Research in International Business and Finance 37 (2016) 620–628

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

Mastering risks: An illusion Truth and tropes on jeopardy

Denis Dupré[a,*], Preston Perluss[b]

[a] Department of Business, University Grenoble-Alps, CERAG, INRIA (STEEP team) and PPL (Philosophie, Pratiques & Languages), France
[b] University Grenoble-Alps, LARHRA, France

ARTICLE INFO

Article history:
Received 21 May 2015
Received in revised form 30 November 2015
Accepted 10 December 2015
Available online 19 December 2015

Keywords:
Finance
Ethics
Risks
Performativity

ABSTRACT

Drawing on examples from maritime insurance, this article seeks to show that historically rules and regulations have often taken into consideration the performativity of risk insurance so as to limit the range of insured risks and thus avoid the realization of the claims through embezzlement or kindred corruption.

Today the question of performativity and corruption remains outside the pale of financial research. Having rejected the distinction between uncertainty and risk, financiers take risk quantification as an incontrovertible given. Quantifying risk has become a key feature in modern finance ever since the difference between risk and uncertainty was rejected by financiers. Two reasons underlie this state of affairs: first the prevalent rationalist paradigm as expounded by highly reputed university professors has elevated “quantifiable risk” to a dogma. Additionally, this idea of risk, and its quantifiable limits, gain acceptance by society to the extent that systemic risk is constrained by a further concept: efficient markets. Herein we develop an idea of ethical responsibility which leads to a novel definition of risk, sharply diverging from current practice and instruction, so as to meeting the contemporary needs of both finance and broader society.

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1. Introduction

“We must remember that the future is neither wholly ours nor wholly not ours, so that neither must we count upon it as quite certain to come nor despair of it as quite certain not to come.” Epicurus in his letter to Menoeceus.

Although appreciating risk varies from culture to culture, its very definition remains unclear, even in the eyes of experts. Anglo-American financial culture takes a favorable view toward risk while European financial culture takes a more conservative stance preferring reduced risk. The riskiest credit instruments bear the name “risky bonds” while in English the term “high yield” is used (however, “junk bonds” is another term). Financial risk weighs both on the individual asset holder as well as society as a whole (in systemic risk). Systemic risk means a risk that the multiplicity of individual actions for gain might undermine the social substrata that enable such behavior and thus may generate greater costs than benefits.

From at least the 17th until the mid 20th centuries, regulatory needs linked to the performativity of financial wagers formed the dominant paradigm of finance’s ability to satisfy the broader economy’s needs; while the broader economy

* Corresponding author.
E-mail address: denis.dupre@upmf-grenoble.fr (D. Dupré).

http://dx.doi.org/10.1016/j.ribaf.2015.12.001
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undergird the nation-states' power. Modern finance has witnessed the rise of a dogmatic belief in limitless mastery of financial risk through use of financial tools and models; this dogma has hastened global deregulation and expanded wagering and risk taking despite the recent "financial crisis".

The assumption of efficient markets has abolished the presence of systemic risk since this hypothesis posits as inevitable the market's return to equilibrium; as this assumption results from the mathematically rationalist paradigm in finance, it has hidden the performative aspect of finance and has successfully eliminated analysis of financial tools impact on society.

2. Regulation and performativity aspects of financial risk

Regulation is often a recognition of risk's performativity. A given financial instrument can both function as hedge – should the buyer own the underlying risk – or wager, in the opposite case. The pair hedge/wager, two faces of a same financial reality, has favored the rise of financial derivatives whose nominal value in 2013 (according to the BIS) exceeded $ 710 trillion, approximately ten times world GDP. Risk hedging, as hedging actual produced wealth, concerns at best merely 10% of these instruments' use, the rest being speculative.

Finance and its "instrumental utility" traditionally allocated resources to those economic sectors where it would be most useful and allocated risk to those agents most capable of assuring such (Dembinski, 2008). Finance, however, has strayed from its original utility (Walter and Pracontal, 2009; Cassidy, 2009) and such views are no longer taught either in business schools or when training financial engineers (Dupré and Raufflet, 2014).

Government attitudes toward wagers have shifted from era to era. Wagers could be favorably received, even eagerly desired by political instances. They might be tolerated without admitting that the players could call upon the courts to settle their contentions. Speculation might be forbidden with possible penalties or fines. It might even be considered a felony.

In 1681 in France, Colbert enacted a maritime ordinance[1] which forbade insuring both the source of profit as well as the associated risk. Hence, the risk of self-realizing prophecies was already taken into account. Colbert prohibited insuring individuals aboard whom thus the policyholder might be tempted to kill. Colbert, in article XV, forbade insurance contracts which weighed on the projects' success by disengaging ship owners, merchants and operators:

> Neither ship owners or ship captains will be allowed to insure their freight, nor merchants their expected profits nor ship owners their lease payments. All these kinds of insurance are for this reason prohibited and thus averting the risk to insurers who otherwise would be subject to fraud, misrepresentation and deceit were the aforesaid risks to be insured.

Colbert required the insured parties to retain 10% of the risk.

Adopted in 1745, the British Marine Insurance act shows a similar reluctance to insure wagers. What could be more risk-fraught than gambling heavily on a merchant vessel's safe arrival? Thus, legislation forbade any insurance contract on an event in which the insured held no stake. Insurance required the insured to demonstrate "policy proof of interest". British courts stayed performance of any insurance policy tainted of betting, whenever the insured owned nothing which risked loss of insured value.

In 1909, the Marine Insurance (Gambling Policies) Act imposed various criminal liabilities on those parties contracting marine insurance on losses in shipwrecks without insurable interest:

> If any person effects a contract of marine insurance without having any bonafide interest, direct or indirect, either in the safe arrival of the ship in relation to which the contract is made; or any person in the employment of the owner of a ship, not being a part owner of the ship [. . .] the contract shall be deemed to be a contract by way of gambling on loss by maritime perils, and the person effecting it shall be guilty of an offence, and shall be liable, on summary conviction, to imprisonment, for a term not exceeding six months and to forfeit to the Crown any money he may receive under the contract.

Hence a significant body of law was implemented to repress wagers linked to crimes and vice.

Elsewhere, wagers were tolerated but players held no claim to legal recourse. Due to the socially inacceptable fallout from gambling, in 1804, the French Civil Code specifically exempted gambling from all legal recourse as regards debts. In the United Kingdom, the Gaming Act of 1845 deemed the wager without contractual force and thus non enforceable in courts until 2005:

> All contracts or agreements, whether by parole or in writing, by way of gaming or wagering, shall be null and void; and no suit shall be brought or maintained in any court of law and equity for recovering any sum of money

If cargoes and vessels – key elements in 17th and 18th century British international economic expansion – were excluded from wagers, how today should we avoid wagers on sovereign defaults or business bankruptcies and keep their worst scenarios from taking place? Among financial researchers, Walter (1996) is one of the few who admit "unlike exact sciences,

[1] Ordonnance of Colbert from 1681, edition of 1714, Charles Osmond, http://gallica.bnf.fr/ark:/12148/bpt6k95955s.r=.langFR.

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