BIPARTISAN POLICY CENTER

The Business of Insurance and Banking

Understanding Two Different Industries

Introduction

Immediately after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), conventional wisdom held that insurers mostly escaped the legislation. Five years later, it is clear that is not the case. The Federal Reserve now plays a significant role in regulating and supervising roughly one-third of the life insurance industry and one-quarter of the property and casualty insurance (P&C) industry. In addition, the Federal Deposit Insurance Corporation (FDIC) now has resolution authority over many insurance companies, and the U.S. Treasury Department has a new Federal Insurance Office (FIO) that may soon activate its authority to negotiate international insurance agreements.

The business of insurance is fundamentally different from the business of banking. Each has its own specific models and practices, risk profiles, risk-management strategies, and regulatory regimes. Each has a different balance sheet, revenue stream, and customer value proposition. Insurers and banks run into financial trouble for very different reasons and the regulatory approaches to managing troubled insurers and banks are markedly different.

This paper describes the differences between insurance and banking. It examines and compares key aspects of both industries: size, business models, distribution channels, regulatory oversight, safety and soundness, consumer protection, reasons for failure, resolution, and systemic risk.

Among the Financial Regulatory Reform Initiative's core observations are:

- The differences between banks and insurance companies are greater than their similarities;
- Policymakers and regulators need to fully recognize and understand these differences and act accordingly; and
- As federal regulators take on roles in overseeing a significant part of the insurance industry, they should be careful to tailor their regulation and supervision of insurance companies to the ways these companies differ from banks.

If these three propositions sound simple, that’s the point.

SIZE OF THE *industry*

Banks

Insurance

BANKS & THRIFTS

LIFE *and* PROPERTY & CASUALTY

$15.8 TRILLION

IN ***assets***

$1.3 TRILLION

premiums COLLECTED

$7.3 TRILLION

IN ***assets***

The size of insurance companies are generally measured by the premiums they receive from policyholders, while banks and thrifts often are measured by total assets.

As of mid-2015, the United States was home to over 6,300 banks and thrifts (or savings and loans), which held more than $15.8 trillion in assets. In addition, there were just under 6,200 credit unions with total assets of over $1.1 trillion.

There were approximately 850 life insurance companies doing business in the United States in 2014, and another roughly 2,600 P&C insurers in 2013. In 2013, life insurers collected about $740 billion in premiums (without adjusting for reinsurance premiums), while P&C companies collected approximately $570 billion. Together, life and P&C insurers held about $7.3 trillion in assets, just less than half of the value of assets held by banks and thrifts.

BUSINESS *models*

Banks

diversify

Insurance

aggregate

Both banks and insurers encourage savings and promote economic growth, but they do so in different ways—and make fundamentally different promises to their customers. Insurers manage risk by aggregating it and by matching the duration of their assets and liabilities. Banks manage risk through diversification to avoid too much exposure to any one set of risk factors.

Banks play a valuable economic and social role as financial intermediaries, connecting savers looking to safeguard their money with borrowers looking to invest or spend. Banks help depositors easily access funds, build wealth, save for retirement, and more. Banks provide credit to borrowers to buy homes, automobiles, or to build and expand businesses. Banks do this primarily through maturity transformation, the process by which banks take relatively short-term funds from depositors and creditors and transform them into assets by lending on a relatively long-term basis. The deposits received by banks are accounted for as liabilities and, generally, can be immediately accessed by the depositors. When a bank makes a loan, that is an asset to the bank—it is a promise by the borrower to pay the bank money in the future (including interest on the loan and repayment of the principal).

Insurance provides social and economic value by helping individuals and businesses reduce their exposure to risks. A policyholder pays premiums to an insurance company in exchange for a promise by the insurer to pay for a future loss covered by the policy. Policyholders get nothing tangible for their premium payments, only a contract setting forth the insurer's promise to pay in the future if a covered loss occurs during the policy period. Insurers count these policy obligations as liabilities on their balance sheets.

Policyholders reduce their own risk by shifting it to insurers. Paradoxically, insurers better manage their own risk by taking on more policyholders, so long as the risks of those policies are diversified and properly underwritten. This win-win situation is made possible by the law of large numbers, which allows insurers to pool risks from their policyholders, spreading their liability for losses over a diverse group of customers.

