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Measuring and Assessing Insurance Company Performance – A Private Investor Perspective

Martin White

(general) Insurance company performance: agenda

- Introduction – UK Shareholders Association
 - Actuarial aside - speaker history
 - Last year's topic was shareholders' views of accounts: same underlying questions apply when considering performance, but need to explore in more depth
 - Typical private investor focus is buy and hold : loyal, or just inertia?
 - Any insurers worth holding for the long term? Why – does performance justify it?
 - How to get trust and confidence from investors
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Performance agenda (continued)

- Conventional measures of performance, and problems with them: what really drives performance?
 - Accounting and regulatory responses: right focus within a company is also important
 - Accounting, regulatory (solvency) and tax issues – please don't miss a once-only opportunity!
 - CFO Forum
 - Success factors and failure factors: actuaries' views
 - Conclusions
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Actuarial aside

- Speaking today as UKSA director, not as actuary or insurance company employee
 - General insurance – International Accounting Standards working party
 - Papers in 2002, 2003, 2004. 2006?
 - Review of Geneva papers
 - 2003 paper on insurance cycle – managing through the cycle and communicating with shareholders to get their support
 - General insurance (UK actuaries) accounting and regulatory committee. Input to accounting and solvency debates: solvency 2 and risk margins.
 - See final slide for references and links (post-conference)
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Private investor perspective

Why interested in campaigning for shareholders ?

- Life insurance – Save and Prosper Group
 - Pensions – Clay & Partners
 - General insurance – Lloyd's of London (Corporation)
 - Commercial support – taxation
 - Regulation – solvency, etc
 - Equitas project (now work at Equitas)
 - **Lloyd's: agency / principal problem writ large**
 - UK Shareholders Association founded 1992 - director
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Private investor perspective

UK Shareholders Association Limited (UKSA)

- Volunteer organisation, rely only on members subscriptions

www.uksa.org.uk

Our aims include:

- Company managers' interests properly aligned with those of shareholders;
 - Empowered and educated individual investors whose interests are respected by government and who can operate on a level footing with institutional investors;
 - Financial services which really are good value for the investor.
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Private investor perspective

UKSA activities include:

- Regional network and meetings, typically with guest speakers;
 - Company analyst-style annual meetings (e.g. BAA)
 - Lobbying and representation to Government, DTI, etc
 - Quarterly magazine
 - E-mail network plus social network
 - Press releases and articles
 - Web site supports campaigns and provides information
 - Example issues: share options, issued guidelines for venture capital trusts, established process to support company action groups
 - Not generally “against the management”
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Private investor behaviour –starting point

- How to assess:
 - Industry worth investing in?
 - Which companies worth investing in?
 - Which companies priced cheaply today?
 - Feedback from members
 - Assessing management the biggest problem
 - Poor historic performance (share price and dividends)
 - Nervousness whether accounts meaningful
 - Integrity of management
 - Buy and hold candidates difficult to identify
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Getting trust and confidence of investors

- Discuss what really drives performance
 - Treat shareholders as intelligent and interested
 - Do not smooth earnings or gloss over problems
 - Explain why you would commit your own wealth to the company (buy and forget)
 - Discuss the soft measures / drivers of performance as much as the hard measures, and the uncertainties in the hard measures
 - Sports analogy: control the controllable – be prepared for the actions of competitors but don't plan for a particular "result"
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Conventional measures

- Valuable, but limitations not fully understood by investors
 - Earnings – how dependent on opening and closing reserves?
 - Framework of rules for reserving does not yet reflect reality
 - Scope for reserve manipulation, inadvertent and otherwise, with reinsurance – only solution is to discount.
 - "Cost of float" is useful concept, but need underwriting year and product group segmentation to be really useful
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The important drivers are difficult to measure

- Negative signals may be easier to spot
 - “We aim to grow our profits by x% per annum”
 - “Our aim is an increased market share”
 - “We will grow by acquisition”
 - Large share options
 - Short tenure of senior managers
 - How do you assess the competence and focus of the managers
 - Intelligent communication to shareholders is the only external sign we are likely to see
 - Falling premiums and market share in downturns may be the best sign of all
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Actions not words

- Design relationships to ensure and maintain trust
 - Get rich slowly with shareholders rather than quickly at their expense
 - Identify true value creators and reward accordingly
 - Options inappropriate in capital-rich company
 - Assisted shareholdings for employees, bought in open market
 - Reward for underwriting profit, not for investment return on shareholders capital
 - Underwriting profit share: delayed distribution to manage reserving hazard.
 - Explain rationale in detail to shareholders
 - Show sensible reaction to changing market conditions
 - Show reaction and opportunism, not wishful thinking
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Different markets, different characteristics

- What is the source of value?
 - Brand and market position
 - Pay employees and management market rates, limited justification for large profit shares
 - Personal lines may be a good example
 - Living on wits? e.g. bespoke underwriting decisions in commercial, international, reinsurance.
 - Key employees can make or break the business
 - So managing them is everything. Only if this can be done without diluting the shareholders is such a business a good investment proposition.
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Accounting issues

- Major improvements under way: phase 2
 - Undiscounted reserves give misleading and distorted results, but:
 - Concern over danger of under-reserving entirely valid
 - Total capital versus total liabilities is what should interest policyholders
 - But earnings is what people focus on – moral hazard
 - Reserves must be > mean discounted amount net of RI:
 - Self-sufficient on wind-up
 - CFO forum: release earnings only as risk runs off
 - ...which brings us to:
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Risk provision in reserves: TAX implications

- No room for theoretical niceties – accounting provisions tend to drive earnings for tax
 - “Fair value” not achievable literally but the concept is still of some use
 - Risk margins within provisions need to be stable over time and comparable within companies
 - Percentile concept is not compatible with portfolio-independent risk margins – which are needed to give comparable reserves.
 - Plenty of technical options for achieving sensible result
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Extract from Groupe Consultatif response to CEIOPS on Solvency 2

- “If however an entity-independent approach is used, this would satisfy many of the requirements we might expect from IFRS. These include :
 - Reserves fully comparable between companies both within and between jurisdictions and also over time.
 - Aggregate reserves not capable of manipulation through company consolidations or subdivisions.
 - Providing a possible base for consistent tax treatment.
 - We note however that an entity-independent approach by design would not take into account diversification effects.”
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But isn't diversification effect economic reality too?

- This can be considered when determining capital requirements, so larger companies will always have an advantage, other things being equal
 - But for shareholders it is vital that there is a greater level of integrity to the earnings
 - And think about the prize of tax following the emergence of earnings as the risk runs off, as per CFO forum submission to IASB.
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Economic reality of purchased reinsurance

- Honest accounting will follow economic reality
 - Reinsurance purchase reduces expected earnings, so why not admit and discuss it
 - Why buy reinsurance?
 - To reduce likelihood and severity of adverse scenarios which imperil the policyholders or the business, and so to use capital more effectively.
 - Not to smooth earnings. Earnings smoothing is not a shareholder-focused activity.
 - Shareholders' hats off to Mr Spitzer
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Soft measures are vital in insurance

- Shareholders should look for competence, and not worry about competition
- Strong leadership and direction (and longevity!):
 - But realistic and patient
 - Clarity and intelligence of goals and ability to communicate internally and externally
 - Quality of implementation
- Abilities of staff
- Suitable alignment of interest
- Improvement of capability over a period may be more important than earnings in period:
 - Explain investments to improve “state” of the business