

How Central Banks are Ruining the Insurance Business

Denis Kessler, CEO of Scor, a large reinsurer, is the most recent [critic](#) of today's low interest rate environment. It's not only the stereotypical retiree clipping bond coupons that is suffering from current interest rate policy. Insurance companies typically hold substantial amounts of their investment portfolios in bonds, both because of regulatory requirements as well as the need to respond to claims whose timing is often unpredictable. Kessler claimed that central banks were "ruining" the insurance industry, and claimed that insurers were the unwitting victims of the aftermath of the financial crisis even though they didn't create it (AIG and its credit derivatives portfolio presumably notwithstanding).

Warren Buffett has described an insurance company's "float", that is, the premiums they receive in return for making payments in the future, as akin to being paid to borrow money. This is true to the extent that insurance companies can operate with a Combined Ratio below 100% (that is, the sum of underwriting losses plus operating expense as a % of net earned premiums). If they spend more than their premiums then of course the float costs money and the difference needs to be made up on the investment side.

Most insurance companies either through poor underwriting or competitive pressure slipped into just this model, whereby positive investment results were needed to cover a Combined Ratio above 100%. One of the capital disciplines practiced by Warren Buffett's Berkshire Hathaway (BRK) in its insurance business is to separate out the management of the float from the underwriting, so as to prevent success at the former from compensating for poor execution of the latter. BRK's insurance businesses have generated a net underwriting profit for eleven straight years. One clear benefit of separating underwriting

from investing is that the insurance executives at BRK have little incentive to grow via unprofitable business expecting to rely on strong investment results as support.

However, for many insurers persistently low interest rates have heaped pressure on one side of this equation. One might have expected the market to adapt, through a “hardening” market (insurance-speak for rising premiums) given lower investment returns, and while this has happened to a degree pricing hasn’t adjusted as much as needed. This is why so many insurance companies trade at a discount to book value – because while profitable, they’re not yet earning an appropriate return on equity.

Aspen Insurance (AHL) is one that we have liked in the past because of their well regarded management but it still trades at only 87% of book value (we don’t currently own AHL). Another name we have owned in the past but don’t at present is CNA also at 87% of book value. We continue to own AIG which is valued at 83% of book value excluding unrealized investment gains (or only 76% of book value if you include such mark-to-market gains, which isn’t an unreasonable approach). And we also own BRK, which trades at around 140% of book value but is of course a diverse conglomerate with large operating businesses and a substantial investment portfolio. You don’t often hear them complaining about low interest rates, either.

Our Hedged Dividend Capture Strategy is designed to extract dividend income from equities while mitigating equity market risk through hedging. It’s designed for investors used to better returns from high grade bonds.