Banks

Banks mitigate credit risk (the risk that borrowers will default on loans) by requiring collateral to back the loans, carefully underwriting loans, and lending to a diverse set of borrowers. When making commercial loans, banks are limited through regulation with respect to how much they can lend to any one borrower and to any one class or industry segment of borrower. Bank regulators watch for over-concentrations in risk, such as having too many loans in commercial real estate.

Banks earn profit on the "spread" (difference) between what they pay to consumers for their deposits and other sources of funding, and the interest rates they charge to their borrowers. In addition to making loans, banks are permitted to invest in certain instruments, such as government bonds, providing another source of income.

"Insurance provides social and economic value by helping individuals and businesses reduce their exposure to risks."

Insurance

Insurance companies underwrite, or evaluate, individual risks to determine what premiums to charge to offset the risks they are insuring. While one might expect that insurers would want to offer as much coverage as a customer would be willing to buy, that is not always the case. For example, providing $1 million in insurance coverage on a building worth $250,000 would create a "moral hazard" incentive to destroy the property to collect the insurance proceeds, or to neglect safety measures at the least.

Underwriters are also concerned about "adverse selection," the idea that people facing the most risk are the ones who will most want to purchase insurance. People tend to wait until they need coverage to actually buy it–to someone whose house is in the path of a looming hurricane, getting property insurance suddenly seems like a much better idea.

The premiums collected by insurance companies are designed to pay expected claims, the costs of paying those claims, and cover business expenses. The bulk of the profits for most insurers comes from earnings on investments purchased with premiums. One can think of this as earning money on the "float" or the interest income earned during the time between when premiums are collected and claims are paid. These investment assets, which must comply with state laws and regulations, can vary considerably depending on the type of insurance they support. Regulators require life insurance companies to certify that they have appropriate matches between the timing of their assets and liabilities. Since life insurance liabilities can last for decades (because people can live for a long time), life insurers generally invest in longer-term assets, such as long-term government and corporate bonds, or long-lasting alternative assets, such as real estate.

The investment strategies of P&C companies are generally shorter in duration. For example, a typical crop insurance policy lasts through a growing season, a matter of months. If there is no covered event from the time the policy is issued until the crops are harvested, the company has no liability for future claims. As a result, the investments backing crop insurance policies tend to be liquid with a short duration.

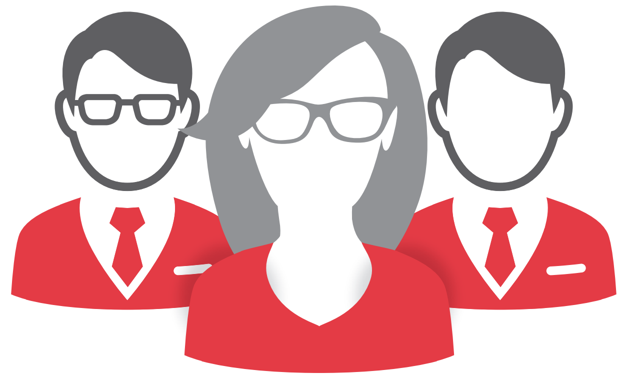
"Policyholders reduce their own risk by shifting it to insurers. Paradoxically, insurers better manage their own risk by taking on more policyholder risk."

Other lines of business, such as medical malpractice and workers' compensation, can have claims that last for years or decades, even after the original policy has expired. Naturally, the investments supporting these "long-tail" policies will have longer maturities than those backing shorter-tail policies. Investments made by insurers provide a critical source of funding for a variety of economic activities. Insurance companies invest in bonds that allow businesses to hire and expand, in apartment buildings and office complexes in which people live and work, and even in municipal debt that finances infrastructure projects for cities, counties, and states throughout the country.

DISTRIBUTION *channels*

Banks

Insurance



Banks and insurers reach consumers in different ways. Insurers rely upon agents and brokers to sell policies. Banks primarily use branches and ATMs to interact with their customers.

