



# NO *free* LUNCH

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*Our challenge as an industry is to reboot many of our long-held views about investments, increase insurance rates to achieve even modest ROEs and prepare our balance sheets for inflation which seems inevitable.*



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**W**e have always known that there is no free lunch and now we realize there is “no risk-free rate.” The notion that even if someone else paid for lunch, it was not really free because there was some expectation on the part of the buyer has been debated forever. The term “free lunch” dates back to bars that gave out free lunches to entice drinkers. The bar food contained a heavy salt content which encouraged the patron to buy yet another drink.

### **A Paradigm Shift**

The concept of a risk-free rate is a central tenet of modern finance. And it posited that since governments or sovereigns could always raise taxes, they would always be able to repay their debts and, as such, holding their debt was, in fact, risk free. Today we see two phenomena altering that tenet. The countries in the euro zone cannot print money since they adopted a common currency and are subject to the European Community's rules and regulations. The second is the fact that the large deficits run by many countries around the globe, including the United States, and their resultant high debt to GDP ratios have made investors wary. While most non EU governments can print money to pay off their bonds, the resultant inflation will hurt the real return—quite possibly significantly. And, it is now recognized that debt to GDP ratios exceeding 80% are a significant detriment to growth. This is true for individuals, corporates and governments.

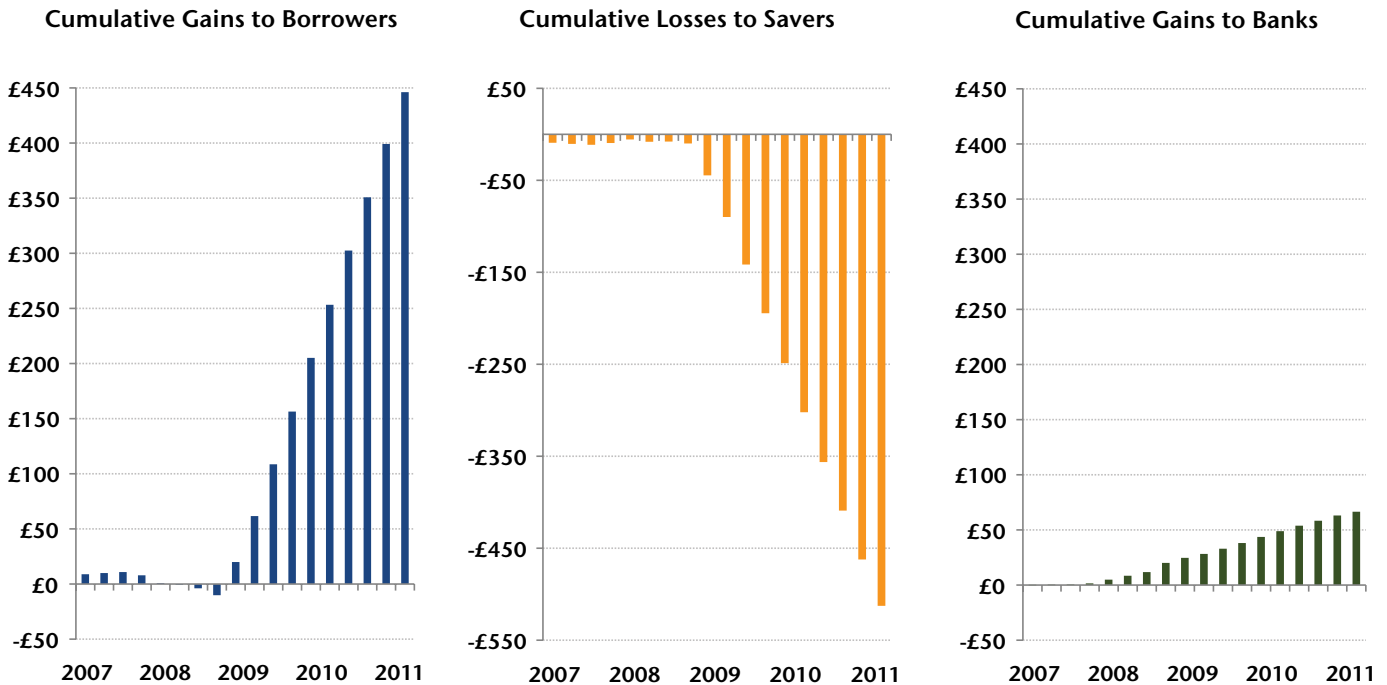
As a result, credit spreads have become more volatile and the traditional ratings from rating agencies less reliable. It's a brave new world, a paradigm shift. During the transition, volatility will increase and uncertainty will be high.

### **The Implications**

Policy makers around the world are compounding the situation by artificially suppressing interest rates on government bonds in an effort to avoid another recession and to recapitalize the banking sector. This policy rewards debtors at the expense of savers and of course the insurance industry is a major saving industry.

The following chart shows the impact of this policy for the UK:

### Savers Bailing Out Debtors



GBP Billions

Source: Bank of England, <http://ukhousebubble.blogspot.com/2011/01/uk-bank-savers-lose-350-billion-since.html>, Gen Re Analysis

Insurance companies around the world are forced to increase premium rates to achieve low single-digit returns on equity since their investment returns are penalized by these policies.

Increasingly, investors are concerned about companies that hold large amounts of government bonds from the peripheral European countries. But, regulators have encouraged this behavior. Both Basel II and Solvency II have a zero risk factor for government debt in their solvency requirements which has encouraged these firms to pile into government debt, and in the process created a systemic risk for both the banking and insurance industries.

### Looking to the Future

Looking to the future our whole perspective on various asset classes and their risks is going to have to change. Our reliance on rating agency credit scores will diminish and may, in fact, cease to be relevant. We will need to develop

independent credit underwriting skills and the investment management function will have to be more geared to analysis.

Our challenge as an industry is to reboot many of our long-held views about investments, increase insurance rates to achieve even modest ROEs and prepare our balance sheets for inflation which seems inevitable. We must do all this in an environment that is constantly changing.

## No free lunch, No risk-free rate.

Who knows, maybe Benjamin Franklin was also wrong and death and taxes aren't certain after all?



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