

Differences and Similarities between Banks and Insurers

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1. Introduction

There is considerable debate at the current time in international forums about the best ways to regulate and manage banks and insurers, particularly in terms of overarching macro-prudential frameworks. For example, the concept of Systemically Important Financial Institutions (SIFIs) is being introduced in macro-prudential supervision. However, actual implementation of this concept raises the issue of what characteristics make a firm “systemically important”, whether similar sized firms in one industry are more likely to be systemically important than those in another industry and if so why.

The purpose of this note is to summarise some of this debate and to suggest ways of reconciling differing viewpoints.

2. Recent history

One starting point is to consider those types of organisation that appeared to be “systemically important” in the recent credit crisis, particularly in terms of needing, in the opinion of politicians, to be bailed out by the public purse to avoid them going bankrupt.

Generally speaking, insurers had a much more positive credit crisis in this respect than banks, with public bailouts being concentrated in most countries nearly exclusively on banks. Insurance industry bodies commenting on such topics, e.g. the Geneva Association [add reference], have recently tended to explore differences in business models exhibited by insurers versus banks and then use the perceived difference in recent actual experience to confirm their views about the intrinsic differences between the two industries.

Sceptics, however, retort that this line of argument glosses over some important counter-examples most notably AIG. The US government bailed out AIG a day or two after allowing Lehman Brothers to fail. A possible conclusion to draw is that at the time the US government thought that AIG, an insurer, was *more* systemically than a large global investment bank. Moreover, mono-line credit insurers generally exhibited poor resilience during the crisis. There were also instances of financial conglomerates involving both banking and insurance subsidiaries that were previously viewed as mainly insurance focused but which switched to bank holding company status during the depths of the crisis, presumably in order to access Federal Reserve support being made available to banks.

Protagonists of the view that insurers inherently differ from banks (here, are intrinsically less systemically important than them) generally argue that these instances represent aberrant business models not followed by the generality of insurers. In their view it was the banking activities of such firms that were their undoing, overwhelming their ‘sound’ insurance components.

Perhaps the most important conclusion that can be drawn is that whilst *typical* characteristics of participants in particular industries may diverge materially, individual firms (particularly large ones) may exhibit a range of characteristics, some of which may be more banking-like and some more insurance-like irrespective of the formal classification of the firm as a whole. This view is supported by a recent EU consultation on regulation of shadow banking, see EU (2012). It proposes to include within its remit some types of insurers focusing on credit markets. It also seems to consider that the

regulatory changes being introduced by Solvency II should provide suitable regulatory oversight tools for such firms undertaking such activities.

3. Industry inter-linkages

A second starting point is to consider the apparent ways in which (typical) participants in different industries interact and to analyse their inter-linkages in an attempt to identify which industries and participants might be most exposed to or liable to create contagion effects.

Here there is general consensus that typical insurers differ materially from typical banks. For example:

- (a) Insurance liabilities generally arise from the sale of an insurance policy and are funded by the associated payment of premiums by policyholders. There is no separation of funding and lending as seen in banking.
- (b) Insurers' liabilities (perhaps ignoring some unit-linked liabilities, see below) are generally much less liquid than those of banks. They can normally only be liquidated by the cancellation or surrender of the insurance policy, often with the policyholder incurring a penalty to do so and potentially only receiving the proceeds after a material delay. For some types of insurance policy (e.g. annuities) even this option may not be practically available. This contrasts with, say, the liabilities created by retail banking call accounts which may be redeemable on demand by customers.
- (c) Inter-linkages between individual insurance companies, with the possible exception of reinsurance operations, are generally much less evident than for banks. For example, the highly developed interbank and wholesale funding markets, in which banks obtain funding in a variety of ways from other banks, have no clear analogues in the insurance industry. As a result, contagion mechanisms that might transmit a stress suffered by one firm to others (particularly others in a domino fashion) are much harder to postulate for insurers than for banks and historically have been much less evident.

However, it is again possible to come up with counterarguments. Insurers might typically be much less inter-linked with each other than banks are, but the industry might exhibit greater commonality or linkage when viewed as a whole. For example, most life insurers are implicitly or explicitly long the equity market. A severe enough decline in equity markets can therefore lead to widespread distress potentially leading to forced sales of equities further exacerbating the stress for everyone, i.e. with the stress being transmitted by a mechanism outside the industry itself. Some non-life insurance markets may share similar types of external linkages. For example, a severe enough Caribbean hurricane experience might create widespread distress for natural catastrophe insurers.

There may also be linkages in terms of capital suppliers, since large insurers and banks are both constituents of wider capital markets (and may be material investors in each other's equity or debt) and this creates further potential stress transmission mechanisms, e.g. via both industries building up exposures to sovereign debt, see e.g. Impavido et al (2011).

Of course, the banking industry is not itself immune from such transmission mechanisms. Many parts of it are implicitly or explicitly long residential and commercial real estate exposures. Banking crises (and, in intervening times, failures of individual banks) are often linked to weak real estate markets (the recent credit crisis being no exception, given its linkage to the US sub-prime market).

The lesser liquidity characteristics exhibited by many insurance products are also not necessarily shared by all of them. Unit-linked and/or some variable annuity products can often be surrendered essentially on demand by policyholders. Commonly they are invested in readily marketable securities (so they behave much like traditional asset management products) but examples invested in money market securities or money market funds form some of the insurance vehicle types that the EU appears to believe contribute to the shadow banking market.

