Insurance float and loss reserves

Letters: 2007, 2011, 2014 · Difficulty: Intermediate

Summary

Insurers collect premiums before they pay claims. The money held in between, **float**, appears on the balance sheet as liabilities (loss reserves and unearned premiums), but if the insurer earns an underwriting profit, it is money that costs nothing to use. Berkshire invests its float.

2007 letter

At yearend these totaled $141 billion (not counting those in our finance or utility operations, which we assign to our second bucket of value). * All per-share figures used in this report apply to Berkshire's A shares. Figures for the B shares are 1/30th of those shown for the A. 3 Insurance float – money we temporarily hold in our insurance operations that does not belong to us – funds $59 billion of our investments. This fl oat is "free" as long as insurance underwriting breaks even, meaning that the premiums we receive equal the losses and expenses we incur.

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Insurance The best anecdote I've heard during the current presidential campaign came from Mitt Romney, who asked his wife, Ann, "When we were young, did you ever in your wildest dreams think I might be president?" To which she replied, "Honey, you weren't in my wildest dreams." When we first entered the property/casualty insurance business in 1967, my wildest dreams did not envision our current operation. Here's how we did in the first five years after purchasing National Indemnity: Year Underwriting Profit (Loss) Float (in millions) 1967 $ 0.4 $18.5 1968 0.6 21.3 1969 0.1 25.4 1970 (0.4) 39.4 1971 1.4 65.6 To put it charitably, we were a slow starter. But th ings changed. Here's the record of the last five years: Year Underwriting Profit (Loss) Float (in millions) 2003 $1,718 $44,220 2004 1,551 46,094 2005 53 49,287 2006 3,838 50,887 2007 3,374 58,698 This metamorphosis has been accomplished by some extraordinary managers.

Let's look at what each has achieved. 9 • GEICO possesses the widest moat of any of our in surers, one carefully protected and expanded by Tony Nicely, its CEO.

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Even in aggregate, these lines will remain a small fraction of our personal auto volume. Nevertheless, they should deliver a growing stream of underwriting profits and float. • General Re, our international reinsurer, is by far our largest source of "home-grown" float – $23 billion at yearend. This operation is now a huge asset for Berkshire.

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What we know for sure, however, is that the London team who joined us, headed by Scott Moser, is first-rate and has become a valuable asset for our insurance business. • Finally, we have our smaller operations, which serve specialized segments of the insurance market. In aggregate, these companies have performed extraordinarily well, earning aboveaverage underwriting profits and delivering valuable float for investment. Last year BoatU.S., headed by Bill Oakerson, was added to the group.

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Learn more about this operation by visiting its display at the annual meeting. 10 Below we show the record of our four categories of property/casualty insurance. Underwriting Profit Yearend Float (in millions) Insurance Operations 2007 2006 2007 2006 General Re ..... $ 555 $ 526 $23,009 $22,827 BH Reinsurance ..... 1,427 1,658 23,692 16,860 GEICO ..... 1,113 1,314 7,768 7,171 Other Primary..... 279 340* 4,229 4,029* $3,374 $3,838 $58,698 $50,887 * Includes Applied Underwriters from May 19, 2006. Regulated Utility Business Berkshire has an 87.4% (diluted) interest in MidAmerican Energy Holdings, which owns a wide variety of utility operations.

2011 letter

In 2012, these expenditures will again set a record. • Our insurance operations continued their delivery of costless capital that funds a myriad of other opportunities. This business produces “float” – money that doesn’t belong to us, but that we get to invest for Berkshire’s benefit. And if we pay out less in losses and expenses than we receive in premiums, we additionally earn an underwriting profit, meaning the float costs us less than nothing. Though we are sure to have underwriting losses from time to time, we’ve now had nine consecutive years of underwriting profits, totaling about $17 billion.

Over the same nine years our float increased from $41 billion to its current record of $70 billion. Insurance has been good to us. • Finally, we made two major investments in marketable securities: (1) a $5 billion 6% preferred stock of Bank of America that came with warrants allowing us to buy 700 million common shares at $7.14 per share any time before September 2, 2021; and (2) 63.9 million shares of IBM that cost us $10.9 billion.

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In extreme cases, such as those arising from certain workers’ compensation accidents, payments can stretch over decades. This collect-now, pay-later model leaves us holding large sums – money we call “float” – that will eventually go to others. Meanwhile, we get to invest this float for Berkshire’s benefit. Though individual policies and claims come and go, the amount of float we hold remains remarkably stable in relation to premium volume.

