much into the heading. It would be very hard to convince a panel on the link simply because of the common use of the term, "domestic regulation". While there was indeed no link conceived of in drafting the Financial Annex, the reading of the Agreement would not, in my view, give a panel a link to the less-than-defined (except in accountancy) disciplines under that article. However, as is correctly pointed out, the real field for speculation rests with the final sentence of the exception, relating to whether such measures undermine commitments undertaken. That's the opening for a panel.

Now, for possible remedies. It would be possible to build in some transparency provisions and relate them to the exception. I believe one could also incorporate some fit and proper standards relating to "governance". That is because these principles are pretty well known. However, the more difficult areas pertain to the two situations addressed in the carve out. That's where burdensomeness and proportionality come in to play, and that is where I think one will get nowhere in developing the rules. Here one has to examine what went on in Basle, but basically bank regulators have never come close to these kinds of principles, even on a voluntary, non-binding basis. No one wants to do so. It is, of course, possible for a panel (which must consist of financial experts) simply to put on the GATT TBT Agreement 'hat' and assess whether a country's capital requirements for branches, which are say, five times those of national banks, are more burdensome than necessary, or, to use EU Constitutional parlance, not "proportional" to the objective of prudential measures. I rather doubt it. In a particular case, for instance, it may hardly be related to the protection of the deposit holders, but may relate more to the "integrity and stability" of the system, which consists of a few state banks with, say, 75% of the assets and which are being constantly bailed out by the state.

So the Swiss are right. An examination of what the prudential exception should mean would be worthwhile, but the will does not exists among the financial people, whose central banks want maximum flexibility to interpret the provision, for all sorts of reasons. That said, I have not come up with an alternative to the author's suggestions. I suspect that, if ever a serious effort were made to clarify the exception, it would not necessarily incorporate analogous provisions of the GATS or the GATT. And, there will be no impetus to launch such an effort unless and until a panel again, consisting of financial experts interprets the exception beyond what the financial people dreamed of.

That brings one back to the introduction to the paper, relating some of the history of GATS, and the U.S. Treasury opposition to even having a GATS (something they fought to the very end of the Uruguay Round). There is no question that our Treasury, and other like-minded sorts, have come a long way since those early days. But I think it's a stretch to believe, by analogy, that it means the next step is the inevitable carve-up of the carve-out! If Central Bankers cannot address the issue with any precision that would be comfortable to them, then you can be sure they would not leave it up to a trade body. It's just not in the cards and was the reason for the rather vehement objections to the Australian delegate's suggestion a couple of years ago that we need to examine its meaning. Perhaps I should finally give a warning against the use of the term "precautionary principle" as a phrase that might generate some momentum on the path of resolving prudential. If ever a term had less credibility, it was its introduction by the Community into the GMO debate, which has been one of the more awkward efforts at providing a legal rationale for denying these imports on the basis of science, under the terms of the SPS Agreement.

Richard B Self,
Nathan Associates, Inc.

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THE 20TH PROGRES INTERNATIONAL SEMINAR

4-5 November 2004, Hotel President Wilson, 47 Quai Wilson, Geneva
[First Draft programme]

"New Developments in the Regulation and Supervision of Financial Services"

Thursday, 4 November 2004

08h30 **Registration and coffee**

08h45-09h15 **Welcome and opening remarks:**

- **Patrick Liedtke**, Secretary General, Geneva Association
- **Julian Arkell**, PROGRES Seminar Organiser

Chair for the morning:

- **Knut Hohlfeld,** Head of Research Programme – PROGRES
  General Introduction

09h15-10h15 **SESSION A - NEW DEVELOPMENTS**

- **Catherine Lezon**, Deputy Secretary General, International Association of Insurance, Supervisors, Basel
  "Recent developments and future work of the IAIS"
- **Daniel Schanté**, Secretary General, European Committee of Insurers (CEA), Paris
  "Challenges for the insurance industry facing a new, more complex, regulatory environment"
- **Gunilla Borer**, Senior Financial Sector Specialist, Financial Stability Institute, BIS, Basel
  "The training programme on insurance of the FSI"
- **Hung Tran**, Deputy Director, International Capital Markets Department, IMF
  [Subject to be advised]

