

Will banking and insurance
business models converge?

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- Commercial banks and insurance companies have two central features in common:
 1. *They have a very long production cycle. They enter into long-term contracts with their customers.*
 2. *The main part of their large balance sheets is comprised of debt-like claims vis-à-vis their customers.*
- The ways banks and insurance companies deal with these large quantities of illiquid, informationally complex assets and liabilities **have massively diverged over the last 25 years.**

- Banks have constantly expanded the business lines for which they adopt the “**originate-and-distribute model**”.

\$3 trillion of outstanding ABS/CDO (2004, Group of Thirty).

Note: I find it unlikely that the current credit crunch will permanently revert this trend.

- By contrast, insurance companies are still by and large “**risk warehouses**”.

(\$10 billion of insurance securitization, 2004, Group of Thirty)

\$ trillion question for insurers and investment bankers:

- *Is this divergence a historical accident, and insurance will catch up?*

or

- *Insurance fundamentals are different, “originating-and-distributing” will always have higher costs and/or smaller benefits for insurers than for bankers?*

Insurance will catch up if the costs of warehousing risks become larger than the costs of securitization

Costs of **not** securitizing

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Costs of securitizing

- ✓ Evolution of **prudential rules**
- ✓ Evolution of **accounting standards**

- ✓ Evolution of **liquidity premia** on insurance-linked securities

Costs of **not** securitizing

1. Prudential Regulation

Ongoing regulatory reforms should imply that capital requirements be more in line with market assessment of risks. This should *reduce* securitization due to regulatory arbitrage in the *short run*, but *spur* securitization for genuine risk management reasons in the *long run*.

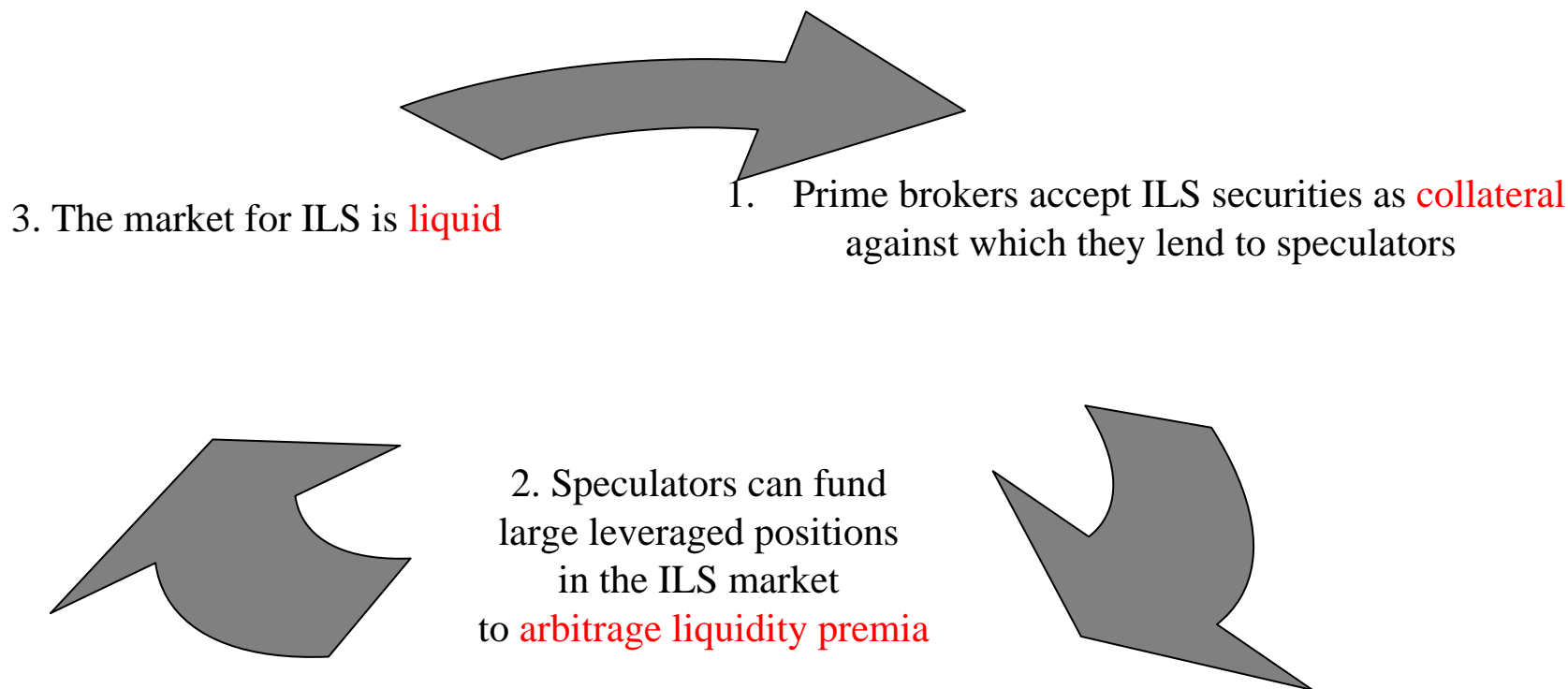
2. Accounting Standards

Marking banks assets to market has played a role in the current credit crunch by amplifying “booms and busts” in CDO markets.

Similarly, marking illiquid items such as pools of insurance liabilities to market might create **endogenous volatility** in insurance balance sheets, thereby making warehousing risks more costly.

Costs of securitizing: Liquidity premia

Insurers pay generous liquidity premia on ILS. To shift to a more liquid market equilibrium, the following **chain reaction** needs to be triggered:



This chain reaction, whereby **market liquidity** and **funding liquidity** reinforce each other, is what lead to a liquid subprime market (pre August 2007...)

Conclusion

1. The opportunity costs of warehousing risks are likely to rise for insurance companies. **This should spur insurance securitization.**
2. Whether this will lead to a massive development of insurance securitization depends on markets ability to **shift to a “liquid” equilibrium for insurance-linked securities.**
3. This, in turn, should stem from a good understanding of the risks and valuation models by prime brokers, so that they view senior ILS tranches as **good collateral** (as they did - perhaps too much - for AAA subprime!).