Insurance & Investments – Two Different Things, *Really*?

A Discussion In The Non-Life Space

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Abstract

How similar, or dissimilar, are the principles? What are the parallels, if any? *Why do I, as a general consumer, approach them rather differently?* The investments industry continues to challenge consumers with exotic products and solutions that stretch the comprehension of risk-return – yet (re-)insurance is arguably stagnated as a commodity most would rather move on from?

The two streams can, and indeed should, be seen on the same paradigm. One addresses upside, other addresses downside – sitting on the same continuum. Where we are today leaves a lot to be desired. If and when we step up the notch in challenging our buyers on their desired risk-return profile, over and beyond the isolated insured risk, we may find a whole new stream of opportunities with greater perceived value – and in turn, relevance.

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Introduction – Missing A Trick?

My work life has always been within non-life (re-)insurance – this after an honours paper in option pricing theory. For some time now, having also dabbled in personal investments, a line of thought began to feature – how similar, or dissimilar, are the principles? What are the parallels, if any? *Why do I, as a general consumer, approach them rather differently?*

If they are indeed similar, the (re-)insurance industry is certainly not approaching as such – in turn, neither would consumers. The investments industry continues to challenge consumers with exotic products and solutions that stretch the comprehension of risk-return – yet (re-)insurance is arguably stagnated as a commodity most would rather move on from?

I explore these themes within the non-life domain – the life industry in such context being a separate subject matter. Also, whilst principles are similar, my own tendencies are towards *re*-insurance rather than insurance – where indeed I feel a stronger need for such reflection.

Parallels in Theory – Not So Different?

Here I discuss in brief several theories and principles well embedded within investments and economics. In particular drawing out the notable parallels in (re-)insurance – as well as the lack of effective association in practice, both within and beyond industry circles.

A Hedging Instrument – Risk vs Return

Hedging is synonymous with the world of investments. Investopedia defines as – *"an investment to reduce the risk of adverse price movements in an asset".* Building in trade-off principles, the use of a hedge essentially reduces potential risk for the price of lower gains.

Investopedia further notes rather aptly that it is *"analogous to taking out an insurance policy"*. For instance, a simple put option protects against risk of underlying asset value falling below a certain point. Reset in context of a fire policy – underlying asset is property, difference in opening value / strike price being deductible, but of course triggered only by loss from fire.

Yet, the application in investments is embraced and systematic – whilst in (re-)insurance we are still often reminding buyers of the value in protection and associated cost in risk transfer.

(Re-)insurance as a risk management mechanism is generally well understood in concept. However, the practice in utilising as an effective hedge to manage net positions is far from embedded. There remains a notable gap in connecting to strategic planning and risk appetite – the essential ingredients in framing why and how a hedge in the first place.

Modern Portfolio Theory – The Efficient Frontier

Building on the principle of risk-return tradeoff, we can construct an efficient frontier of "optimal" asset portfolios that maximise the expected return for a given level of risk.

Despite rarely featuring in (re-)insurance, the same theory can be applied. Firstly, in that insured risks, being the underlying assets, should be holistically assessed as a portfolio (and not just by line of business as often remains the case). Secondly, in varied form here, with focus on the "optimal" composition of protections against a given portfolio of insured risks.

As a simple example, a more predictable motor policy should have lower expected margin than a (slightly) more volatile fire policy – with both correlated and diversifiable risks present. Typically, an insurer with such risks would have a sense of margin and tolerance tied to business plans which in turn frames the desired composition on gross underwriting.

Too often though, we are not successfully engaging as to what is "desired" on net. From a buyer's perspective as well, different compositions and variations in protections can set out the corresponding efficient frontier. (Re-)insurance can be "optimised" depending on where one wants to sit on the risk-return frontier – but it does not tell one where to sit.