10h15-10h45 **Questions to the Panel and discussion**

10h45-11.h15 *Break for tea and coffee*

11h15-12h15 **SESSION B - REINSURANCE REGULATION**

- **Ernst Csiszar**, Director, South Carolina Department of Insurance, Columbia; Chairman, IAIS Reinsurance Subcommittee
  "IAIS activities on reinsurance"
- **Ralph Vogelgesang**, Chief Legal Officer, Munich Re, Munich
  "View of the Munich Re on reinsurance"
- **William C Marcoux**, Partner, LeBoef, Lamb, Greene & MacRae, London
  "Ways to improve the supervision of reinsurance"

12h15-12h45 **Questions to the Panel and discussion**

12h45-14h30 **Lunch**

14h30-15h30 **SESSION C - SOLVENCY AND CAPITAL ADEQUACY**

- **Wil Dullemond**, PVK, Apeldoom, Chairman, IAIS Solvency Subcommittee
  "IAIS activities on solvency in the insurance sector"
- **François-Charles Laprevote**, Services Division, DG Trade, European Commission, Brussels
  "Report on progress of Solvency II, on behalf DG Internal Market"
- **Thomas Schubert**, Association of German Insurers (GDV), Berlin
  "Insurance sector views on Solvency II"

15h30-16h00 **Questions to the Panel and discussion**

16h00-16h30 *Break for tea or coffee*

16h30-17h30 **SESSION D**

- **Marie-Louise Rossi**, Chief Executive, International Underwriting Association of London
  "Progress on the agenda of the IUA"
- [other speakers to be approached]

17h30-18h00 **Questions to the Panel and discussion**

19h30 **Reception and drinks, followed by the PROGRES Seminar Dinner**

Friday, 5 November 2004

09h15-10h15 **SESSION E - ACCOUNTING ISSUES**

- **Florence Lustman**, Secretary General, Commission de Control des Assurances, Paris; Chair, IAIS Accounting Subcommittee
  "IAIS activities on accounting in the insurance sector"
- **Gerald Dickinson**, Professor, City University Business School, London
  "Activities of the Geneva Association on accounting"
- **Douglas Barnert**, President, Barnert Global Ltd, New York
  "International accounting standards – an update"

10h15-10h45 **Questions to the Panel and discussion**

10h45-11.h15 *Break for tea and coffee*

11h15-12h15 **SESSION F - REGULATION OF INSURANCE**

- **Professor Jan Monciewicz**, President KNUIFE, Warsaw
  "Joining the EU: the effect on insurance regulation and supervision in Poland"
- **John Cooke**, Consultant, London (formerly Association of British Insurers)
  "Report on research for the City Corporation on EU-US Insurance/Reinsurance Market Inefficiencies"

- **Stuart Brahs**, Vice President - Federal Government Relations, Principal Financial Group [provisional]

  "Global Pension and Asset Management Developments: opportunities and challenges"

12h15-12h45 **Questions to the Panel and discussion**

12h45-14h30 **Lunch**

Chair: Julian Arkell, International Trade and Services Policy

The GATS negotiations and financial services liberalisation

14h30-15h30 **SESSION G**

- **Ambassador Alejandro Jara,** Permanent Mission of Chile, Geneva, Chairman, Special Session, GATS Council
- **[Ms Miyon Lee**, Permanent Mission of Korea, Geneva, Chairperson, Committee on Trade in Financial Services [invited] **]**
- **David Usher**, First Secretary, Permanent Mission of Canada, Geneva, Former Chairman of CTFS
- **François-Charles Laprevote**, Services Division, DG Trade, European Commission, Brussels

  "Financial services negotiations: the EC view on state-of-play and prospects"

15.30-16.00 **Questions to the Panel and discussion**

16h00-16h30 *Break for tea or coffee*

16h30-17.30 **SESSION H**

- **Abdel-Hamid Mamdouh,** Director, Trade in Services Division, WTO, Geneva

  "Reflections on the DDA services negotiations"

- **[Audo Falero**, Permanent Mission of Brazil, Geneva [invited] **]**
- **Bradley Smith**, Managing Director, International Relations, American Council for Life Insurers, Washington DC [provisional]

17h30-18h00 **Questions to the Panel and discussion**

18h00-18h30 **General discussion on Seminar and suggestions for issues to include in the 2005 programme for 7-8 April**

**** * * * * * Please notify Julian Arkell before Friday 2 July if you wish to speak and / or attend, by sending an email message to: arkell@infotelecom.es***

