

2013 Convention
new solutions for a new world

31 Oct - 1 Nov 2013
Sandton, Johannesburg



EMBEDDED VALUE REPORTING IN A SOLVENCY ASSESSMENT AND MANAGEMENT WORLD

David Kirk

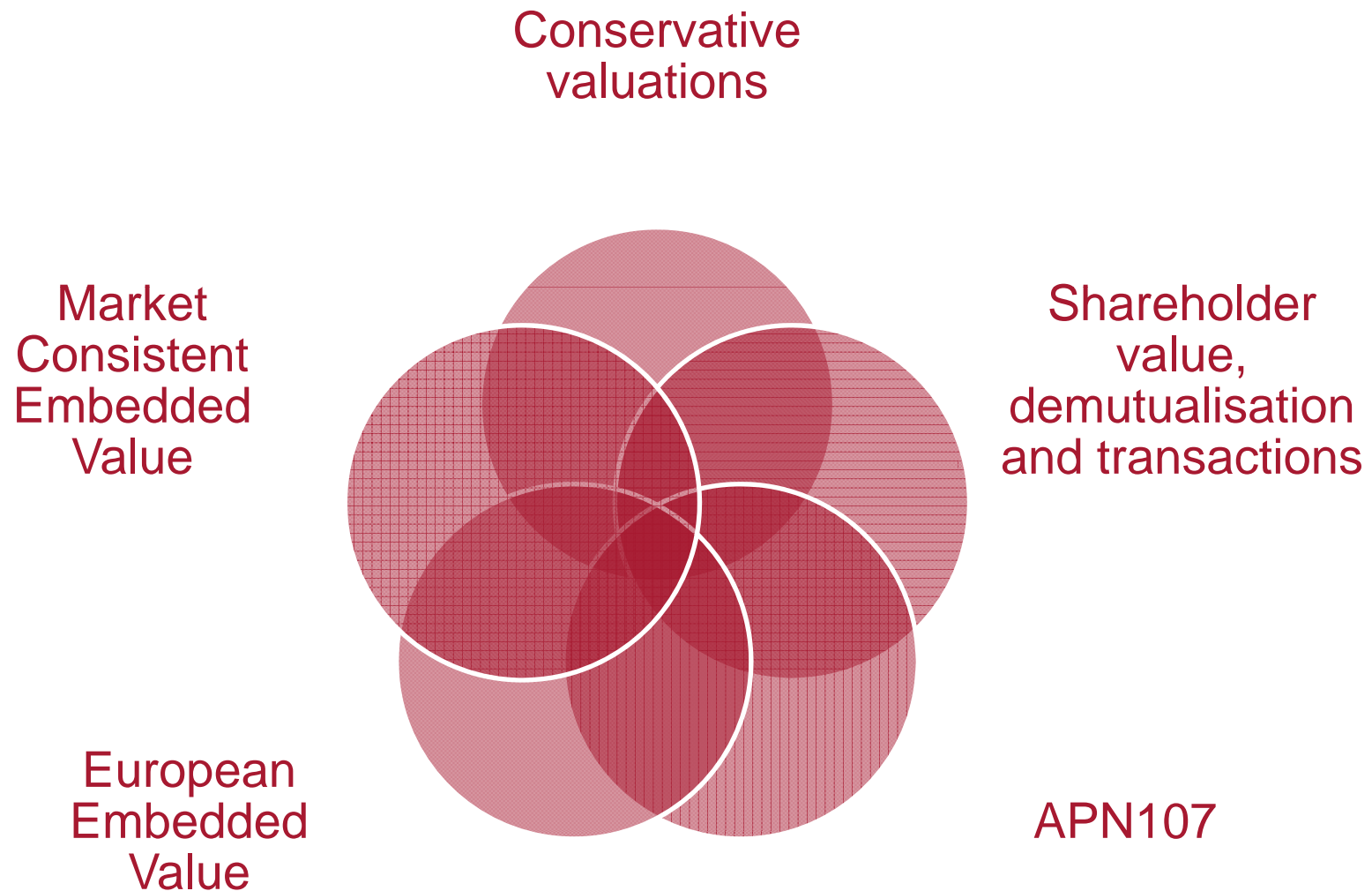
2013 Convention

31 Oct & 1 Nov

Agenda