Traditional banks tend to sell a uniform set of financial products, ranging from basic checking and savings accounts to lending products such as credit cards, mortgages, and personal and business loans. In general, these products are sold directly by employees of the bank. However, sometimes banks act as agents for other institutions or use agents to sell their own products and services. Banks may be chartered at either the federal or state level but, unlike insurance companies, their employees do not have to be individually licensed to sell or service their banking products.

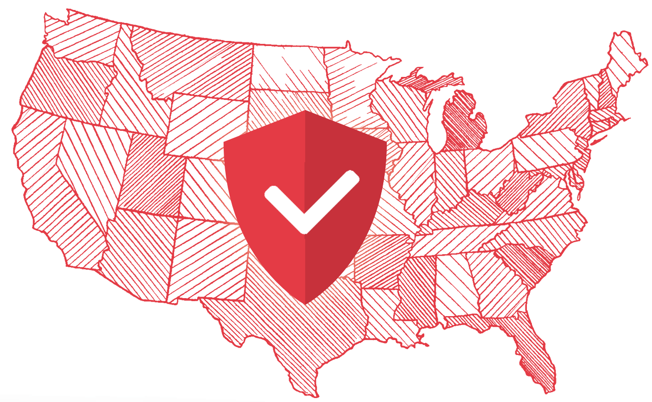
An old insurance adage is that life insurance products are sold, not bought. The insurance industry has traditionally relied on tens of thousands of brokers and agents to establish relationships with families and businesses, identify their needs, and help them choose the best insurance products. Some agents work exclusively for one insurance company, while "independent agents" sell products from multiple companies. Insurance agents and brokers must hold an appropriate license for each line of insurance they sell in each state in which they solicit policies. For the most part, this is also true for the employees of direct writers— companies that use employees rather than agents to sell and service their insurance products.

Some insurance products are required by the government or by lenders to be purchased. For example, many states require auto insurance to drive, and mortgage lenders require property insurance to cover their mortgage loans.

REGULATORY *oversight*

Banks

Insurance



safety & soundness

Prior to the passage of the Dodd-Frank Act, insurance was regulated by the states. Dodd-Frank gave the federal government a new role in regulating the insurance industry. All banks are regulated to one degree or another by the federal government.

The United States has a dual-banking system that combines state and federal regulation. The primary regulator of nationally chartered banks is the Office of the Comptroller of the Currency. State-chartered banks are primarily regulated by the state in which they are chartered and have secondary regulation by either the Federal Reserve (Fed) or the FDIC, depending on whether each bank chooses to belong to the Federal Reserve System. All banks and thrifts are subject to federal regulation. Banks and thrifts are usually organized in holding companies, and those holding companies are regulated by the Fed.

For decades after the Depression, interest rates paid by banks to depositors were regulated. This regulation was phased out in the 1980s. Today, bank regulators do not subject banks to rate regulation, although some states have usury laws that cap certain lending interest rates.

Insurance has a long history of state-based oversight that continues today. Under this state-based system, an insurer's state of domicile plays the principal role in regulating its financial condition. While the other states in which a company is authorized to conduct business also have regulatory authority, they generally defer to the home state as long as they have confidence that the oversight of the state of domicile is active and effective. Each state monitors and regulates the business operations of companies operating there. State authorities perform periodic, as well as targeted, examinations of companies' market practices. They approve policy forms and, to one extent or another, they regulate the rates a company may charge for its products. In fact, a number of states require P&C insurers to obtain regulatory approval of the rates they want to charge before the insurers can begin charging those rates.

Banks

"All banks and thrifts are subject to federal regulation. Banks and thrifts are usually organized in holding companies, and those holding companies are regulated by the Federal Reserve."

Insurance

Although states remain the primary regulator of the insurance industry, the Dodd-Frank Act gave the federal government a new role in regulating the industry through a series of measures that have granted the Federal Reserve Board authority to regulate a range of insurance companies.

