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Letter from Geneva

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Every year for the last twenty-four, the Geneva Association (officially the International Association for the Study of Insurance Economics) has conducted a seminar dealing with insurance regulation and trade issues. Every year for the last ten, I have traveled to Geneva to take part.

Although it is a congenial assignment, there is always some hesitation. As home to many international organizations Geneva is a fascinating city, and when the weather is clear and sunny, it can be spectacularly scenic. When the international bureaucracies grind slowly and the weather turns nasty, it can be extraordinarily dull and gloomy. Mont Blanc commands the skyline above Lake Geneva, but only inveterate optimists expect this glorious view on any particular visit to Geneva.

Inveterate optimists left their legacy in the proliferation of international organizations with headquarters in Geneva, starting with the International Red Cross and including several UN organs, such as the World Trade Organization. Although conceived after the Second World War, along with the World Bank and the International Monetary Fund, to reestablish the global economy, the WTO took shape only in 1995 when the nebulous General Agreement on Tariffs and Trade finally secured a general agreement that it should have a permanent organizational structure. This agreement resulted from the Uruguay Round of negotiations, so named because the negotiations began in Punta del Este, Uruguay, in 1986. Previous rounds of international negotiations, especially the Kennedy Round in the 1960s and the Tokyo Round in the 1970s, produced agreements to lower tariffs and other trade barriers across the board for all the signatory countries. Partly for this reason, international trade expanded over a hundredfold in the decades since.

Tariffs originated centuries ago as a revenue source, not as trade policy. Anyone who has waited in the airport customs line when arriving in another country knows that high tariffs distort trade and sap the efficiency of the economy. Governments hesitate to reduce tariffs, however, because they fear their trading partners might not reciprocate. Moreover, since every economic change produces winners and losers, they face certain criticism from the disadvantaged sector at home.

Multilateral negotiations enable governments to coordinate the reduction of trade barriers and thus strengthen the political support for sensible economic policies. Thus WTO members subscribe to the principle of progressive liberalization. Each round of negotiations becomes harder, however, because they involve more issues, as well as more participants and more constituencies.

While the early rounds dealt only with barriers to merchandise trade, the Uruguay Round introduced trade in services into the negotiations. The resulting General Agreement on Trade in Services (GATS) established basic norms for services trade and imposed transparency requirements. As stated in its Preamble, the GATS is intended to contribute to trade expansion "under conditions of transparency and progressive liberalization and as a means of promoting the economic growth of all trading partners and the development of developing countries." All Members of the World Trade Organization are signatories to the GATS and assume the resulting obligations. Article XIX commits them to further rounds of services negotiations. The first such Round, which started in Geneva in January 2000, was incorporated along with agriculture and implementation issues into the negotiations launched in Doha in November 2001. To emphasize the role of developing countries, these negotiations are called the Doha Development Round. Trade ministers met again in Cancun and Hong Kong, and between ministerial meetings the negotiations continue in Geneva.

Traditionally the Geneva Association seminar offers a worthwhile informal exchange of views on global regulatory issues, but the final day adds the insights of participants in the ongoing negotiations in Geneva. Usually the ambassador of a key country in the negotiations summarizes their current status and suggests that a services agreement is still possible, no matter how many deadlines have already been missed. It is only that developing countries lacked the time and resources to master the technical complexities that services present, or that services are being held hostage to agriculture, or that India or Brazil must learn a new leadership role, or that given enough time the negotiations will ultimately succeed regardless because failure would be unthinkable. Diplomats, after all, are professional optimists.

This year's event ran true to form, with cogent presentations on solvency, group-wide supervision, policyholder protection funds, and new reinsurance centers. Michel Flamée, who chairs the Executive Committee of the International Association of Insurance Supervisors (IAIS), spoke glowingly about future supervisory cooperation based on IAIS standards. The other speakers competently described bits of the world as it is. But on the afternoon of the second day I felt as though the clouds had lifted over Mont Blanc and I should take another look at the whole Geneva scene.

Over lunch Julian Metcalfe, the British Deputy Permanent Representative in Geneva, assured us that the prospects for a services agreement had improved of late. Among several reasons, he pointed to the extent of autonomous liberalization that has occurred because developing countries now recognize that financial services contribute to their economic development. Even an agreement that simply turns these recent policy changes into binding commitments would constitute significant progress since the last round.

During the question period that followed, one of his compatriots complained that binding commitments to existing policies offered no new commercial value for British insurers. My reaction was quite different, since furthering global standards for insurance markets is the mission of the International Insurance Foundation. Sound prudential supervision of competitive insurance markets promotes economic development, and every affirmation or endorsement, no matter how redundant, strengthens the global consensus. And as Ambassador Metcalfe replied, existing policies can be revoked more easily than treaty obligations.