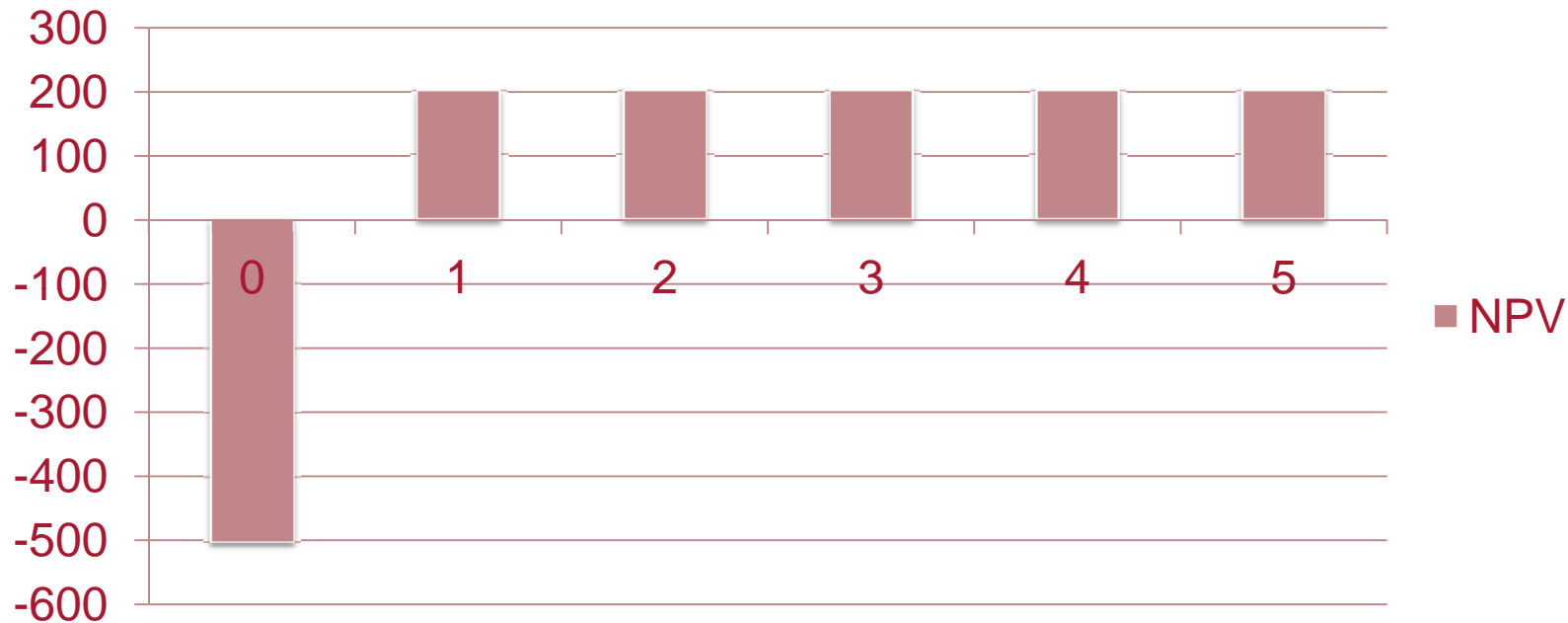
1. The origin and evolution of Embedded Value Reporting
2. The need + opportunity for change – SAM & IFRS4 Phase2
3. Stakeholders, their views and preferences
4. Some options for EV reporting in this new world
5. An Aside: Profitability reporting