As a result of the Dodd-Frank Act, the Fed now oversees thrift holding companies (THCs) that include an insurance company. Fourteen insurers are part of THCs and thus are subject to consolidated or company-wide supervision by the Fed. Dodd-Frank also created and empowered the Financial Stability Oversight Council to designate nonbank financial institutions, including insurers, as systemically important financial institutions (SIFIs). SIFIs are subject to examination, supervision, and regulation by the Federal Reserve. Three of the four companies designated as SIFIs have been insurance companies: AIG, Prudential, and MetLife. Between THCs with insurers and insurer-designated SIFIs, the Fed now supervises and regulates about one-third of the life insurance industry and one-quarter of the P&C industry, when measured by premiums. All such companies still face regulation by the states.

Banks

Insurance

consumer protection

In the business of insurance, consumer protection is conducted by the states and focuses on marketing practices and rates. In banking, consumer protection is conducted at the state and federal levels and focuses on applying rules and regulations.

Banks are subject to consumer protection by both state and federal regulators. State bank regulators enforce state laws, which can in certain cases be preempted by the Office of the Comptroller of the Currency for nationally chartered banks. Federal consumer protection is largely handled by the Consumer Financial Protection Bureau (CFPB). Dodd-Frank created the CFPB and gave it direct regulatory authority over all banks and credit unions with assets in excess of $10 billion. Even though the bureau does not have direct supervisory authority over banks with less than $10 billion in assets, these institutions must also comply with the CFPB's rules and guidance, and with compliance enforced by their primary federal regulator.

State insurance departments respond to customer complaints. Although each state has different priorities, consumer protection generally focuses on the rates charged to consumers and the insurance coverage provided, disputes regarding claim payments, and unfair trade practices.

All states have adopted market-conduct standards for insurance companies operating within their borders. Among other things, those standards prohibit insurers from engaging in unfair or deceptive acts or practices, and require insurers to follow claims settlement standards. States also enforce rating restrictions for certain lines of insurance, primarily personal auto and other forms of P&C insurance. The oversight of insurance company rates ranges from requiring prior approval from the state regulator to allowing insurers to charge rates based on market conditions. Dodd-Frank generally bars the CFPB from regulating insurance products.

REASONS FOR *failure*

Banks

Insurance

Banks can be subject to runs by depositors or creditors. Bank deposits can be withdrawn at virtually any time, and short-term debt can be called or not rolled over—meaning that bank funding can disappear relatively quickly. Bank loans generally have longer durations. Insurance companies often fail either because they have made bad investments or have misjudged actual risk in what they are insuring and, in turn, set the wrong prices or terms for their policies.

A bank can fail when its principal assets—loans—are not paid back and its total assets become worth less than its liabilities. This can occur because a bank has mispriced its risk (poor loan underwriting) or from an economic shock that affects the ability of many borrowers to repay. Banks can also run into problems because their liabilities—deposit accounts—can "run," or ask to immediately withdraw their funds, leaving banks with illiquid assets (like loans) that cannot easily and immediately be turned into cash to pay depositors.

During the recent financial crisis, some commercial banks such as Wachovia and IndyMac experienced runs, ultimately leading to their collapse. Other investment banks (those engaged primarily in the business of underwriting securities) such as Lehman Brothers and Bear Stearns failed when counterparties either withdrew their funds or refused to roll over short-term lending.

An old industry adage that generally holds true is that life insurers get into trouble on the asset side of their balance sheets, while the liability side of the balance sheet poses the greatest threat to P&C companies.

Life insurers face a complicated task in matching the duration of their investment assets with the duration of their expected liabilities while maintaining enough liquidity to cover operating expenses and pay current claims and policy benefits. In the past, poor investment decisions, including a failure to adequately diversify invested assets, have led to financial problems for certain life insurers. Rarely have liabilities contributed to the insolvencies of life insurers. One of the few times a "run" or near run impacted a life insurer was in the

Banks

No bank could survive a run in which a sizeable fraction of its customers asked for their deposits back at the same time. The advent of deposit insurance in the 1930s largely removed the possibility of a sudden evaporation of consumer confidence that causes "bank runs" to spread from institution to institution and turn into systemic risk. Even so, banks fail when they take losses on loans, and when investors providing their funding—in particular large, uninsured depositors—lose confidence.

