Complex Risk
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Demystifying Capital: How Insurance Capital Deployment Drives Retail Pricing

The premise of insurance is that we are all safer if we pool our risk. Capital serves as a buffer to risk, but shareholders want a return on capital. Unfortunately, 2023 is an incredibly complex marketplace for both advisors and carriers.

How do we move forward with this current complexity?

Mark Moitoso, EVP, Risk Practices Leader at Lockton Companies, and Sanjay Godhwani, Head of North America at Berkshire Hathaway Specialty Insurance, provided an overview of how capital and reinsurance capacity impact retail pricing at Lockton’s 2023 Complex Risk Symposium.

Insurance companies need to make a profit on equity, and that return on equity happens in two ways: underwriting and investment income. Investing in treasury bonds typically yields a safe but relatively low 4%-5%, so investors often look to insurance with the hope of earning higher yields. According to Moitoso, “insurance has a lot of float” because good returns on wise investments can fluctuate.

According to the traditional laws of supply and demand, the 2021 trillion-dollar industry surplus may have resulted in lower premiums in the past, but prices have continued to increase. Why? Global volatility and higher interest rates that decrease bond value, causing investors to worry about the safety of their money. Recent bank failures resulted when Silicon Valley was forced to sell bonds at a loss.

Godhwani explained that insurance premium change had been fairly insignificant, though risk on liability has increased. “Insurance costs are hard to predict, because in the insurance industry, we don’t know the actual cost… unlike manufacturing…” where costs are more predictable. Because of the tremendous risk on the liability side, the insurance industry has been forced to invest with less risk on the asset side.

During the session, a series of charts and graphs illustrated how industry profits have changed since 1986. With a hypothetical $100 investment, profits have decreased from a 15% return in 1986 to the current 8%. Similarly, since 1990, only 3 years resulted in operating returns of over 10%. The forces driving these decreases exist both in personal and commercial insurance and are impacted by social inflation.

To address the question of how much capital is needed, one slide described three hypothetical companies with varied loss patterns. Moitoso and Godhwani asked the audience to choose which of the three companies compared the closest with their own. The chart demonstrated that even a business which sustains more losses can require a lower premium than a business with fewer losses. One major loss can result in higher premiums, which is why increased volatility is so expensive for the industry — and why more capital is needed and why premiums must increase.

Godhwani believes that consumer confidence will return, but he advocates caution. Both actuaries view modeling as critically important to the industry because of its ability to combine simulated history with potential future events. The resulting standard deviations become the viable predictors of volatility.

As a buyer, look to the standard deviation to determine best options.

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