



International Association for the  
Study of Insurance Economics

# Études et Dossiers

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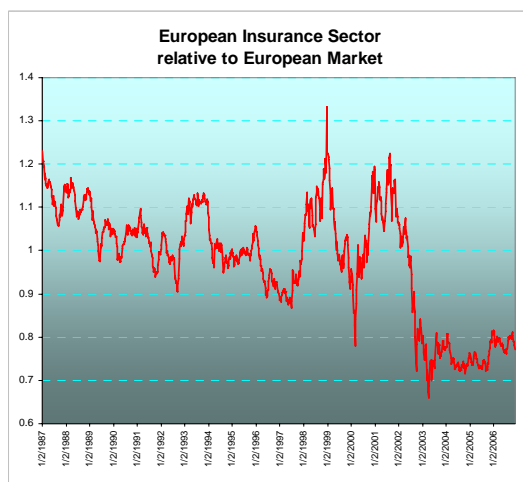
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Layout & Distribution: Valéria Kozakova

# Creating and Managing Economic Value in Insurance Companies ...and crystallizing it...

Maurizio Lualdi

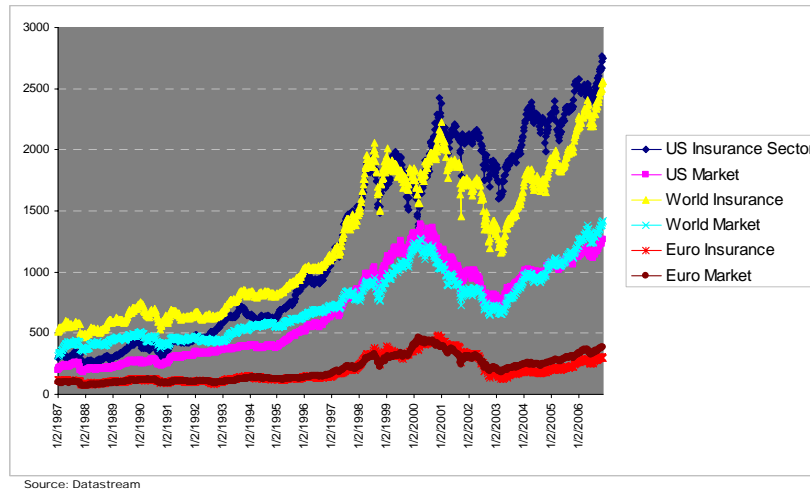
## 20 Years...generating value?



Source: Datastream

- The insurance industry in the long run has not been very successful at generating value for **shareholders**.
- Who has been the beneficiary?
  - **Policyholders?**
  - **Intermediaries?**
  - **Nobody?**

...but it doesn't appear to be an industry problem...



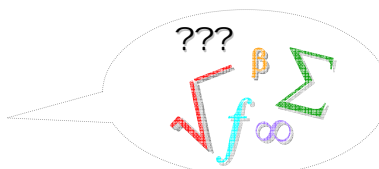
## Coming back to Earth

- The European Insurance sector has been underperforming its US peers and the market as a whole.
- This lacklustre performance has happened even when the sector has been going through a favourable operational environment (rising yields, stable equity markets, hard P&C cycle).
- Why?

## Are they not all insurers?

- Why is Europe so decoupled relative to the US and the World?
- The markets don't appear to give a lot of credit to insurers in Europe for their track record in value generation.
- Sure companies will argue that they have indeed generated value and that this can be seen in their results...
- Have the published results been a reliable reflection of reality?

...oh...but you can't use those numbers...



- The accounting reporting framework (old and new) for life insurers is a "forced" adaptation of P&C reporting.
- From the accounts it is possible to calculate combined ratios for life insurers !!! (And some people do !!!)
- So what has been the solution to increase transparency and make sense out of this?

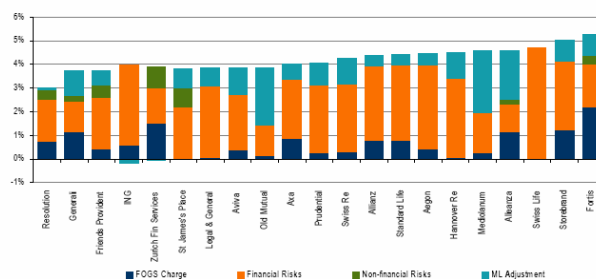
## Embedded Values !!!

