



ulm university universität
uulm



Market discipline in insurance: Does it really work?

Martin Eling
Institute of Insurance Science
Ulm University

26th PROGRES International Seminar
Glion sur Montreux, Switzerland
April 16, 2010

Outline



1. Motivation
2. What is market discipline? Classification, definition, and measurement
3. What drives market discipline? Facilitators and impediments
4. Does it really work?
5. Conclusion



Aufsicht



Öffentlichkeit



1. Motivation

- An important new dimension of the regulatory environment in banking and insurance is the explicit reliance on market discipline
- Expectation: A transparent market will require less overt intervention by regulators (market participants themselves force appropriate behavior)
- The extent to which market discipline can be relied on for successful regulation, however, depends on the strength of its influence
- Two key reporting requirements scheduled by CEIOPS (CP 58) are:
 - Solvency and Financial Condition Report (SFCR)
 - Report to Supervisors (RTS)



Aufsicht



Öffentlichkeit



2. What is market discipline? Classification

- From regulatory discipline to market discipline:

Instrument	Idea	Examples	Problems
Safety nets	Lender of last resort or insurance scheme	FDIC in the U.S. (Great Depression)	Moral hazard incentives
Limit competition	Restrictions on market entry, among others	EU until 1994	Decreases efficiency and limits innovation
Capital adequacy	Imposition of requirement to have sufficient capital	Pillar 1 of Basel II and Solvency II	Capital arbitrage (e.g., securitization)
Market discipline	Increase transparency and disclosure requirements	Pillar 3 of Basel II and Solvency II	Does it really work? We don't know!

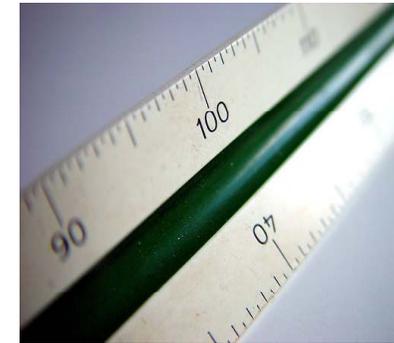
- Four main mechanisms each with pros and cons



2. What is market discipline? Definition

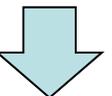
- Neither the Basel Committee nor CEIOPS have provided a clear definition of “market discipline”
- Banking literature:
 - (1) the ability of market participants to accurately assess the condition of a firm (*monitoring*) and
 - (2) their ability to impact management action that reflects those assessments (*influencing*)
- Another dimension relevant to insurance: *customer-driven* market discipline vs. *investor-driven* market discipline
- Proposal for a definition in insurance:

Monitoring and influencing conducted by customers, investors, and intermediaries



2. What is market discipline? Measurement

- How is market discipline measured?

Who?	Customers	Investors- stockholders	Investors- bondholders
How?	Risk-sensitive customer demand	Risk-sensitive stock prices	Risk-sensitive bond yields
Measurement	- Growth in premiums and policies - Lapse	Equity prices	Debt yields
Relevance in insurance			