Prospect Theory – The Loss Aversion Angle

This theory suggests that the value function is asymmetrical – in that the risk of loss has greater impact than potential for gain. In simple words, there is more value in avoiding a loss of $5 than making a gain of $5. One would imagine then that there should be greater focus and attention on (re)insurance – which reduces loss?

Perhaps time horizon matters and alters behavioural response – investment strategies often focus on the shorter term, whilst (re-)insurance necessarily considers a longer time horizon. Or perhaps the theory no longer holds true to a degree – in that our society today has shifted to valuing gains over and above potential losses, a less risk averse culture in all.

Before such questioning, consider first if we practise in a manner that connects (re-)insurance to the broader value function – as is necessary for theory to apply.

Firstly, how effective is our industry in connecting the protection to the value of the asset? Despite conceptual appreciation, (re-)insurance is most often seen as a cost – on a separate value function disconnected from the risk and volatility in the value of the asset itself.

Secondly, the industry's proposition in its own narrow silo does not encourage the two streams – in making a gain through investments and in avoiding a loss through (re-)insurance – to be assessed in tandem, on the same value function.

Leveraging Parallels In Practice – Much To Be Desired?

As intimated, (re-)insurance in practice has not been effective in associating its proposition to foundations nor in leveraging parallels with the more embraced stream of investments. Notwithstanding, here are the notable examples of investments tying in with (re-)insurance.

Insurance Distribution – Bancassurance

There are indeed models that package and cross-sell products across the two streams. In general though, the practice remains very much in bundling two *separate* streams together – without explicit effort in tying the value propositions together.

There appears to be space for more focus on the sales process and narrative – in perhaps connecting the collective and holistic impact on a single risk-return continuum to strengthen the appreciation of the insurance mechanism.

Insurance Product – Long Term Savings-Linked Insurance

South Korea is one of the unique markets whereby long term insurance features so prominently in the non-life space. It is in fact the largest non-life segment – long-term insurance on personal lines coverage with maturity periods and savings components that allow policyholders to receive maturity and surrender values.

It is commonly acknowledged that the demand emanated from growing retirement and investment needs in the face of persistent low interest rate environment – such themes far from unique in the global landscape. Given this has been successful in one of the largest non-life markets globally, it is instructive to evaluate the potential for application elsewhere.

Insurance Model – South Africa's Discovery

Discovery recently launched the world's first "behavioural bank" – a fully digital platform that leverages on behavioural science and incentive design to address the spectrum of financial health. There are many stimulating aspects (eg. digital, behavioural), but of immediate relevance here is the *differentiated* proposition in their 5-3-80 model.

"Five controllable behaviours of spending less than we earn, saving regularly, having insurance in place for serious events, paying off property and investing for the long term; can alleviate three key risks of unaffordable debt, exposure to unexpected expenses, and insufficient income in retirement. These risks result in 80% of events where individuals are not able to meet their financial obligations."

Discovery neatly ties together the otherwise segregated components of financial health – investments and insurance, explicitly extended to include debt and retirement. Success in execution aside, we cannot argue the intuitive sense in what they have sought out to do.

Reinsurance Capacity – Insurance-Linked Securities

ILS has taken its place in the reinsurance world without question. However, in its essence, we are accessing an alternate space for capacity – leveraging on the inherent diversification between traditional investments and (re-)insurance, from an investor's standpoint.

In the context of this discussion, ILS does not alter nor enhance the fundamentals in (re-)insurance value proposition. The instructive element here is perhaps in how we have managed to appeal as an investment – whilst being in the same conundrum with consumers.

Reinsurance Model – Hedge Fund Reinsurers

Still somewhat in its infancy, the basic premise here is that underwriting is but a means to premium and capital float – which are then invested in hedge fund strategies to generate superior returns. Vis-à-vis traditional models – which whilst reliant on investment income to buffer underwriting margins, remains generally conservative in investment strategy.

Again, the crux of this model is predicated on the investor standpoint. That being said, there are example transactions with such reinsurers which explicitly leverage on their greater appetite for investment risk – in directly linking reinsurance risk transfer with shared and guaranteed investment returns to the buyer.

