Insight Briefing

Why insurers differ from banks

Insurers and banks need their own specific regulation that reflects the differences between the two industries.

In response to the financial crisis a large number of national, regional and global reforms have been introduced to address problems in the banking sector. This work to ensure stability in the financial markets is fully supported by the insurance industry.

A worrying trend has, however, emerged.

Several regulatory initiatives directed at the banking business have been applied to other financial industries, such as insurance, without taking into account the significant differences between them.

This is because the financial sector in Europe is often, incorrectly, perceived to be one single intertwined industry. This leads to the equally flawed assumption that banking regulation can be used as a blueprint for insurance regulation.

There are, however, many differences between the two industries which require their own specific regulation.

They have different business models and roles in the economy

Insurers and banks have significantly different business models and play very different roles in the economy.

The core activity of insurers and reinsurers is risk pooling and risk transformation. Insurers make an important contribution to economic growth by providing individuals and businesses with protection against negative events.

Banks' core activities are the collection of deposits and the issuing of loans, together with the provision of a variety of fee-based services.

Banks are also part of the payment and settlement system and — through their role as credit providers — they are the main transmission channel of central banks' monetary policy.

They have different balance sheet structures

As a consequence of their activities, the balance sheet of insurers is economically stable, as fairly long-term policyholder liabilities are matched with assets of corresponding duration.

In the case of banks, which engage in maturity transformation, assets and liabilities are not matched, and the average duration of most bank assets is generally longer than the average duration of their liabilities.

They have different risk exposures

The risk profiles of insurance companies and banks are also very different.

Insurance companies are mainly exposed to underwriting risk, market risk and the risk of mismatch between assets and liabilities, whereas the most significant risks that banks are exposed to are credit risk, liquidity risk and market risk. Importantly, the risks faced by an insurer depend on both assets and liabilities and on the way these two interact.

In the case of banks, assets and liabilities are very loosely interrelated, as they are generated by different lines of business.

Difference in systemic risk potential in case of failure

A bank's business model relies on complex interconnections with the rest of the financial system through interbank lending (when a bank takes out short-term loans from other banks to cover their liquidity needs, or makes a short-term loan to another bank) and through financial markets. In addition, in banking, the central bank has a role to play as "lender of last resort". As a result, there is a high degree of interconnectedness not only between banks, but also between banks and central banks.

The larger a bank is, the more interconnected and therefore systemically risky it becomes, since its failure would create a domino effect which could seriously impair the functioning of the entire system and generate shockwaves which could be detrimental to the financial health of sovereigns.

In contrast, insurance companies are generally more financially stable the larger they get, as the correlation between the risks faced by policyholders decreases with the total number of risks insured. Underwriting risks are also generally not correlated with other financial risks.

Furthermore, interconnectedness in insurance and reinsurance is significantly different from banking. Insurance obligations, unlike short-term bank obligations, are not very liquid and settle over a long period of time.

Consequently, insurance companies have very limited short-term funding requirements and do not need to establish balance sheet links with other counterparts through short-term loans. Actually, there are generally no close business relationships between competing insurers. The fact that there is also no "central insurer" similar to a central bank makes it difficult to argue that an "insurance system" even exists.

All these features of insurance drastically limit the risk of contagion in the case of a single insurer's failure. And, even if they occur, financial problems develop at a much slower pace in insurance than in banking so that — should an insurer run into trouble — an orderly wind-up is much easier.

This is due to the fact that insurers strive to match expected future claims by policyholders with sufficient assets; this facilitates the transfer or run-off of their portfolios. The services that support insurance activities are readily substitutable in the market, with portfolios being easily transferable to alternate providers.

Regulations need to reflect these differences

Insurance Europe has repeatedly been faced with over-simplifications on the part of some policymakers and governmental institutions, which too often seem to believe that banks and insurers are alike and that they should, therefore, be subjected to similar regulations.

In fact, applying banking-inspired regulatory frameworks to insurers would have a material negative impact on the sector and the whole economy.

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Going into more detail

In order to better inform policymakers about the important differences between insurers and banks, Insurance Europe has published a detailed study called "Why insurers differ from banks".

The report is organised into two sections:

Section I provides an overview of how banks and insurers differ, including comparisons of their business models and key activities. Particular attention is given to the different risks banks and insurers face and to the implications of these differences, both for the companies themselves and the wider financial system.

Section II outlines the need for effective regulation for insurers. This is done through a series of questions which are asked and then answered; the questions address a number of topics and issues which often come up in discussions about regulatory developments. For every question, both a short and a long answer are provided.

The study is available for download from Insurance Europe's website: www.insuranceeurope.eu