THE GENEVA ASSOCIATION PUBLISHES A NEW STUDY ON MARKET IMPACT OF FAIR VALUE ACCOUNTING

Impact of a Fair Value Financial Reporting System on Insurance Companies: A Survey
by Gerry Dickinson and Patrick M. Liedtke (84 pages)

This second report to The Geneva Association's Accountancy Task Force provides an empirical analysis of the views of insurance companies on the likely impact that an international financial reporting standard based on a full fair value methodology, if it were to be introduced, would have on a number of their key corporate policy areas. The survey of a sample of leading international insurance companies and the follow-up interviews with CEOs, CFOs and other senior staff reveal a number of important issues:

First, no insurance company in the forty international insurance companies that participated in the survey currently uses a full fair value system as a general accounting model for internal planning and control, nor would any company wish to do so voluntarily.

Secondly, senior management in insurance companies consider that they would be under some pressure to change their internal accounting systems over time to realign them more with a new financial reporting system. This is in part to be consistent with investor and other user perceptions and in part because it would be costly and confusing to have two very different accounting systems running side by side.

Thirdly, the introduction of a full fair value reporting system would significantly change the business strategies, corporate policies and systems over time in a way that most companies consider would reduce their competitiveness.

Fourthly, there is a high degree of agreement that the higher volatility of reported earnings would increase the cost of capital of insurers and that it would be more difficult to provide earnings' forecasts or forward-looking information to the investment community.

Fifthly, most insurers consider that measuring the fair value of insurance liabilities (insurance contracts) would be very subjective and there might be compliance problems under the Sarbannes-Oxley Act.

Sixthly, a majority of companies perceive that the disclosure of fair values of insurance liabilities, even if they could be measured credibly, would be unlikely to increase the transparency of financial statements to users, but a significant minority, all outside of the United States, consider that it would increase transparency to some degree over the prevailing national reporting standards. However, nearly all companies consider that this increase in transparency should be provided in the notes to the accounts rather than distorting the primary financial statements.

Seventhly, there is a broad consensus that a fair value reporting system would have some adverse impact on the risk transfer role that the insurance industry plays within the wider economic system.

The study can be downloaded for free from The Geneva Association's website:
www.genevaassociation.org

The first study in this series was written by Prof. Gerry Dickinson and published by The Geneva Association in February 2003 under the title "The Search for an International Accounting Standard for Insurance". It charts the development of international accounting standards and discusses some of the key issues for insurance and possible future developments. It can also be downloaded for free from the above website.

International Association for the Study of Insurance Economics

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Conferences organised and /or sponsored by The Geneva Association

2004

September

20-22	**Marseille**	**The 31st Seminar of the European Group of Risk and Insurance Economists (EGRIE)**

October

14-15	**New York**	**2nd Annual Round Table of Chief Risk Officers**
15	**Rome**	**Montepaschi Vita Annual Forum 2004, 3rd Edition of the MPV Forum "The Paradigms of Value",** Montepaschi Vita and The Geneva Association
21-22	**Trieste**	**2nd Conference on Health and Ageing**
25	**Hanzhou**	**Insurance Leaders Panel in China,** co-organized with the Asia Insurance Review
28-29	**Zurich**	**2nd Conference on Liabilities and Legal Developments in Insurance,** co-organised with Munich Re, RSA, SCOR, Swiss RE and Zurich Financial

November

4-5	**Geneva**	**20th PROGRES Seminar on Regulation, Supervision and Global Trade Issues**
8-9	**Bordeaux**	**19th M.O.R.E. Seminar at AXA University near Bordeaux** (Management of Risks in the Economy)
11-12	**London**	**1st Geneva Association Insurance and Finance Conference,** hosted by Prudential Corp. Plc
19	**Geneva**	**Travailler jusqu'à 67 ans ou Retraite Flexible?** Organisation Uni 3 en collaboration avec l'Association de Genève et Avenir Suisse

December

6-7	**Zurich**	**2nd Meeting of the Global Insurance Communications Network,** co-organised with Zurich Financial Services
13-14	**Paris**	**3rd Paris International Insurance Conference,** co-organized with the FFSA

2005

January

11	**New York**	**Joint Industry Forum for P&C Insurance Industry,** co-sponsored by The Geneva Association