The True Value Of Insurers' Float

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When a policyholder is forced to engage in several years of litigation over an insurer’s denial of property/casualty coverage, and ultimately prevails in proving the denial was erroneous, is it fair that the insurer is required to pay only what it owed in the first place? Should the insurer also be required to disgorge the true value of the money it kept during those years? Some states address this issue by imposing double-digit prejudgment interest rates on the insurer, thereby helping to reduce the insurer’s incentive to delay resolution of the claim. In other states, however, with relatively nominal prejudgment interest rates, the insurer is rewarded by delay. In considering this issue, it’s important to understand the true value of a property/casualty insurer’s “float.”

Theoretically, nearly all the premiums an insurer collects in a given year from the many must eventually be used to pay the covered losses and liabilities of the unfortunate few. The float consists of the premiums an insurer holds and invests until they are used to pay claims. One insurance company routinely explains the float, and the integral role it plays in the economic model of the property/casualty insurance industry, in its annual letters to shareholders. In 2012, for example, the insurer wrote:

Property-casualty (P/C) insurers receive premiums upfront and pay claims later. 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 [the insurer’s] benefit. Though individual policies and claims come and go, the amount of float we hold remains quite stable in relation to premium volume. 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. That’s like your taking out a loan and having the bank pay you interest.

Thus, unlike other companies, which would have to pay interest to a bank to borrow money for capital investments and expansion, insurance companies borrow money from policyholders interest free. Insurers enjoy the use of free money and get paid for holding it. The true value of a property/casualty insurer’s float, therefore, is not merely the “return-on-investment value” – i.e., the return the insurer makes by investing premiums in bonds and other investments. Rather, the true value of the float also consists of the “use value” of the money the insurer borrows from its policyholders, which can be measured by the avoided cost of borrowing the money (typically two percent or more above the prime rate). If an insurer were required to disgorge the

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true value of the money it kept while erroneously denying coverage, it would pay the cost of borrowing that money plus any return on investment during that time.

When both the use value and return value are taken into account, the true value of the property/casualty insurer’s float far exceeds the single-digit rate of prejudgment interest set forth in a number of state statues. As a result, an insurer involved in coverage litigation in those states has little incentive to timely resolve the claim. In those states, legislative reform is due.