New Regulations Should Differentiate Between Banks and Insurers

Insurers have significantly less run-risk compared to banks

Insurers are more sustainable than banks in the face of a run or crisis, according to BGOV's Christopher Payne.

"As the financial crisis showed, solvency issues for banks are of utmost importance given that solvency concerns can set off a run on various sources of funding. Not only is such a run unlikely with an insurer, but factors that lead to the fall in value on the asset side (say, a rise in interest rates) are also likely to lead to an offsetting fall in the value of liabilities. There is, in essence, a natural hedge in the balance sheet of an insurer."

Chris Payne, "Big 3 Insurers Face Tougher Regulation Under Dodd-Frank Law," *Bloomberg Government*, 2/27/13

Run-risk is further mitigated by penalties for withdrawals and insurance guarantee funds.

"Because insurers are not funded by withdrawable deposits, such redemption risk is not relevant in the insurance industry. While there is a theoretical possibility that policy cancellations result in a cash drain for individual life insurers, such policy cancellations are usually financially unattractive for policyholders who in many jurisdictions are in any case protected through an insurance guarantee fund."

Marian Bell and Benno Keller, "Insurance and stability: The reform of insurance regulation," *Zurich*

Insurers face uncorrelated, exogenous risks, unlike banks

Brookings' Doug Elliott argues the big risk for insurers is on the claims side, which has little correlation with financial crises.

"However, the nature of traditional property/casualty insurance creates little risk for the financial system as a whole. The investments of these firms tend to be very conservative and liquid, since they could be needed quickly in the event of a natural catastrophe. As a result, the big risks to these insurers are on the claims side, which has little correlation with financial crises."

Douglas J. Elliott, "Regulating Systemically Important Financial Institutions That Are Not Banks," *Brookings*, 5/9/13

Insurers face uncorrelated, exogenous risks such as natural hazards, not correlated financial risks like banks, according to Oliver Wyman report.

"Risk pooling works best for exogenous insurance risks which are largely uncorrelated, such as natural hazards, fire, and individual mortality… In contrast to certain insurance risks, many of the financial risks assumed by banks may be correlated, in which case the risk pooling effect is dampened."

"The Implications Of Financial Regulatory Reform For The Insurance Industry," *Oliver Wyman*, 8/11

Systemic panics generally involve exogenous and endogenous shocks, not just an exogenous shock insurers face, according to Plantin and Rochet.

"…there are not many examples of purely exogenous shocks bringing down the financial system. Harmful systemic risks, such as stock market crashes or bank panics, generally involve both an exogenous shock and an endogenous response of the financial system that amplify each other."

Guillaume Plantin and Jean-Charles Rochet, "When Insurers Go Bust," *Princeton*, 07

Insurers do not suffer from lack of substitutability

The insurance market "does not suffer from lack of substitutability" argues Temple University's David Cummins and Mary Weiss.

"For an activity to pose a systemic threat due to lack of substitutability, it is necessary not only that the activity not have substitutes but also that it is critical to the functioning of the economy. Banks pose substitutability problems because of their role in the payment and settlement systems, in transmitting central bank monetary policy, and in providing a critical source of liquidity and financing for consumers and businesses. Although insurance plays an important role in the economy, it does not suffer from lack of substitutability to the same extent as banking."

J. David Cummins and Mary A. Weiss, "Systemic Risk And The U.S. Insurance Sector," 07/11/07

Conclusion: Banks and insurers should face different regulations

Because insurers are different from banks, costly regulations like those faced by banks are "inappropriate," according to Payne.

"Making insurers subject to the same kinds of prudential regulations as banks is inappropriate and unnecessarily costly for the insurers who may also be required to comply with any special SIFI rules to be written for nonbanking institutions."

Chris Payne, "Big 3 Insurers Face Tougher Regulation Under Dodd-Frank Law," *Bloomberg Government*, 2/27/13

Elliott asserts insurers and non-banks are fundamentally different than banking institutions and should be regulated accordingly.

"The key message of this paper, however, is that non-banks are not just funny looking banks, but operate in truly different industries, providing different services, and facing a different balance of risks and opportunities than do banks."

Douglas J. Elliott, "Regulating Systemically Important Financial Institutions That Are Not Banks," *Brookings*, 5/9/13

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