The origin and evolution of Embedded Value Reporting



Profit profiles under different bases

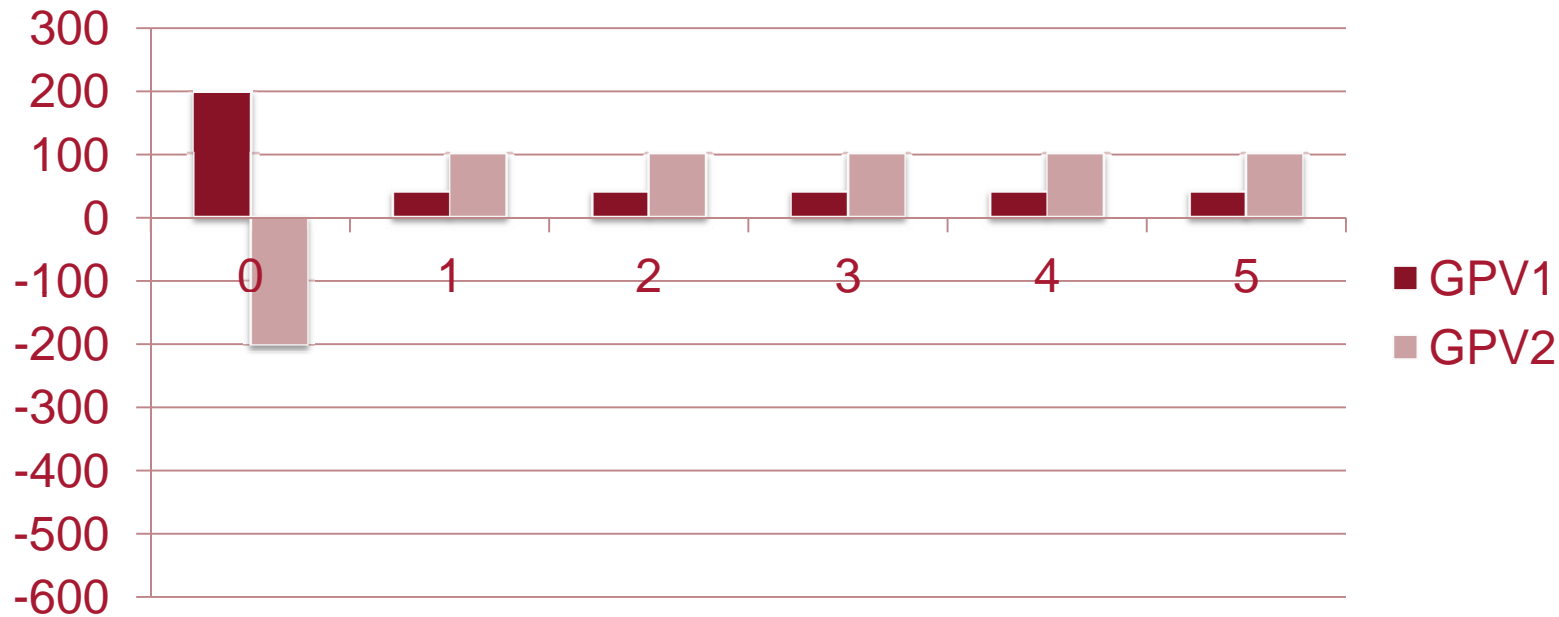
New Business Profit Profile



- Net Premium Valuations typically result in significant new business strain followed by profit emergence
- Overstates Liabilities, Understates NAV and shareholder value

Profit profiles under different bases

New Business Profit Profile



- GPV1 – Gross Premium Valuation without additional margins
- GPV2 – GPV including significant Discretionary Margins or Zeroisation

