Why are insurers willing to make permanent losses on insuring people? [1]

Written by **Tim Worstall** [2] | Saturday 21 September 2013

Following on from my blog post of yesterday I've been emailed with an interesting question. I asserted [3] that the very evidence that banks are making losses on current accounts (before we consider the value of the float that is) is evidence that the banking market for current accounts was competitive. I was then asked this follow up question:

> "Tim, you say that banks consistently lose money and/or fail to make a decent return, thus perfectly competive. I?ve no reason to doubt you. A query for those who understand these things. Why do some markets consistently lose money for those trying but failing to be ruthless capitalists? Motor insurance is a consistent loser overall, even though there is a captive market. But no one drops out. Professional indemnity insurance for solicitors is another consistent loser, despite a captive market. Whenever someone drops out, some obscure Latvian/Irish insurer comes in, keeping the rates down. Newspapers are another, but they are fun/prestigious/influential. Motor insurance is not. What is it about certain markets that makes capitalists tolerate endless losses?"

The newspaper point is fun: there are those willing to take financial losses for the proximity to power and sheer self importance of being a media magnate. Which leads to the thought that those who tell us of the financial sacrifices they make to be in "public service" might have similar motivations.

The answer to the insurance question though is simple: premiums are not the only revenue stream in an insurance company.

We pay our premiums in and the insurance company only has to pay them out at some point in the future. They thus get to play with that vast pile of cash for some amount of time. What they actually do with it is invest it. What they invest in will depend a little on what type of insurance they're writing, what the likely time scale is before any potential payout. Someone writing car insurance will probably have a more liquid investment (ie, shorter term) portfolio than someone writing earthquake reinsurance (ie, insurance to insurance companies about earthquakes). The reinsurance companies have some of the longest term investment portfolios around, often longer even than pension providers.

These investments of course make a return (well, hopefully they do!). And that's the second source of insurance company income. The returns they get on the money they get to play with inbetween receiving the premiums and having to pay out the losses.

The end result of this in a competitive market is that said insurance companies are going to compete among themselves over the price they will set those premiums at. Given that second income stream it actually makes sense for them to lose money on the underwriting, a loss which is more than compensated for by the investment returns. Indeed, we can take this one step further. Given that income stream from investment returns we have a very simple test for whether an insurance market is in fact competitive or not. If the companies are all making a profit on the simple underwriting then probably not. By this measure the UK car insurance market probably is competitive, the US one not.

There are other points we can make as well. When investment returns fall then we might expect to see insurance prices rise. I don't know whether that has happened recently and if anyone knows do please tell me. Other businesses work in much the same manner. Futures broking say. The actual business of doing the buying and selling is a loss leader for gaining access to the deposits that the customers must leave with the firm (the "margin"). This is invested for the benefit of the firm, not the customer. It was indeed falling returns on bonds and bills (the allowable investments for these firms) that led MF Global to stretch itself into the Euro Sovereign market in search of higher yield. An adventure that ended horribly of course.

Another observation is that the part of Obamacare that insists that medical insurance companies pay out 80% of premiums on actual medical care doesn't matter very much. For no one's bothered to take account of the investment returns from having all that cash while they wait for people to get cancer.

And finally, this is the secret of Warren Buffett's wealth. Yes, he is indeed a very astute investor. But as soon as he'd scraped together enough money to do so the first thing he bought was an insurance company. So his excellence in investing has not been applied to his own money (nor those of his partners) over the decades, but to the multiples of their capital that owning that cash float and investment pool inside an insurance company offers him. He's been using leverage: not by borrowing but by owning the returns from the insurance company premium pile. Oh, and Geico, which Berkshire Hathaway owns, generally does make a profit on car insurance underwriting. But then I've already said that the US car insurance market might not be all that competitive.

Source URL: http://www.adamsmith.org/blog/economics/why-are-insurers-willing-to-make-permanent-losses-on-insuring-people

Links:
[1] http://www.adamsmith.org/blog/economics/why-are-insurers-willing-to-make-permanent-losses-on-insuring-people
[2] http://www.adamsmith.org/taxonomy/term/5778
[3] http://www.adamsmith.org/blog/money-banking/what-an-interesting-example-from-zoe-williams
[4] http://disqus.com/?ref_noscript
[5] http://disqus.com