- Embedded values are an operational monitoring tool.
- Embedded values are valuations...can you do a valuation on a valuation? Valuation<sup>2</sup>?
- And what is the reason for using these?
- ...the cost structure of distribution...
- Fund managers do understand the meaning of embedded values, however, they struggle to accept (with reason) (a) its comparability and (b) its use as a valid valuation metric relative to other sectors.
- The US insurance sector never embraced embedded value reporting - US GAAP rules there.

## ...but Embedded Values are getting better...

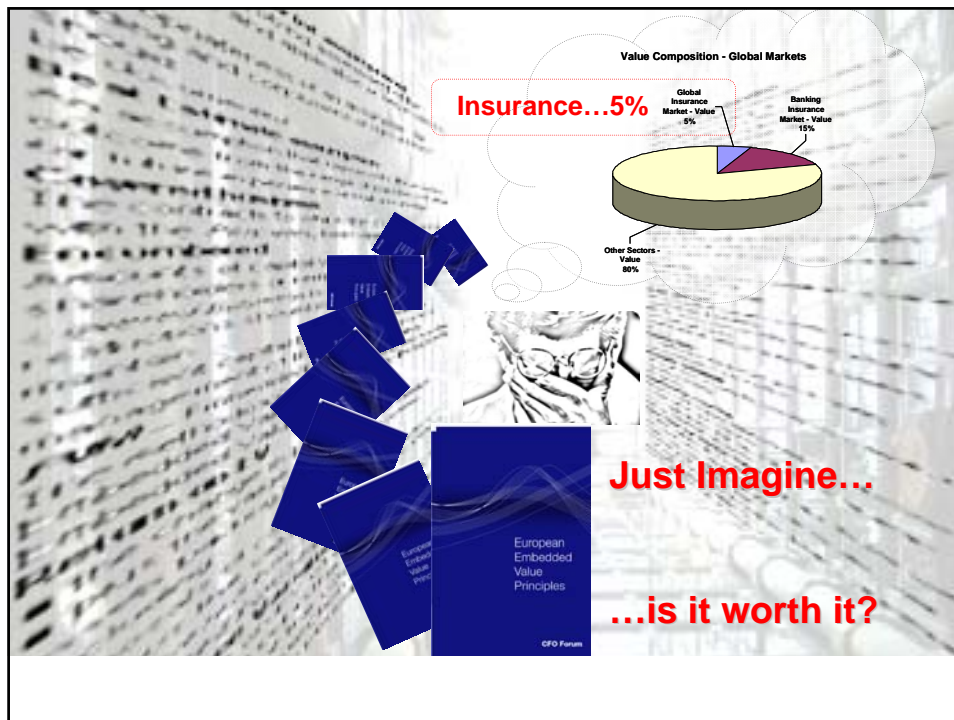
Deterministic was not good...risks were not captured and companies could fiddle with results...so now we get... European Embedded Values...and soon...Solvency II...

Chart 19: Comparison of ML adjusted discount rate excl. risk free rate



Source: Company reports and Merrill Lynch.  
Source: Merrill Lynch

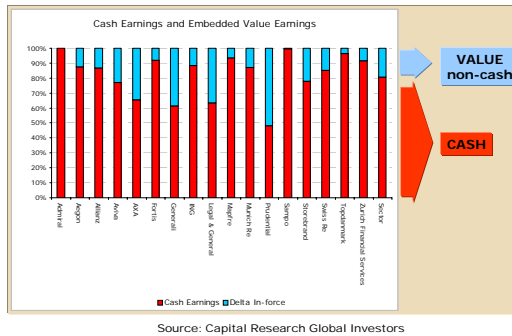
...the land of confusion...



## Back to Basics

- Any asset's value is determined by the net present value of the free cash flow generated.
- Embedded values are already cash flows discounted. However, the market applies multiples to embedded values and embedded value earnings.
- So is an insurance P/E a valid comparator against an industrial company?

...if the industrial sector could use embedded values...



1. If we were to apply a P/E multiple to embedded value earnings, the insurance sector will be 20% over valued relative to any other sector. In certain cases the difference between embedded value earnings and cash earnings is far higher.
2. What happens with CAPEX in the industrial sector? That is also an "investment" that will generate future cash flows, however, industrial companies don't capitalise this in its earnings...ENRON tried...