Consequently, as our business grows, so does our float. And how we have grown, as the following table shows: Year Float (in $ millions) 1970 $ 39 1980 237 1990 1,632 2000 27,871 2010 65,832 2011 70,571 It’s unlikely that our float will grow much – if at all – from its current level. That’s mainly because we already have an outsized amount relative to our premium volume. Were there to be a decline in float, I will add, it would almost certainly be very gradual and therefore impose no unusual demand for funds on us.

If our premiums exceed the total of our expenses and eventual losses, we register an underwriting profit that adds to the investment income our float produces. When such a profit occurs, we enjoy the use of free money – and, better yet, get paid for holding it.

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I believe it likely that we will continue to underwrite profitably in most – though certainly not all – future years. If we accomplish that, our float will be better than cost-free. We will profit just as we would if some party deposited $70.6 billion with us, paid us a fee for holding its money and then let us invest its funds for our own benefit. So how does this attractive float affect intrinsic value calculations?

Our float is deducted in full as a liability in calculating Berkshire’s book value, just as if we had to pay it out tomorrow and were unable to replenish it. But that’s an incorrect way to view float, which should instead be viewed as a revolving fund. If float is both costless and long-enduring, the true value of this liability is far lower than the accounting liability. Partially offsetting this overstated liability is $15.5 billion of “goodwill” attributable to our insurance companies that is included in book value as an asset.

In effect, this goodwill represents the price we paid for the float-generating capabilities of our insurance operations. The cost of the goodwill, however, has no bearing on its true value.

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Fortunately, that’s not the case at Berkshire.

2014 letter

This collection of businesses will increase in both number and earnings. Our ambitions have no finish line. ‹ Berkshire’s huge and growing insurance operation again operated at an underwriting profit in 2014 – that makes 12 years in a row – and increased its float. During that 12-year stretch, our float – money that doesn’t belong to us but that we can invest for Berkshire’s benefit – has grown from $41 billion to $84 billion. Though neither that gain nor the size of our float is reflected in Berkshire’s earnings, float generates significant investment income because of the assets it allows us to hold. * Throughout this letter, as well as in the “Golden Anniversary” letters included later in this report, all earnings are stated on a pre-tax basis unless otherwise designated. 4 Meanwhile, our underwriting profit totaled $24 billion during the twelve-year period, including $2.7 billion earned in 2014.

And all of this began with our 1967 purchase of National Indemnity for $8.6 million. ‹ While Charlie and I search for new businesses to buy, our many subsidiaries are regularly making bolt-on acquisitions.

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In extreme cases, such as those arising from certain workers' compensation accidents, payments can stretch over many decades. This collect-now, pay-later model leaves P/C companies holding large sums – money we call "float" – that will eventually go to others. Meanwhile, insurers get to invest this float for their benefit. Though individual policies and claims come and go, the amount of float an insurer holds usually remains fairly stable in relation to premium volume.

Consequently, as our business grows, so does our float. And how we have grown, as the following table shows: Year Float (in $ millions) 1970 $ 39 1980 237 1990 1,632 2000 27,871 2010 65,832 2014 83,921 Further gains in float will be tough to achieve. On the plus side, GEICO and our new commercial insurance operation are almost certain to grow at a good clip. National Indemnity's reinsurance division, however, is party to a number of run-off contracts whose float drifts downward.

If we do in time experience a decline in float, it will be very gradual – at the outside no more than 3% in any year. The nature of our insurance contracts is such that we can never be subject to immediate demands for sums that are large compared to our cash resources. This strength is a key pillar in Berkshire's economic fortress. 8 If our premiums exceed the total of our expenses and eventual losses, we register an underwriting profit that adds to the investment income our float produces. When such a profit is earned, we enjoy the use of free money – and, better yet, get paid for holding it.

Unfortunately, the wish of all insurers to achieve this happy result creates intense competition, so vigorous indeed that it frequently causes the P/C industry as a whole to operate at a significant underwriting loss. This loss, in effect, is what the industry pays to hold its float. Competitive dynamics almost guarantee that the insurance industry, despite the float income all its companies enjoy, will continue its dismal record of earning subnormal returns on tangible net worth as compared to other American businesses. The prolonged period of low interest rates our country is now dealing with causes earnings on float to decrease, thereby exacerbating the profit problems of the industry.

As noted in the first section of this report, Berkshire has now operated at an underwriting profit for twelve consecutive years, our pre-tax gain for the period having totaled $24 billion.

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 2007, 2011, 2014 (berkshirehathaway.com/letters). Excerpts © Berkshire Hathaway Inc., all rights reserved; reproduced in part for non-commercial teaching. "…" marks skipped text. The summary is original course material by Jaeyoon Yu; not affiliated with or endorsed by Berkshire Hathaway Inc.