Profit profiles under different bases

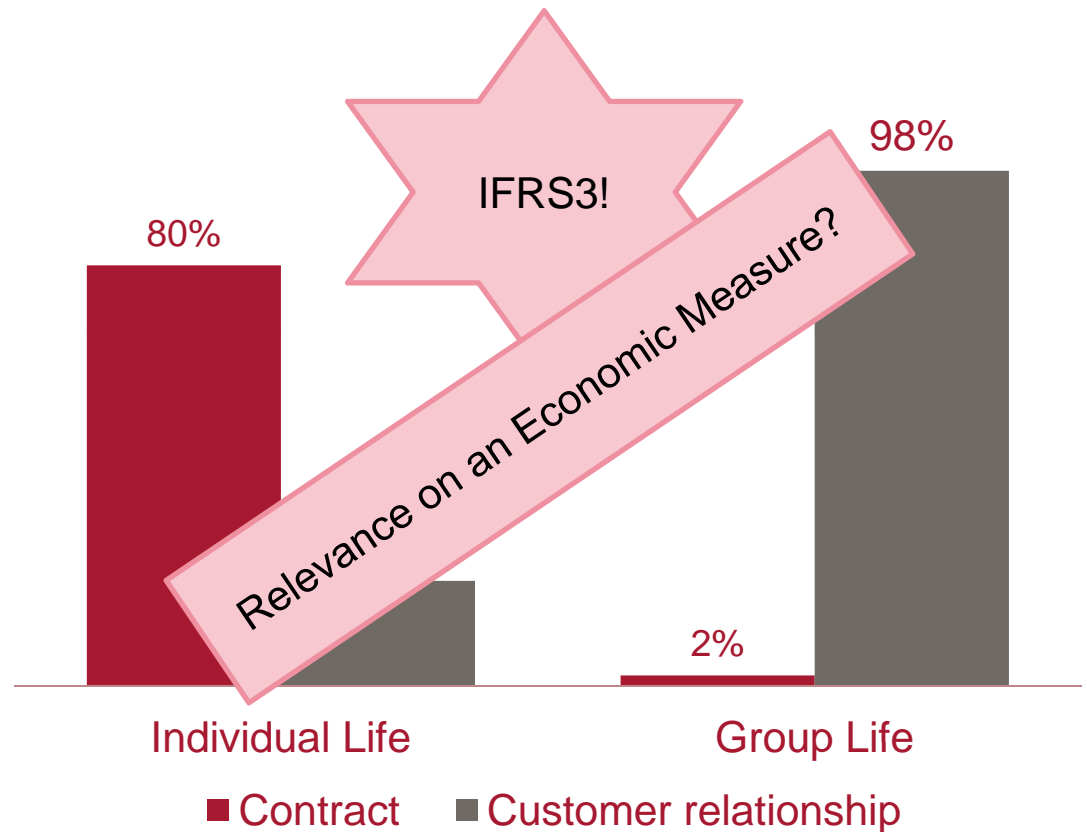
New Business Profit Profile



- Embedded Values discounts Best Estimates of all cash flows under an economic boundary
- Value from Contract + Customer Relationships

What are we measuring?

- Value embedded in conservative valuations of contractual rights and obligations to policyholders
- Group Life? EB admin? EB investments? Health Administration? Short Term Insurance?



Market Consistency

- Key criticisms of traditional Embedded Values
 - ✗ Risk Discount Rate is wrong
 - ✗ Liability valuations capitalise value from asset risk premiums
 - ✗ Not market consistent
- Key criticism of Market Consistent Embedded Values
 - ✗ They're market consistent
 - ✗ There isn't a market → fake volatility
 - ✗ Nobody understands them – not how analysts measure value
 - ✗ Adds complexity in projections and understanding results

