Warren Buffet on the Advantage of the Insurance Business for Investors

“Insurers receive premiums upfront and pay claims later. ....This collect-now, pay-later model leaves us holding large sums - money we call "float” - that will eventually go to others. Meanwhile, we get to invest this float for Berkshire's benefit....

If premiums exceed the total of expenses and eventual losses, we register an underwriting profit that adds to the investment income produced from the float. This combination allows us to enjoy the use of free money and, better yet, get paid for holding it”.

Warren Buffet – 2010

IMPORTANT NOTE (1):

Berkshire did not *consistently* “enjoy the use of free money and … get paid to hold the float” until Berkshire acquired Geico and did not *cumulatively* “enjoy the use of free money and … get paid to hold the float” until 2006. For nearly 40 years, Berkshire’s cumulative cost of float was 2.2% per year.

IMPORTANT NOTE (2):

If a reinsurer had a portfolio of risks, whereby it took in the premiums and deposited it in a bank in the current low interest rate environment, but never, ever paid out more in claims and expenses than it took in as premiums (in other words, the reinsurer would never, ever suffer an underwriting loss), it wouldn’t need any capital and ROEs would be infinite.

The laws of supply and demand would suggest that the prospect of infinite ROEs would be so attractive that the market would discount its pricing to a level of equilibrium and take a slight underwriting loss in order to invest the float for returns greater than the costs of float and earn a spread. Historically, this discount set the cost of float to 3% per year industry wide (so when Berkshire paid 2.2% for its float, it was still a pretty good underwriter). With a 3% cost of float, the industry could invest the premiums in a high grade, short duration, long only buy and hold to maturity (in order to avoid mark to market and smooth earnings), that historically yielded 5% per year earning a 2% spread on each turn of balance sheet leverage. They then levered that balance sheet 5 to 10 times to generate competitive ROEs that would allow them to attract capital.

With rates lower than 3% today, the spread is negative and each turn of leverage reduces ROEs further. The obvious solution is to raise prices. But they cannot do so unilaterally. Reinsurance is a commodity business. One does not price risk, the market does. You simply decide to accept the price or pass.

As such, with the exception of Berkshire, which has monopolistic pricing power for policies needing very high limits (no one else can take a multi-billion dollar loss), or a reinsurer that either specializes in a line of business or reinsures sister insurers, we do not think any general reinsurer can have any edge unless it is in its investment strategy. In our opinion, those reinsurance underwriters who have demonstrated consistent underwriting profits are analogous to the one person in 128 who has called 7 correct coin flips in a row. Many an investor who would recognize the futility of a Martingale system at roulette have backed such underwriters (and grossly overpaid them for the privilege) to their ultimate dismay.

Underwriters can bring significant value if they can suppress their urges to hit it out of the park (or a boundary for those in the cricket world) and limit the range of outcomes in the cost of float and marry it up with an investment strategy that can return more than 5% per year over any five year rolling period of time.

IMPORTANT NOTE (3):

Unlike reinsurers, insurers *can* have an underwriting edge. It is often protected by regulation or industry structure (such as Geico or title insurance), point of sale advantages (FedEx or car warranties), or targeted policyholders (USAA). However, launching and building an insurer is a herculean task compared to a reinsurer, so acquisitions paired with sister reinsurers in order to lower taxes on the ecosystems’ collective value are the best way to enter the insurance business. Unfortunately, most insurers under reserve to boost earnings and do not mark their portfolios to market, leaving most of their balance sheets untrustworthy.