NU PROPERTY CASUALTY360° | A NATIONAL UNDERWRITER COMPANY
An ALM Website
SEPTEMBER 17, 2019
www.propertycasualty360.com

The future belongs to capital-light insurance businesses

Technology's impact on the value chain is allowing radical transformation of how insurance businesses are structured and, in turn, valued.

BY WILLIAM SPIEGEL

iStock

Thanks to digital disruption, the traditional value chain in insurance and financial services is starting to come apart at the seams.

Technology is enabling insurance companies to increasingly separate capital from the origination, underwriting, and servicing functions. This creates an opportunity for insurance businesses to transform themselves into balance sheet-light asset managers.

Asset managers trade at significantly higher valuations than traditional insurance companies, based on multiples of EBITDA rather than multiples of book value.

Private equity fueled more than $50 billion into fintech and related services in 2018, which has enabled smaller and mid-sized companies to disrupt and compete with scale insurance and financial services firms in a way never before possible.

What is being overlooked in this evolution is that technology's impact on the value chain is allowing radical transformation of how traditional insurance businesses are structured and, in turn, valued.

Historically, an insurance company has owned all four elements of the value chain: originating a product (e.g. a policy); underwriting that product; servicing that product (collecting payments and ensuring agreements are being met); and lastly, gathering the capital the business needs to grow.

This model provided many advantages through savings derived through economies of scale — bulk purchasing power for technology, human capital, and access to financial capital.

But today it is viable to break out the capital from that value chain and create a stand-alone asset manager that controls capital and gets paid fees for its ongoing origination, underwriting, and servicing.

Why is this breakdown now possible?

Quantitative easing put a great deal of capital into the economy and drove interest rates so low that institutions, family offices, insurance companies, pension funds, and other investors started a massive search for yield, particularly in uncorrelated asset classes.

The first place this really happened was in insurance, and in particular within the catastrophe business, where the whole industry has now been disrupted by collateralized vehicles. This concept has spread, and now Investors can invest in private credit, private loan funds, bank funds, etc., where they buy and become the capital behind the balance sheet products generated by financial institutions that manage the products but don't have to put much of their own capital behind them.

The goal for modern financial institutions is to enhance value by creating an asset management firm, distributing their products to the lowest cost of capital. The financial institution of the future needs to control, but not necessarily own, its capital.

Technology made this disintermediation possible, and that's where traditional insurance businesses begin to be disadvantaged. Bigger institutions always had the lowest cost of capital but are now beginning to question whether they still have that advantage and how long it will last.

We're heading toward a situation where the financial institution of the future is a business that can own assets when they want but can distribute their risk to the lowest cost provider when they don't. The end result will be a more highly-valued, capital-light financial services businesses — or at least "capital lighter."

This means new competition for the historical rulers of this space — big insurers — that are slower to adapt. This disruption gives an incredible benefit to small and mid-sized businesses that don't have to deal with legacy issues of culture, systems or balance sheets.

These developments will necessarily drive an evolution in the insurance ecosystem. Separating capital from the value chain will bring about a democratization of the space, a development that will be good for companies that invest in new technology and processes ahead of the curve.

William Spiegel *(WSpiegel@pinebrookpartners.com) is managing partner of Pine Brook, which he co-founded in 2006. He is responsible for managing Pine Brook's financial services investing activities.*

Reprinted with permission from the September 17, 2019 edition of PropertyCasualty360 © 2019 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited.
For information, contact 877-257-3382 or reprints@alm.com. #PC-09302019-418371