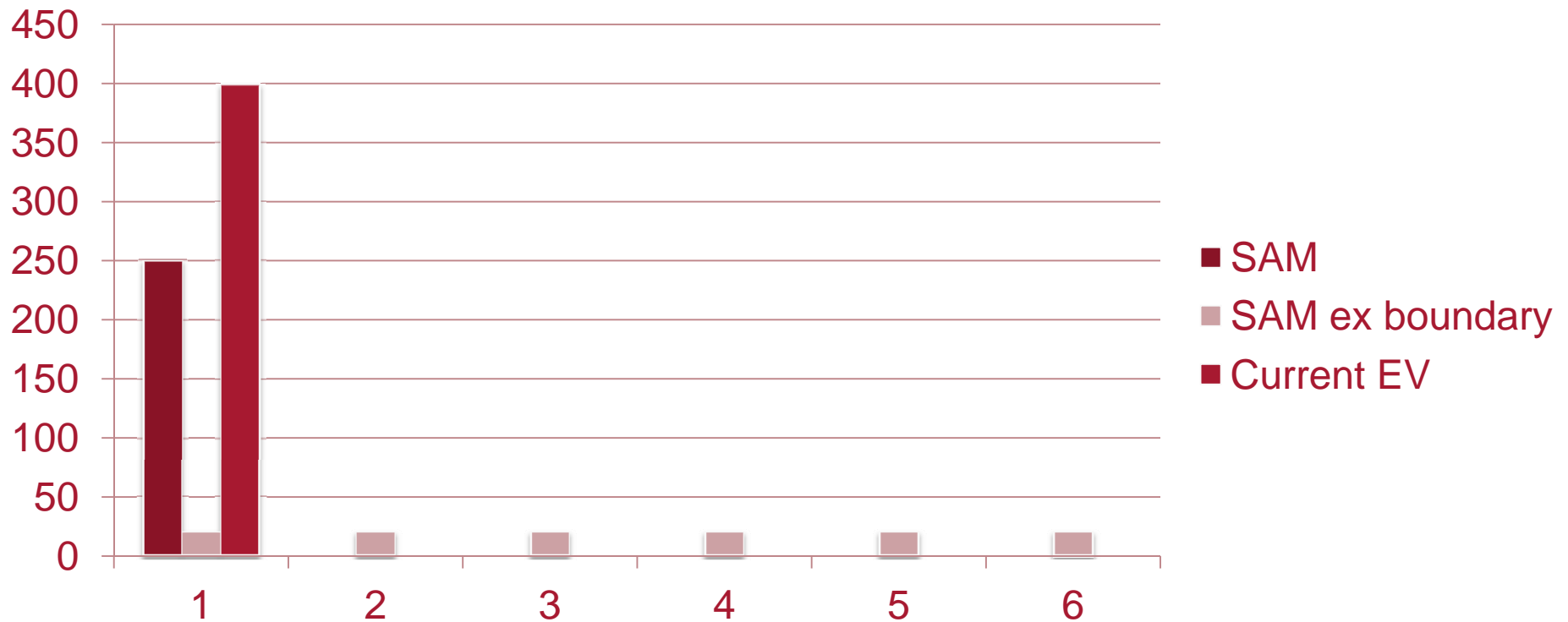
The need + opportunity for change – SAM & IFRS4 Phase2

- New standards, new pressures
 - SAM and IFRS4 Phase 2 are changing existing measurement standards for Insurers
 - Reporting timelines are shrinking, complexities are increasing and the number of bases is potentially growing