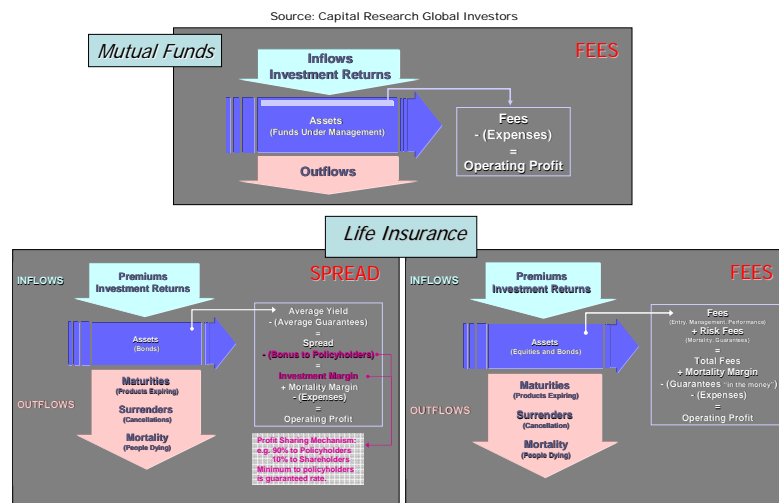
The Actuarial Olympics...nice...but who is your real audience...

- Actuaries and insurance analysts (especially those with actuarial background), delight themselves in "intellectual debates".
- And...who is the end consumer?  
FUND MANAGERS!
- The intellectual debate is costing a lot of money to investors...and ultimately...why should be insurance different from any other sector?

## What is a life company?

- Is a combination of an asset manager and a risk manager.
- And how does it make money? By managing assets, "creaming off" margins and selling "micro" hedging.
- And how is this different from the mutual fund world? Not that different, assets under management, and fees ("creaming off") + risk pricing.
- So how come that asset managers understand their own business and don't understand insurance?
- Because the industry has been reporting based on a "product design mentality" rather than through an economic framework.

## Flows and Margins



Source: Capital Research Global Investors

Source: Capital Research Global Investors

Yes but insurance companies  
take risks...

...how can you reflect that?

- Banks also take risks (credit, market, operational).
- They don't report using embedded values.
- Banks report using conventional accounting standards – and investors do understand.
- The risk is reflected in the regular publication of Value at Risk.
- Accordingly banks have done better than insurers.

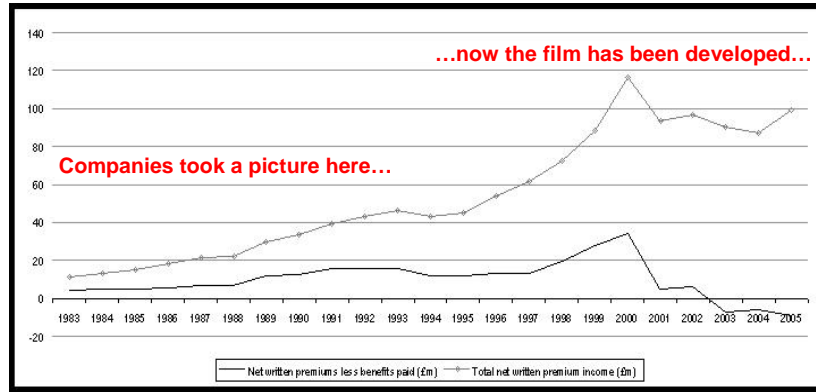
## Generating the wrong type of risk

- Asset managers analyse industries and take investment decisions conscious of the operational risks (positioning, profitability, growth, etc.).
- What the insurance industry in Europe has managed to do is to add a new layer of risk... reporting risk.
- This has crystallised in:
  - Lack of understanding of "true" life profitability.
  - Poor understanding of "soundness" of P&C reserves.
  - Ultimately mistrust on the sector.
- Fund managers' response: I don't understand this sector, therefore, I don't invest.

Life...