4. Underlying role played by the industry

A third starting point is to explore what appears to be the underlying role of the industry (or its wider contribution to the financial services landscape). This gets to the heart of an aspect of the debate that most protagonists take for granted corresponds with their own perspective but rarely then check to ensure that this is so. This is the issue of what is the “system” which we might be considering to be relevant in the term “systemically important” and if there is more than one such system how important each one might be.

Here it is perhaps worth characterising money as having two overarching roles, see e.g. Kemp and Varnell (2010):

- (a) As a *medium of exchange*, allowing individuals, firms and others to exchange the fruits of one sort of labour with the output of another sort; and
- (b) As a *store of value*, allowing economic participants to shift consumption forwards and backwards in time.

The former is more strongly associated with banking. If you go into a grocery store to buy essentials to keep you alive then those on the checkout are likely to stare in disbelief if you try to pay by offering them a share in your life insurance policy! Some insurance products do in effect offer cheque facilities in some circumstances but usually the process involves transferring the policy proceeds into a banking environment (albeit one that might still be in the same group as the insurer highlighting the point made above that segmentation by industry is not absolute).

The latter is associated with a much wider range of firm types including (life) insurance. It is the essence of the savings market (and of capital markets more generally).

Governments are not indifferent to the sound functioning of money in a savings context, particularly if concerns relating to inflation and especially hyper-inflation come to the fore. However, during the credit crisis their worries were primarily about whether the money in people’s bank accounts would be practically accessible and whether confidence in the ability to use money as a medium of exchange might collapse. The “system” that was perceived to be at risk related to the element of money’s intrinsic economic role linked mainly to banking. No doubt mindful that political revolutions and the like often have an economic component, developed Western governments focused their interventions in ways aimed to bolster the soundness of money as a medium of exchange, and hence primarily targeted their support towards banks.

Property/casualty (i.e. non-life) insurance and the protection rather than the savings component of life insurance do not readily fit into such a formulation. This is because they relate to another “system”. At times their “system” might be systemically important, at least within a particular economy. For example, if an insurer has a dominant role in a particular non-life insurance market that is perceived to be highly important to the sound functioning of some part of an economy then the failure of such an insurer could have significant “real economy” implications. This might require

the government to step in and provide insurance-of-last-resort. For most non-life insurance lines it is debatable whether this would have a large public purse implication, as the government would presumably only need to provide coverage against future events, and should be able to arrange to receive a fair premium for doing so. However, for a small number of lines, most notably credit insurance (especially if it is being provided to components of the government itself) the analysis is less rosy. This was perhaps illustrated during the recent credit crisis by the impact on the US municipal bond market of challenges faced by credit insurers who had previously provided credit enhancement wraps to such bonds).

5. Governance disciplines

Having formed a view on whether a particular industry (or its participants) contributes to systemic risk, the debate moves on to explore how such exposures might be best managed and mitigated. At an individual firm level this is strongly related to governance and risk management disciplines promulgated by regulation and applied in practice, as well as to typical individual firm and employee behaviours in the presence of such risks. At a macro-prudential level it is also influenced by how feedbacks in overall financial services markets might operate, and how feedback mechanisms might be adjusted by suitable national and international interventions.

At an individual firm level lessons may be drawn from relevant best practice elsewhere within the overall financial services industry. An arguably important contributor to the relative resilience of insurers through the recent credit crisis was the professionalism and expertise of actuaries. Relevant (life) insurance regulatory frameworks in most jurisdictions place considerable reliance on a specific actuary or actuarial function. Arguably this introduced behavioural drivers that fostered more effective holistic and risk-sensitive management of insurers' finances. Such a model might usefully be applied elsewhere, as long as it is accompanied by suitable expertise in all aspects of a particular firm's operations. Mindful that there is as yet only a fragmented risk management professional landscape across the financial services industry more generally and mindful that many risk managers do not operate within clearly articulated professional structures, the worldwide actuarial profession has developed a credential, the Chartered Enterprise Risk Actuary (CERA) designation, that aims to make leading edge risk management expertise underpinned by a strong professional ethos more widely available both within and outside areas of the financial services industry in which actuaries are traditionally well represented. CERA qualified actuaries may be expected to be well versed in leading edge risk management disciplines applicable to a wide range of industry types, including banking, insurance and asset management and indeed with risk management disciplines prevailing outside the financial services sector.

At a more macro-prudential level, cross-industry expertise of the sort being fostered by initiatives like the CERA designation should over the longer term also prove valuable. The firms and activities that have most potential to surprise are arguably the ones that are currently most poorly understood or that create the most opaque inter-linkages.

6. Conclusions

Some leading insurance industry bodies have recently been arguing that insurance is inherently not systemically important. Whilst there is some substance to the arguments that such bodies propose, the reality is more nuanced.

Whilst most types of insurance may contribute less to systemic risk than most types of banking, both industry types in practice involve a wide range of activities some of which themselves create greater or lesser systemic exposures. Moreover, the notion that firms, particularly large conglomerates

involved in multiple business lines, can be easily characterised along monochromatic lines is itself unrealistic.

Over the longer term, tackling this complexity effectively will require relevant individuals within firms and regulators to have broad knowledge and expertise across the entire financial services arena framed within a strong professional ethos and structure. Some professional bodies, e.g. the worldwide actuarial profession, have created specific programmes designed to enhance the supply of individuals who exhibit these characteristics.

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Postscript

On 31 May 2012, the International Association of Insurance Supervisors (IAIS) released its proposed assessment methodology for the identification of global systemically important insurers, or G-SIIs. The IAIS' proposed assessment methodology includes 18 indicators under 5 categories: size, global activity, interconnectedness, non-traditional insurance and non-insurance activities, and substitutability.