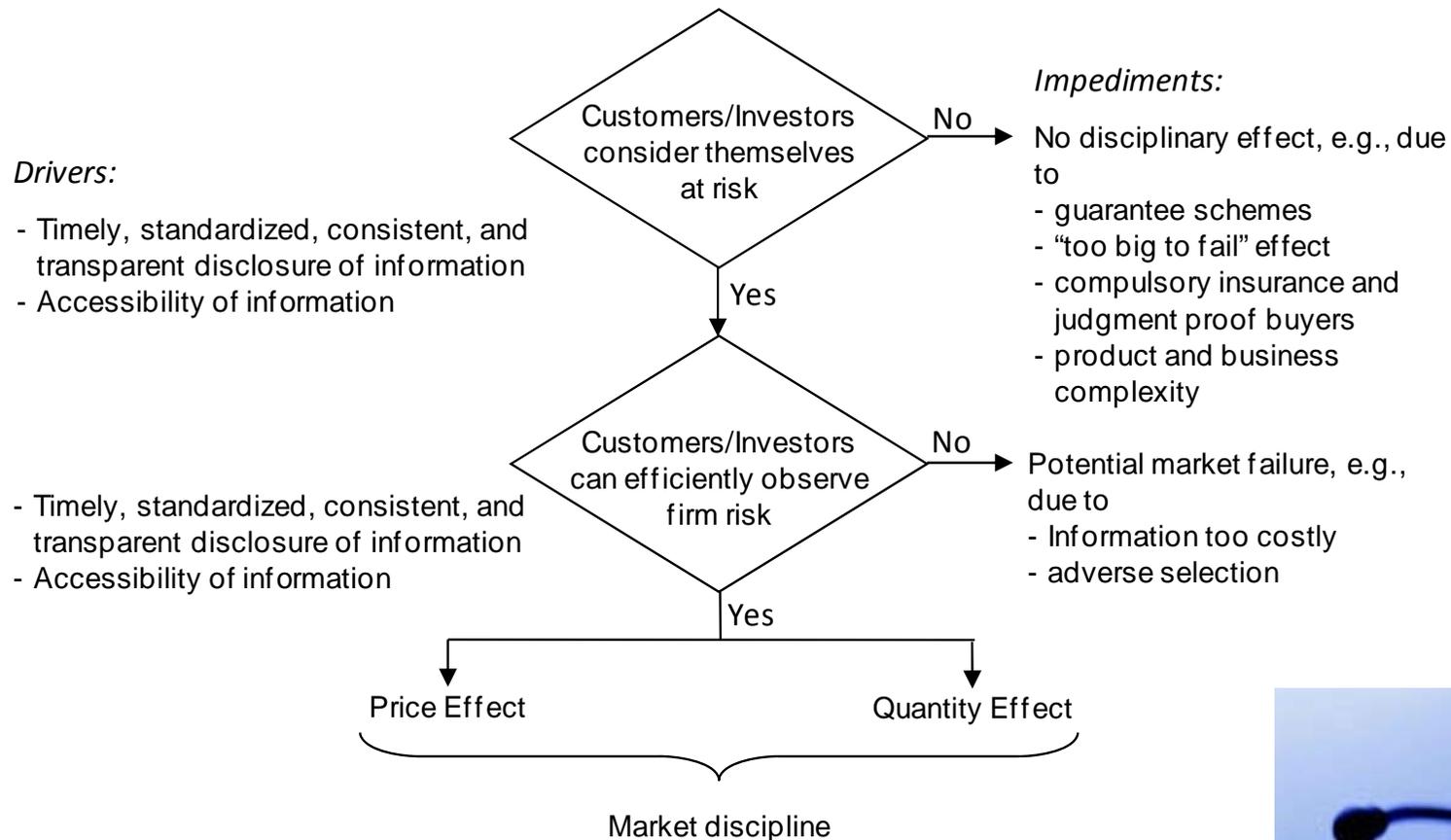
See Eling (2010) for more details

3. What drives market discipline? Facilitators and impediments

- The most important facilitator is timely, standardized, consistent, and transparent disclosure of relevant information to all market participants
- As to impediments, there are important differences between insurance lines that affect market discipline:
 - a) guarantee fund protection (including “too-big-to-fail”)
 - b) compulsory insurance and judgment-proof buyers
 - c) complexity of products and business
 - d) types of customers (personal vs. commercial lines)



3. What drives market discipline? Facilitators and impediments



See Eling (2010) for more details



4. Does it really work?



Facilitators of market discipline		
1) Timely, standardized, consistent, and transparent disclosure of information		
2) Accessibility of information		
Impediments to market discipline		
1) guarantee schemes, including too-big-to-fail		
2) compulsory insurance (judgment proof)		
3) product and business complexity		
Conclusion		
Customers consider themselves at risk?		
Customers can efficiently observe firm risk?		
=> Hypotheses: Market Discipline  > 		

4. Does it really work?



- Hypotheses: Market Discipline  > 
- Empirical Evidence:
 - Epermanis/Harrington (2006), U.S. Data:
Premium declines of 4 to 12% following downgrades
 - Eling/Schmit (2009), German data:
Premium declines of 2 to 6% following downgrades
- Result:
 - Market Discipline  > 
 - Regulators need to enforce mechanisms than strengthen market discipline, if they want a strong pillar 3.

5. Conclusion

- Market discipline:
 - Risk sensitivity of customer demand (customer market discipline) and investor willingness to pay (investor market discipline)
 - Monitoring and influencing conducted by customers, investors, and intermediaries

- The insurance sector is unique in a number of aspects:
 - The widespread use of intermediaries (facilitates monitoring) ✓
 - Its legal form and financing (limits influencing component) ✗
 - No risk of a bank run (limits the influencing component) ✗

- Difficult to say whether market discipline will work under Solvency II, but the most significant facilitators and impediments are well known





5. Conclusion

- Three recommendations to policymakers:
 1. Reform guarantee funds to increase risk sensitivity
 2. Timely, standardized, consistent, and transparent disclosure of relevant information
 3. Recognize differences between banking, insurance and between insurance lines of insurance in designing market discipline
- For more information: martin.eling@uni-ulm.de