Insurance

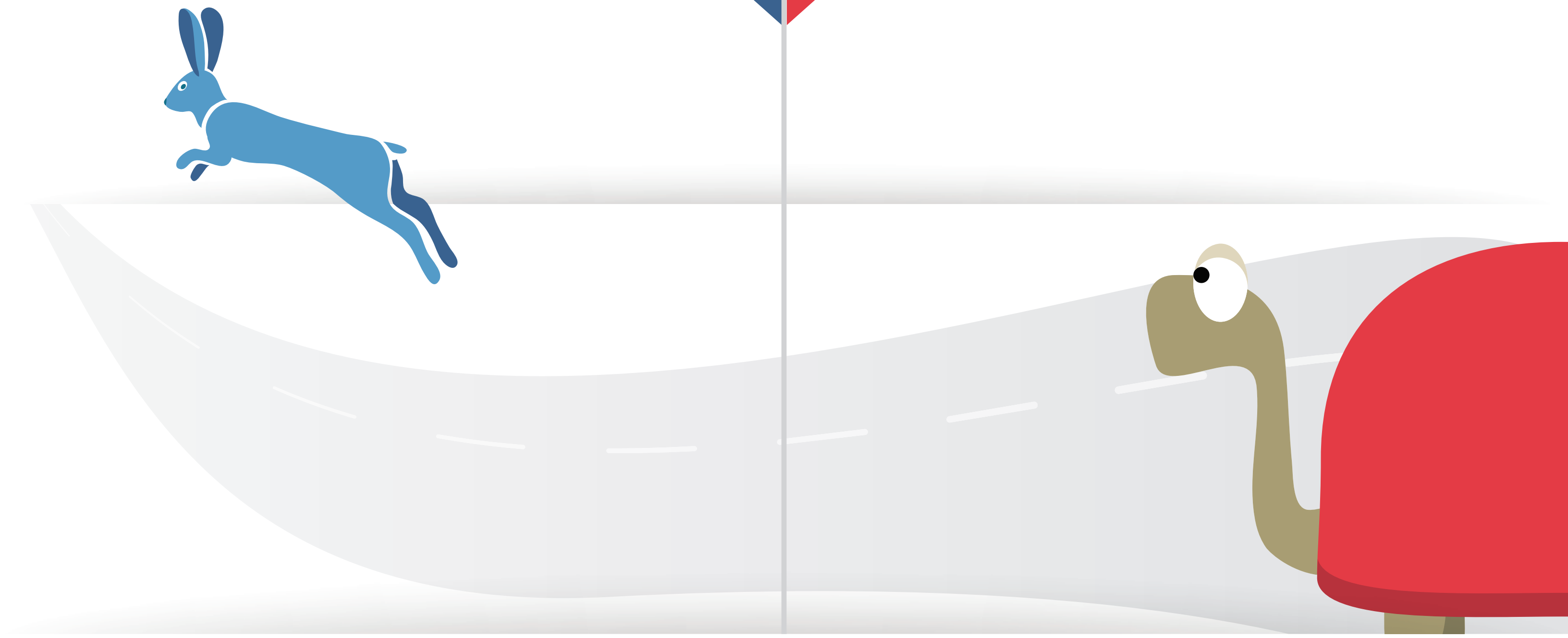
early 1990s, when a large eastern life insurer was subjected to a run that led to its ultimate insolvency. However, this run was triggered by the nontraditional contracts it had issued to large institutional investors. These contracts were similar to bank certificates of deposit. As institutional investors moved their money to investments offering higher rates of return, the publicity associated with these massive withdrawals led ordinary consumers to lose confidence in the company, which ultimately led to its insolvency.

P&C insurers generally get into trouble when they incorrectly estimate risk. One of the lessons of Hurricane Andrew was that many property insurers were not paying adequate attention to the specific geographic location or the amounts of their hurricane exposures. Realizing this led to the widespread use of modeling to estimate an insurer's probable maximum loss due to catastrophes. It is hoped that this will significantly moderate property insurers' exposure to future insolvency stemming from similar catastrophes.

Because insurance claims are paid out over time and most policies (annuities and whole life insurance excepted) have finite, relatively short policy periods (typically a year or less for most P&C products), insurance company insolvencies can be managed in an orderly fashion.

