

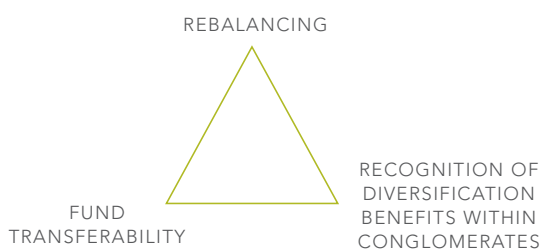
## It is Time to Decide What Kind of Crises We Want to Have in the Future

by Ioannis Chatzivasiloglou and Charalampos Fytros

Crises are devastating. They leave behind a high amount of entropy (unemployment, poverty, lack of safety). But this is half the truth. The other half says that crises are to some extent good, because they provide a natural crash test to discover current practices' risks and limitations, and in response give rise to more efficient regulation, to financial innovations and to the wakening of the vitalizing powers of society, as the old and corrupted die and new ideas emerge and give us the opportunity to reflect upon the future we want to have.

Now that the basic structures of the financial system have collapsed, it is time to reflect and decide what kind of crises we really want to have in the future (the option of not having crises in the future, unfortunately, is unavailable). In order for our decision to be effective, it should be informative. This is why we should elaborate more on the basic structure of the current crisis.

The three factors that this paper distinguishes to support the genesis and the proliferation of crises can be depicted as the three angles of a pyramid:



Let's make some definitions:

Let a micro-crisis be a crisis that is faced by a certain company, or a group of companies (either banking group, insurance group or a conglomerate). A micro-crisis is restricted to the group and is local in nature.

And let a macro-crisis be a crisis that affects macroeconomic factors and consequently real economy.

Fund transferability (at the one bottom of the pyramid) is defined as the ability of funds to be transferred from one specific subsidiary of a group to another subsidiary of the same group which is in financial difficulty. The higher the ability to transfer funds, the higher the probability a potential crisis inside a group never emerges. Therefore, the level of fund transferability implicitly defines the frequency for a micro-crisis to emerge.

On the other bottom of the pyramid, if diversification benefits at the level of a group are recognized, the overall (i.e., at the group level) capital available to fund potential micro-crises is lower than the sum of the capital of the subsidiaries of the group. The lower the perceived correlation between the subsidiaries, the higher the diversification benefits recognized by the regulator and the lower the total capital of the group—which essentially means lower risk capital to absorb potential losses. Therefore, the level of diversification benefits implicitly defines the severity of micro-crises.

Both fund transferability (frequency) and recognition of within-group diversification benefits (severity) make up the bottom line of the pyramid, i.e., the micro-level.

Rebalancing is the term used to denote the macro-level, on top of the pyramid. Why is such a term used? Consider an institutional or even an individual investor: consistent with his/her investment policy statement, s/he follows a method of rebalancing so that the portfolio's long-term strategic allocation is not heavily distorted by the drifting values of the underlying assets. Now consider the largest possible investor—the government. Does this exceptional investor differ so radically? Governments spend, leverage, sell and lately invest in distressed securities. Their portfolio is society, and this portfolio should at minimum be balanced. So, rebalancing seems quite essential not only for the average institutional or individual investor but in this case too. Letting big-company financial establishments become bigger is like letting your originally strategic alloca-

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tion drift away while undertaking a series of concentrated exposures that might affect the value of your whole portfolio—in this case, society itself. Financial institutions have the potential to leverage profits or losses by using a void but powerful substance: it is called credit. Proper rebalancing, i.e., imposing a ceiling on the amount of credit a financial institution might use or invest upon, contributes to a long-term financially balanced society (given that governments opt for such a long-term balanced strategy).

We talked about a pyramid. This pyramid is not static: it constantly moves like a pendulum. The nail is at the point of “Rebalancing”; at the bottom of the pyramid, you may

find two antidiagonally placed massive bobs: “Fund transferability” and “Recognition of diversification benefits within conglomerates.” The higher their masses (when, for example, lower fund transferability and higher diversification group benefits coexist), the higher inertia contributes to a highly uncontrolled swinging back and forth, i.e., the more intense the crisis. “Rebalancing” determines friction in the pendulum movement: the lower the ratio of credit to real output (imposed by a consistent rebalancing strategy), the lower the size of financial risk: swinging finds a natural resistance.

We may have a choice upon future crises:

| Macro Level    | Micro Level          |   |   |
|----------------|----------------------|---|---|
| Financial Risk | Fund Transferability | Regulator’s Recognition of Real Diversification Benefits within Conglomerates | Crisis  |
| No Rebalancing | Low                  | High  | Macro-level: Uncontrolled<br>Micro-level: Low/High frequency, high/low severity<br>Overall: Varying effects that do not exclude extremities |
| No Rebalancing | High/Low             | High/Low  | Macro-level: Uncontrolled<br>Micro-level: Low/High frequency, high/low severity<br>Overall: Varying effects that do not exclude extremities |
| No Rebalancing | High                 | Low   | Macro-level: Uncontrolled<br>Micro-level: Low frequency, low severity<br>Overall: Varying effects that do not exclude extremities. Managed  |
| Rebalancing    | High/Low             | High/Low  | Macro-level: Controlled<br>Micro-level: Low/High frequency, high/low severity<br>Overall: Managed   |
| Rebalancing    | High                 | Low   | Macro-level: Controlled<br>Micro-level: Low frequency, low severity<br>Overall: Preferred   |

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