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Q&A with Professor Eloy B. Garcia

By Ronald Poon-Affat

As the editor of *Reinsurance News*, I recently caught up with Professor Eloy B. García, Professor of Banking, Finance and Economic Environment - IE Business School (Madrid, Spain). Professor Garcia was speaking at a CFA luncheon on "Geopolitical Challenges in a Multipolar World" in Sao Paulo, Brazil.

Ronald Poon-Affat: Your presentation gave us a whirlwind tour of the forces of innovation that are disrupting so many traditional business models/industries. Why do you think that the Insurance/Banking markets are still following what are essentially traditional models?

Professor Eloy: We must differentiate in both banking and insurance, very clearly the essential components of their respective business models and the delivery models/channels for their products.

We also must be aware that both are the most regulated ones with very high and difficult entry barriers for new comers. This alone provides incumbent entities with a formidable first mover advantage that provides considerable protection against exogenous disruptive business models, that affect many other industries (note, please, that I don't mean here impenetrability but just that they enjoy a "built-in natural protection").

Ronald Poon-Affat: But can't it be argued that both Banking and Insurance are financial services industries, and hence are more similar than dissimilar?

Professor Eloy: Both industries are essentially service industries based on "knowledge." However, here is where the first major difference between the two arises: the knowledge of banking is derived from the intermediary function exercised between two counterparts: the original supplier of funds (depositor, investor, etc.) and the user (borrower), that form the supply and demand. In the case of insurance, the "knowledge" component resides in the experience and dynamic probability distributions accumulated over long periods that accrue specifically to each company or line of insurance business. That is, in the insurance business, there is no intermediation, but only contingencies; that is the essence of insurance. Some of this is present in banking in the form of options, carried off a balance sheet.

Ronald Poon-Affat: So what's your opinion regarding the susceptibility to disruption? Banking or Insurance?

Professor Eloy: The key point rests in understanding how the nature of the balance sheets of both businesses differ radically. Whereas in banks the assets belong (or are owed to) the counterparts present in the liability side (depositors, bond holder, etc.), in the insurance business, both assets and liabilities are owned by the insurance company. The assets are the investments that protect the contingencies reflected in the liability side of the balance sheet. As long as an "event" does not arise, the "funded reserves" belong to the firm itself or the members of the "mutual" as a whole.

This is in my opinion the basic reason why insurance is not a very attractive (read here possible) industry to disrupt. The ownership of the knowledge related to probability of occurrence of a given event is particular to each insurance company or line of business.

This is not the case with banking in which institutions intermediate specific flows of funds that belong to specific individuals and specific users or borrowers. This type of "service knowledge" is an easy target for disrupting newcomers as it is already happening with P2P, crowdfunding, etc., as alone these don't leverage their financial positions (through fractional reserve requirements and/or straight balance sheet leverage or capital/lending ratio).

In the latter case, disrupters are attacking the essential of the banking business by poaching clients or piercing into the banks' value chain as well as the delivery channels. (This may get even more critical if the bitcoin-related block-chain technical breakthrough proves to be the demise of the "third trusted" party model pervasive in financial markets, which in the case of banking is present precisely as the "intermediary role" knowledge/function.

In short, insurance is probably proving to be so far unattractive for disruption because it is a business that does not have a defined counterpart: it is not a third trusted party that may be replaced (digitally or with whatever new business model that may emerge). The very existence of the insurance firm itself, fund, mutual, etc., offering specific risk coverage

Table 8.1 Ranking of IC Management Scores (from high to low)

Rank	Component	Category
1	Management	Human Capital
2	Employees	Human Capital
3	Network	Relationship Capital
4	Customers	Relationship Capital
5	Brand	Relationship Capital
6	Business Recipe	Bisiness Recipe
7	Process	Structural Capital
8	Intellectual Property	Stuctural Capital

based on proprietary actuarial knowledge is the essence of the insurance. In a way, it is a business model that could be described—stretching it a bit, as an "immanent" business model.

Nonetheless, this does not mean that the "delivery channels" (marketing, etc.) cannot be disrupted. But even in this case, what would be the use of this disruption if the "essence" of the business cannot be captured as well? What would be the attraction of capturing the "hardware" (i.e., the delivery channel) if you can't own the "software" (i.e., the dynamic actuarial knowledge).

Ronald Poon-Affat: I find your comment regarding the fundamental differences that exist between the balance sheets of insurance companies versus banks to be very interesting. I was recently reading about the effect of intangible capital on balance sheets, which leads me to ask what are your views regarding the treatment of insurance companies? Can you recommend additional reading?

Professor Eloy: Intangible capital is a topic that is currently very central to valuation of businesses. Whereas in the past the values of business were fundamentally given by the productive fixed assets carried in their balance sheets, nowadays the most valuable companies are those that possess specific types of intangible (read here different kinds of knowledge) assets. I would list the insurance industry within this group of businesses.

There is a relatively recent book *Intangible Capital: Putting knowledge to work in the 21st-century organization* by Mary Adams and Michael Oleksak (Praeger, 2010), that covers how the function of the traditional balance sheet is becoming severely limited in reflecting the true value of modern businesses/industries that have or are becoming digitized.

The authors suggest a ranking of Intangible Capital Management Scores. We observe that the lower we go on the list, the change in those business models may come less easy. If we were to position the insurance industry somewhere in the last three, where I think it belongs, (Business Recipe, Process or Intellectual Property) the path to change may not be easy according to the findings of that research.

Ronald Poon-Affat: I would like to thank you for your time and insights regarding the future of the insurance markets within this brave new disruptive world in which we now live. ■

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