RESOLUTION *process*

Banks | **Insurance**



The failure of an insurance company is typically a slow process, which takes years or decades to resolve. Bank failures are usually resolved in a matter of days. Insurance policyholders are covered by state-based guarantee funds and associations that are funded ex-post (after insolvencies occur). Bank depositors are covered by a national fund, which is funded ex-ante (before insolvencies occur).

When a bank is near collapse, supervisors from the FDIC join with the bank's primary regulator to sell or close the bank. The FDIC shuts down most banks after the close of business on a Friday night and reopens it the following Monday morning after being acquired by another bank or under a new company managed by the FDIC. For customers, the resolution is mostly a non-event, with depositors having full and often immediate access to their funds up to the insurance coverage limit of $250,000 per account, a level Congress set for all depositors. Bank failures are governed by banking laws that empower the FDIC to act swiftly to minimize potential costs to the FDIC insurance fund. Speedy resolution of a failing bank helps ensure that depositors do not flee, preserving the franchise value of the bank and maintaining stability of the broader banking system.

There is no national process for handling bankruptcies of insurance companies. That responsibility falls to the regulator in the state in which the insurance company is domiciled, acting pursuant to the order of a court in the same state. Once an insurer's insolvency is declared by the court, claims and other policy liabilities are referred to state guaranty mechanisms: guaranty funds for P&C policies and guaranty associations for life policies and annuities. The limits of protection offered by these mechanisms vary based on each state's laws. Nevertheless, even after a court finds an insurance company is insolvent and refers the insurer to the guaranty mechanisms, a complete wind-up of the affairs of an insurance company can take years—even decades—since many of the claims and other policy obligations take that long to be triggered.

Banks

The FDIC's Deposit Insurance Fund (DIF), which guarantees deposit accounts, is pre-funded through assessments on banks. As of the first quarter of 2015, the DIF had $65.3 billion in assets to cover deposit liabilities of $11.8 trillion.
If more funds are needed, the FDIC can borrow from the U.S. Department of the Treasury and then repay the loan from future premiums. Deposits above the FDIC-insured limit have the possibility to receive more of their funds in a process administered by the FDIC.

"Speedy resolution of a failing bank helps ensure that depositors do not flee, preserving the franchise value of the bank and maintaining stability of the broader banking system."

Insurance

State guaranty mechanisms are typically private, nonprofit entities. Following insolvencies, they assess other healthy insurers in their states to pay the insolvent insurer's unpaid policy obligations in each state where the insolvent company operated. Each healthy insurer is assessed a percentage of the total assessment (which can be stretched out over time, as can be the payment of unpaid claims) based on the percentage of the total premiums each writes in a state.

Congress gave the FDIC new resolution authority under Dodd-Frank to resolve SIFIs. Since most nonbank SIFIs are insurance companies, the FDIC has the authority to potentially resolve insurers, although Dodd-Frank gives clear precedence to state regulators to handle this process.

SYSTEMIC *risk*

Banks | *Insurance*

There is a debate as to whether the traditional business of insurance can even pose systemic risk. Within that debate, there is general agreement that P&C insurance is unlikely to be systemically risky. There is broad agreement that certain banks are systemically important. The factors that may pose systemic risk for insurance companies are structurally different from those that exist for banks, involving different problems on the asset and liability sides of their balance sheets.

Banks are inherently interconnected, as banks lend to each other and are exposed to each other's balance sheets. Due to the nature of fractional reserve banking and maturity transformation, banks have historically faced substantial risk of not having enough liquidity to cover their obligations. The Federal Reserve and other central banks exist in part to provide backstop liquidity to banks in the case of market failures. Because they are so interconnected, a problem at one bank or a group of banks can be readily transmitted to other banks or other financial institutions, with exposure to the troubled bank(s). This happened during the financial crisis when the value of home prices suddenly dropped, leading to defaults on mortgages and a loss of market confidence and resulting panic. Banks were forced to sell off their mortgage-based assets at fire-sale prices to meet capital requirements. Many other banks and financial institutions also held similar assets on their balance sheets, and the resulting sell-off devalued the asset side of their balance sheets as well.

