Episode #279: Why Insurance Companies are Safe and Banks are Not

Hey there, my name is Kevin Nuber. Thank you so much for watching today's Money Script money video where I'm going to be talking about why insurance companies are safe and banks are not. If you've been reading the news or are on the internet, something's happened over the last few weeks. One day, everything was perfectly normal in the global financial system and, suddenly, you pick up the paper, you go to the internet, and you find out that we're in a worldwide banking crisis. Multiple banks fail. And you see a couple of videos of people lining up at ATMs. How do we go from a situation in which everything's perfectly normal to worldwide financial stress on the banking system?

Well, if you're somebody who has money in a bank, I'm sure you're nervous. You're thinking, "What am I supposed to do?" Or, "Do I have to go get my money out of the bank?" And I bet if you had money with an insurance company in the form of an annuity or an insurance policy with cash value, you're probably thinking the same thing. Is my money safe? Is there something that I need to do?

The purpose of this video is for you to understand that there's a substantial difference between a bank and an insurance company. Banks are not safe, even the biggest and the strongest banks aren't safe, but that's how it works. It's not surprising. And the reason why you don't pick up the newspaper and read headlines about insurance companies failing is because it doesn't really happen very often.

The first thing that I want to talk about is why a bank is not safe. Now, I'm not trying to scare you, don't worry, you're not going to lose any money in a bank, but a bank is just fundamentally risky. You see, the simplest way to explain the difference between a bank and an insurance company is talking about the difference between assets versus liabilities. The asset is the money, how much they have, and the liability is how much they owe to you, the depositor, the person that has money on deposit.

The problem with the banking system all across the world is this, if you give $10,000 to a bank, your bank account might save $10,000, but the bank is only keeping $1,000 of that money in a reserve, and they're immediately lending the other $9,000 out. You see, they don't make any money by just sitting on your money and processing all your transactions. They make money by lending it out to people immediately. So $9,000 gets lended out, $1,000 is in reserve. They're just hoping that you keep that $10,000 that you have in there because if everybody goes and tries to take all their money out, they're never going to have enough money to cover all those deposits.

There's an immediate liability mismatch between what they have on deposit and what they owe to people that have money with them. And this ratio can be 10 to 1. I'm using a 10 to 1 ratio in my example, it could be less than this, but it could be more like this. The problem is that there's an incentive for the bank to create as big of a liability mismatch as possible and to have this ratio between what they keep in reserve and what they actually lend out as big as possible because that's how they make money.

This isn't a surprise. As I said, I'm not trying to scare anybody. This is how the banking system has always worked. It's nothing new. And this is why at that first sign of any type of financial trouble, people get nervous about the money that's inside of a bank because they know that the bank never has enough to pay them.

This is how a bank run starts. Everybody goes down to the bank, you've seen it during the Great Depression, lines of people at the bank trying to get all their money out. It's because this is the nature of how they work.

Well, what happened recently with current events is word got out that there might be some financial trouble. Next thing you know, billions of dollars are being requested to withdraw from a big bank and they don't have enough money. Well, what happens? In order for us, as a consumer, to have confidence in the banking system so that we don't go and do runs on the bank, the FDIC insurance, the federal government, has to ensure the deposits of banks so that it prevents us from the hysteria of going and trying to take all our money out and collapsing this banking system, which they never have enough money to actually pay us. That's what's happening recently, and the FDIC insurance had to step in in order to insure all the deposits.

Now that we understand why a bank is risky, it's how they operate. What makes an insurance company so safe? So an insurance company is different, okay? And it's as simple as just saying that they have more assets in reserve than they actually do in liabilities. When you give $10,000 to an insurance company, they might put $90,000 of that money in reserve, they might put $95,000 of that money in reserve, but with an insurance company, they don't owe you the money today, they owe you the money in the future. It could be in 5 years or in 10 years, so that's why they can put a little bit less.

They go and they invest in bonds, corporate debt, treasury bills, government securities, and that money's safe in reserve. And they always have enough to pay people those future dollars that they owe them. This is what makes them so safe. This is why you don't have situations where insurance companies just suddenly fail.

So, how do we measure how strong these reserves are? The industry has formulas, one of them is called the risk-based capital. The other one is called solvency ratio. Essentially, regulators look at this reserve and they give it a ratio to express how safe it is. A good RBC ratio might be 400%, and a good solvency ratio might be 200%. What this means is that if there's a solvency ratio of 200%, it's like the insurance company has 200% of the money in reserve that they owe people in the future. It doesn't mean exactly that. So it's not saying that they're keeping $2 for every $1 that they owe you. That's not what it's saying. It's an expression of saying that they always have more than enough money to pay you in the future when the money is owed to you.

The other thing is that there's a difference between an insurance company's reserve, the money that they owe you, and the surplus. The surplus is the money that the company uses for operations, for paying their employees, for paying out dividends, for paying out stockholders, for opening a new building, or developing a new product.

The nature of how an insurance company fails, if they do fail, is you'll see the surplus getting smaller and smaller and smaller, and then suddenly, the insurance company no longer has any surplus. They can't operate anymore because they have no more operating capital. All they have left is enough money to pay back the policyholders. That is how an insurance company goes into receivership. That's the definition of insurance company failure. That's different than a bank which never has enough money. An insurance company gets to the point where they only have enough money.

Now, that's not always how it works. You can have a situation in which the insurance company doesn't have enough money that they owe back to the policyholders. But the important thing is, it's never as big of a spread as a bank and that there are mechanisms in place in order to make sure that the insurance companies are made whole and the money that you have with an insurance company is always given to you.

The next thing I want to talk about is, what do you do to evaluate the strength of an insurance company? You're not expected to understand what solvency ratios are. Instead, there are rating agencies out there that are going to look at those insurance companies, do all this hard work for you, and they're going to give you a rating of how strong that company is. The industry leader is AM Best. And our standard for a minimum strength for a company is that they have to be A-rated or better. If an insurance company is A-rated or better, there is a very high likelihood that they can withstand a financial crisis. Even in 2008, the biggest financial crisis of our lifetime, A-rated companies were able to withstand that type of pressure and strain on the system.

If the insurance company that you're looking at is anything less than an A rating, I would really recommend not going with that company. If they're not big enough to be rated by a company like, then again, you should not go with that company. But what happens if a bank or an insurance company does actually go into receivership? What happens to make sure the policyholders are made whole?

This is where the state guaranty fund comes into play. Think of it like the FDIC insurance. Every company that does business in the state you bought your policy in is required to participate in a state guaranty fund. It's like insurance so that if one company fails, all the other companies step in and they're responsible for proportionally paying into the fund in order to make the reserves whole so that the policyholders are paid everything that they're owed. This is how the system works. And this is why since 2008, there's been hundreds and hundreds of bank failures where the FDIC has had to step in, but there's only been 25 or so companies that have gone into receivership, and they're all companies that you've never even heard of before. They're not these big, highly-rated companies that had very strong ratings.

Hopefully after watching this video, you can pick up the newspaper, and even if there's stuff in there about the financial system being in crisis and that banks are having a strain on the system, that you could rest assured that you're not going to wake up and find your insurance company on a list of companies that's suddenly gone into receivership. There's a substantial difference between how risky a bank is and how safe an insurance company is, and you can rest assured that the money that's owed to you is going to be there when you need it. Thank you so much.