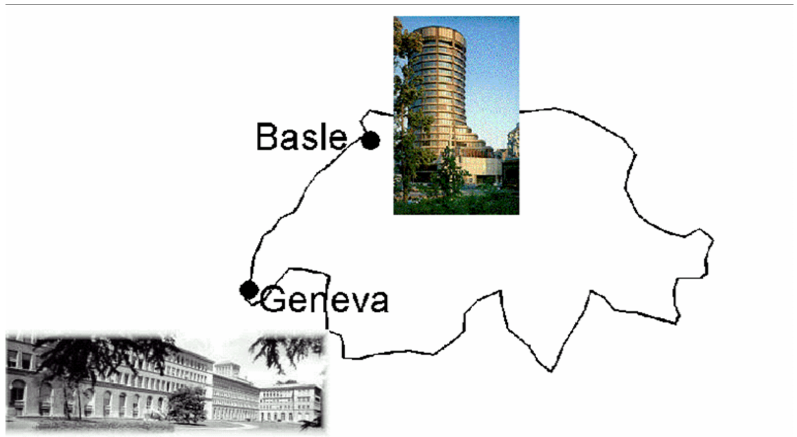
As Counselor in the WTO Trade in Service Division, Juan Marchetti stays close to the negotiations. His seminar presentation confirmed the growing recognition within Geneva circles of the contribution insurance makes to economic development. The supporting research he cited included three papers I had sent him last year, including two by the International Insurance Foundation's Research Director, Dr. Ian Webb.

Reassured that the IIF has been on the right track, I glimpsed the way forward thanks to Paul Myler, the Australian diplomat who chairs the WTO Committee on Trade in Financial Services. After alerting us that his remarks did not represent Australian government policy, he recited some of the obstacles to a services agreement so far. Not only had the proponents of financial services liberalization lacked the tools to make their case, they had not articulated clear objectives. Differences in the regulatory frameworks advocated by the U.S. and the EU clouded the common vision. Technical issues require the expertise of national regulators, who have not been much involved. And the "prudential carve-out" is a black box.

That black box arises from Article 2, section a, of the GATS Annex on Financial Services, which provides that:

> Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for **prudential reasons**, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.

Understandably the meaning of "prudential reasons" is not obvious, and protectionist reasons might easily be disguised as prudential despite the admonition to the contrary. Inevitably trade disputes will center on this term, unless a new agreement gives it more precision. Formerly I argued that global regulatory issues should be settled in Basle, not Geneva. Now I realized that Geneva is scarcely aware of what has happened in Basle since the GATS Financial Services Annex was concluded in 1997. As a fledging organization in 1997 the IAIS devised a weak set of Core Principles, but substantial overhaul since then has strengthened them immeasurably. Countless self-assessments, training programs, and Financial Sector Assessments have so reinforced the global consensus surrounding the Core Principles that "prudential reasons" now has a clear meaning in Basle circles. It is time for Geneva and Basle to come together, perhaps with help from Berne and Zurich, to establish an effective global framework for trade in services.



Coming together means changing habits, or at least perspectives, to see the whole picture. Insurance supervisors generally avoid trade issues, which they regard as political and therefore a threat to their independence. Trade negotiators rarely possess specific technical knowledge of regulatory issues. Industry representatives tend to focus on commercial advantage. Consumer advocates suspect that unequal bargaining positions may lead to unfair outcomes. On cloudy days in Geneva, it is easy to lose sight of the real objective: a global system of rules that work for everyone.

While regulators and negotiators clearly need to cooperate, industry can do more to articulate the advantages of competitive insurance markets for developing countries. Traditionally suppliers of insurance services have not emphasized the value they offer in ways that fit the logic of trade negotiations. An industry whose prices can fluctuate widely from year to year and that compensates its producers mostly by commissions obscures its core value. When outsiders to the insurance business have difficulty imagining how insurers earn their profits, a comparative advantage in the provision of insurance services goes unrecognized.

Gains from trade happen just as much in services as in goods. Some firms are more efficient providers of financial services because they possess unique professional skill and can exploit economies of scale. The unique skill of insurers is the identification, pricing, underwriting, and monitoring of risk. Over time competition stimulates ever increasing efficiency, which for society as a whole means treating the same risks at lower and lower cost. It also creates incentives for greater safety, and therefore increased productivity.

But because of the fragile capital structure of financial firms, prudential supervision is essential to give potential customers the confidence to buy financial products. Add substantially more risk and what is true for banks becomes even more true for insurers. Transparent, non-discriminatory prudential supervision provides a clear set of rules within which an insurance market can flourish. Global standards improve the quality of prudential supervision because they lead to more transparency, more consistency, and therefore more effective implementation. The industry benefits because compliance costs diminish. Consumer awareness and confidence in supervision increase as nations coordinate their approach to supervision.

The way to advance the Doha Development Agenda is to open the black box with an unrelenting commitment to transparent prudential supervision in compliance with global standards. In 1997 the prudential carve-out strengthened the hand of regulators; now its imprecision weakens their hand. As global standards emerge, their incorporation into WTO commitments facilitates their implementation. Synchronization of standard-setting and trade liberalization can lead to an open, fair, rules-based multilateral framework for trade in services.

With a sound global regulatory framework in place, the world economy can transfer risks more efficiently. Insurance markets will flourish, giving more people access to products that protect their assets and stabilize their incomes. Incentives to manage risks better will allocate resources more efficiently, and economies will grow. This boost to development is the promise implicit in the GATS Preamble.

Flying out of Geneva, I could see the lake and the mountains, the old city and the new, the offices and the parks, all at once. Then I closed my eyes and imagined the scene somewhere, anywhere, in the aftermath of a terrible storm with claims adjusters distributing insurance payments to help people rebuild their damaged homes. Few homes were severely damaged, however, because most people had previously reinforced their roof straps in order to lower their insurance premiums. Meanwhile with only slight disruption the government authorities continued to focus on improving the health, education, and general welfare of their citizens. Of course I am an inveterate optimist.

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