### The UK life insurance market Premium income vs. net fund flow (premiums less benefits)

**Has the industry generated value for shareholders?**

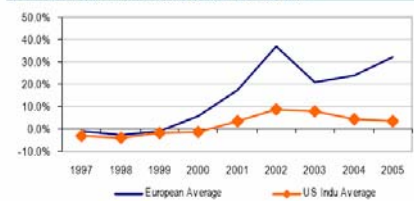


Source: Association of British Insurers, Credit Suisse research

...and P&C

### Reserves...

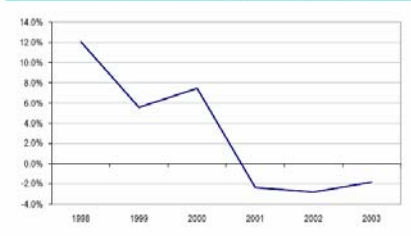
Chart 7: Impact of Reserve Moves on US Calendar Year Loss Ratio



Note: All figures are net of reinsurance. A positive number denotes a reserve increase. Munich Re figures have been adjusted for the 2003 loss portfolio transfer. FSA figures have been adjusted for an adverse development cover.

Source: Company reports and Merrill Lynch

Chart 9: Reserve Development by Accident Year, Consolidated Operations of the Europeans

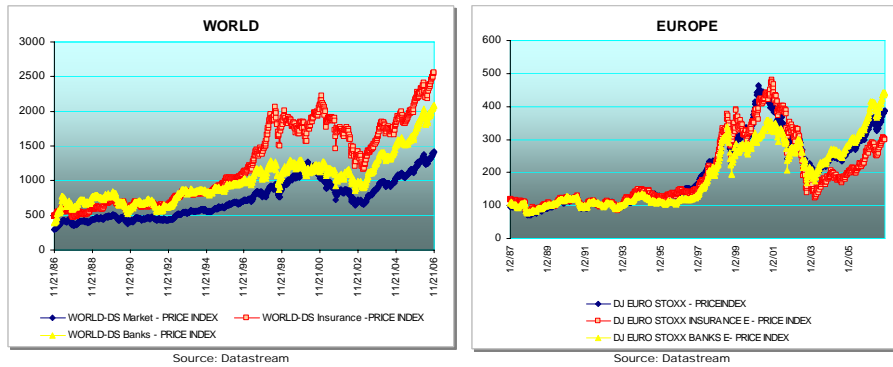


Note: Figures are shown as a percent of initial accident year reserves and exclude the first year of development. Except for Allianz, we have reworked the calendar year change tables into an accident year basis and all figures are our estimates. Allianz has disclosed data on an underwriting year basis. Allianz and AIA are gross of reinsurance, others are net. A positive number denotes a reserve increase. Figures exclude currency movements.

Source: Company reports and Merrill Lynch

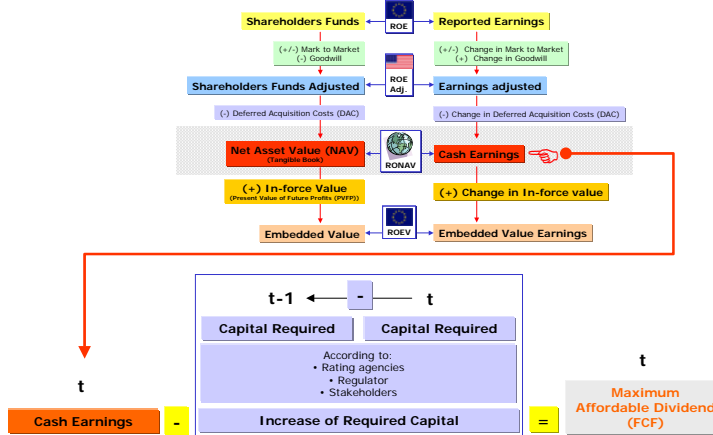
- The P&C sector doesn't appear to reach an "equilibrium" state.
- Significant reserve increases "wrecked" companies' ratings in 99-02 and now reserve releases (apparently structural) are boosting earnings...
- Difficult to judge "true" earnings' sustainability.
- Once again...the US has shown the way in terms of disclosure...(yellow perils).

## Operational stability and...



**A common phrase we get from insurance executives is that now the insurance industry is going through the same transformational period that the banks had 15-20 years ago...the jury is out...**

## ...cash...cash...cash...



**Don't ask what the market can do for you...ask what you can do for the market...**