Banks must mitigate liquidity risk, or the risk that depositors demand their money back at the same time—that is, a bank run. Over the years, the United States has put in place safeguards to avoid bank runs and to reduce the impact of bank failures on the nation's economy. (Though the financial crisis showed that enough bank failures will have an impact.) Bank depositors with federal insurance bolster consumer confidence in individual banks and the banking system as a whole. Banks can access the Federal Reserve's discount window if they are solvent but face liquidity pressures. Nonetheless, regulators closely monitor the financial condition of banks to make certain (or as certain as possible) that they will be able to meet depositor demands.

The question of whether the business of insurance is, or individual insurance companies are, systemically risky continues to be the subject of debate. The core activities of P&C insurers are unlikely to present systemic risk because these insurers only pay out claims when an insurable event occurs. For this reason, they are not as susceptible to economic shocks the way banks are.

Life insurance is the subject of somewhat greater debate. Most experts agree that whatever systemic risks life insurance annuity contracts may pose, these risks are much less likely than those posed by banks, in part because the assets of life insurers are largely marketable securities in contrast to the dominant asset of banks: loans, which are less liquid. However, some have argued that a large enough combination of insurance companies could produce systemic risk if they had to sell their assets in a fire sale during a crisis period. Insurance regulators are much more concerned about the ability of insurers to fulfill their long-term promises than they are about runs on the companies.

Core life insurance policies do not entail the risk of "runs" that are inherent in banking. One type of traditional insurance policy that could be viewed to have a "run" component is cash value whole life insurance. Policyholders can surrender these policies and receive the surrender values in cash. However, the terms of insurance contracts usually provide companies the right to defer payment for a period of months (six months is typical). This allows insurers to mitigate the threat of a run by spreading out payments over time. Historically, there have been few

"The Federal Reserve and other central banks exist in part to provide backstop liquidity to banks in the case of market failures."

examples of mass redemptions of these policies, even during the recent financial crisis or the Great Depression. Insurers are not interconnected the way banks are. Whereas one or more bank failures can spread a contagious panic throughout the banking system, among creditors, there is no comparable "insurance system" to spread panic. On the contrary, other insurance companies are generally eager to take on the policyholders of a failed company as new customers.

Insurance companies, however, can be systemically risky if they offer certain kinds of nontraditional products and services. AIG's Financial Products division, for example, drastically underestimated its risk in selling credit default swaps—in effect, insurance against the default of a bond—and, in the process, exposed AIG as a whole to financial losses that threatened to inflict massive damage on financial markets without the federal bailout that instead followed. Other products that offer financial guarantees, or activities like lending out securities to enhance investment yields ("sec lending"), may present risks that traditional insurance products and activities do not.

Conclusion

Banks and insurance companies are different. They have different business models, risks, and implications for the financial system and broader economy. Therefore, it makes sense for the regulation of banks and insurance companies to differ as well. With federal regulators becoming increasingly involved in the supervision and regulation of the insurance industry, it is important to tailor the regulation and supervision of insurance companies to the circumstances of these businesses.

About the Insurance Task Force

The Insurance Task Force is part of BPC's Financial Regulatory Reform Initiative, which was created to assess the Dodd-Frank Act and recommend practical policy solutions to improve it. The task force is co-chaired by Republican William H. McCartney, former president of the National Association of Insurance Commissioners and Nebraska state insurance director, and Democrat Robert E. Litan, longtime regulatory policy scholar and former Clinton administration official. Through stakeholder engagement and in-depth analysis, the task force is examining the changing structure of insurance regulation as a result of Dodd-Frank, both within the United States and internationally, and recommending policy reforms that promote effective and efficient regulation for the 21st century. The task force plans to release a series of mini-papers on current topics in insurance regulation, along with a final report of recommendations in 2016.

BIPARTISAN POLICY CENTER

Founded in 2007 by former Senate Majority Leaders Howard Baker, Tom Daschle, Bob Dole, and George Mitchell, the Bipartisan Policy Center (BPC) is a non-profit organization that drives principled solutions through rigorous analysis, reasoned negotiation, and respectful dialogue. With projects in multiple issue areas, BPC combines politically balanced policymaking with strong, proactive advocacy and outreach.

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