It is with such that we begin to move the dial on proposition. Whilst few and far between, the potential is here for greater connectivity between reinsurance and investment in solutions.

Where From Here – In Search Of Greater Relevance?

We discussed examples which start to pull the thinking together across the two streams. Considering the broader dynamics for the industry – are these isolated efforts enough?

This discussion does not presume to have the answers – the contentions themselves remain to be acknowledged. Notwithstanding, here are some views as to what we should consider.

Resetting the Narrative

As intimated, the industry has found itself in a rather narrow, isolated space – on a separate value function to a consumer's holistic needs. Compounding that, we have collectively commoditised the offering into a stream of disconnected products.

Our value proposition is in need of stronger, clearer, more relevant narrative – to reconnect to the broader value function.

Discussions should not begin with product – rather, it should be with *motivation*. Beginning with the "asset", connecting to protection through consequences and downsides. Similarly, we can better connect to a buyer's broader risk-return, beyond any one insured risk.

De-commoditise – Challenge The Buyer

Take for example Equity-Linked Notes in the investments space – which reconstructs the risk-return profile from traditional stock holdings. In simplest terms – when stock prices are doing really well, there is less upside; when they are trading stably, there is greater margin; when pear-shaped, the stock is yours.

The point is not to advocate unnecessarily complex products for broad-based consumption – I have my own reservations as a separate subject matter. What is instructive though, is that it challenges the informed buyer to more closely consider the broader risk-return spectrum.

"Structured Solutions" explores this angle in practice – discussions beginning with motivation to elicit risk-return desires then matched with tailored solutions. Given its very broad nature, there are aspects to consider in framing to be more scaleable. Importantly, we can better integrate this thinking in day-to-day proceedings away from the transactional commodity.

Dual Trigger Solutions – Linking Coverage To Investments

An extension of above is in linking reinsurance coverage to a secondary risk factor – most obviously investments. Such have been done in practice, but again few and far between.

The proposition is simple – in times when investments underperform, earnings is dependent on delivery from the underwriting side. It is here where greater protection is desirable to ring-fence underwriting results and in turn total return.

The solution is equally simple – when investments underperform, coverage automatically increases on a pre-agreed mechanism to provide more stability to underwriting. To avoid direct investment risk to said reinsurer, the pre-agreed mechanism would include price adjustments commensurate with the change in coverage.

Such a solution should have general appeal in the reinsurance space as insurers grapple with volatility in the investments space – or indeed can be applied to other measurable non-insurance risks of concern. Intuitively, it could also apply in the insurance space.

Undertaking Direct Investment Risk

As a simple example, based on the Dual Trigger above, we remove the pre-agreed pricing adjustment on coverage change, with this absorbed in upfront pricing and thereby removing residual volatility arising from price change – in turn providing greater stability to total return.

In general, whilst worth noting, this is not one for the immediate horizon – it necessitates a fundamental structural and appetite change to undertake investment risk. Although as briefly discussed before, hedge fund reinsurers are well placed to explore.

Conclusion – One Increases Upside, Other Reduces Downside

The two streams can, and indeed should, be seen on the same paradigm. One addresses upside, other addresses downside – sitting on the same continuum. Both instruments shape the overall risk-return profile – this being the beginning and end to consumer engagement.

Where we are today leaves a lot to be desired. The industry does not effectively address the fundamentals in risk-return nor exploit the continuum with the embraced investments space. Instead, it is a silo-ed industry that speaks of commodotised products, disconnected from the broader value function. As for initiatives that genuinely buck the trend – few and far between.

We need to reset our value proposition in search of greater relevance. A good part of this lies in our basic narrative to start – beginning within our industry circles.

If and when we step up the notch in challenging our buyers on their desired risk-return profile, over and beyond the isolated insured risk, we may find a whole new stream of opportunities with greater perceived value – and in turn, relevance.