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Guillaume Plantin & Jean-Charles Rochet: When Insurers Go Bust

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Introduction

The insurance industries of several countries have recently experienced periods of stress related to the failure of large, sometimes well-established, insurers. We begin our analysis with a study of four such cases: Independent Insurance and Equitable Life in the United Kingdom, Groupe des Assurances Nationales (GAN) and Europavie in France. These scandals have prompted a general and fierce debate (in the press, in the academic literature, but also in the political arena) about the need to reform the complex regulatory–supervisory systems that most countries have designed. The aim of this book is to offer practical recommendations, backed by rigorous economic analysis, for the reform of the prudential regulation of insurance companies.

Insurance companies are heavily regulated within virtually every country with a well-developed financial system. Moreover, insurance regulations endow public authorities with very significant control rights over insurers’ strategic and financial decisions. This is even the case in countries where *laissez faire* economic policies are the order of the day. The regulator intervenes in the strategy and financial management of insurance companies via three channels:

- tariff restrictions;
- entry and merger restrictions;
- prudential regulation (including insurance schemes that protect against company failures).

The first two types of intervention are rather common tools, used to regulate many other sectors, such as essential facilities. By contrast, prudential regulation is specific to financial institutions. Banks are, indeed, subject to prudential rules that are very similar to those applying to insurance companies. The rationale usually invoked for the prudential regulation of banks does not clearly apply to insurance companies, however. It is commonly asserted that banks have to be regulated because of their crucial role in issuing very *liquid* claims used as means of payment, namely deposits, while financing projects by means of *illiquid* loans. Thus banks are by nature illiquid and fragile, and subject to “runs.” In addition, they finance each other via the interbank market, so that isolated runs may trigger systemic panics, likely to have important real effects on economic growth. Conversely, insurance firms are invested in more liquid and tradable assets that match their liabilities much better than bank loans match bank deposits. Moreover, the organization of the reinsurance market makes it less prone to contagion than the interbank market. Thus, firms seem less fragile, and contagion less likely. Insurance panics have not occurred, to our knowledge, in recent financial history.

So, what is special about insurance? Which achievements are out of range of free insurance markets? How could a prudential regulator do better than them? These are the main questions addressed in this book.

The book is organized as follows. Chapter 2 presents four case studies of insurance companies that went bust during the 1990s. We will draw lessons from these cases throughout the remainder of the book. Chapter 3 describes the practical organization of prudential supervision in the largest insurance markets. It also describes the risk-management tools that are most commonly used to analyze prudential supervision, and stresses what we view as the limits of these tools. Chapter 4 is our first application of modern corporate-finance theory to the insurance industry. We argue that because of the length and the

inversion (this notion is explained in chapter 4) of the insurance production cycle, insurance firms are subject to severe agency problems that greatly amplify their operational risks. We show how capital requirements are an appropriate tool to discipline firms and contain these risks. Chapter 5 develops another application of corporate-finance theory to prudential regulation. We discuss the role of the allocation of control rights within firms, and the reasons why it may be desirable to grant such control rights to a supervisory authority in the case of financial institutions. Reconciling the evidence described in chapter 2 with the theory developed in chapters 4 and 5, chapter 6 develops our view of the optimal design of prudential regulation in the insurance industry, and offers concrete recommendations for the practical organization of supervision. Chapter 7 discusses the specifics of reinsurance—a crucial feature of the non-life insurance business. In chapter 8 we discuss the implications of our view of regulation for two fiercely debated issues: the supervision of financial conglomerates and the management of systemic risk. Chapter 9 concludes.

The reading of this book requires no particular prerequisites, neither in financial economics nor in insurance. Very simple models support some of our points. The important intuitions underlying them are always exposed in a nontechnical fashion.