Recognising new business value

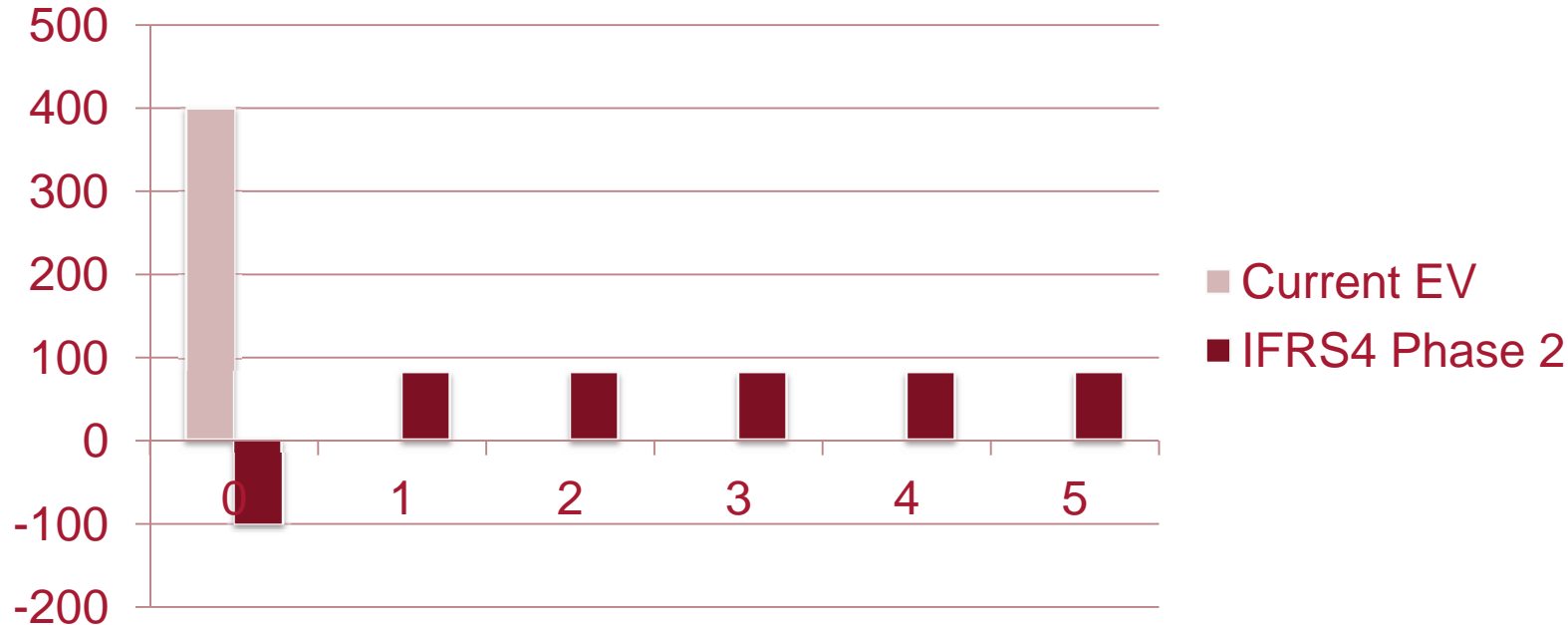
New Business Profit Profile



- SAM Technical Provision principles are best estimate and market consistent
- Key differences exist, but plenty of common principles too

Profit profiles under different bases

New Business Profit Profile



- IFRS4 Phase 2 results in new business strain for insurance contracts
- IAS39 / IFRS 7 can still result in new business strain for investment contracts

Stakeholders, their views and preferences

- Analysts:
 - Your RDR is too low
 - We don't trust your assumptions (lapses, expenses)
 - There are too many one-offs and other changes
 - Your cost of capital is based on too little capital
 - It's too hard to reconcile your EV, IFRS and SVM figures
 - Just give us the forecasted cash flows in sufficient detail so we can plug the info into our own models
 - (Highly regulated industry, mature South African market et al)

Stakeholders, their views and preferences



- CFOs and Investor Relations
 - It's too hard to reconcile our EV, IFRS and SVM figures
 - We need to get our results out quickly, but I still want to have confidence in the numbers.
 - I don't want surprises
 - Does it support my share price?
 - Should I pay this to acquire a business?

Stakeholders, their views and preferences



- Finance actuaries
 - It's too hard to reconcile our EV, IFRS and SVM figures
 - We need something simple and useful
 - Am I going to have to change all my models again? Will I need to rebase? What will happen to my runtimes?
 - I don't want to have to do multiple runs on multiple bases – can't we just use IFRS or SAM?
 - We should focus on cash flow, payback periods and Internal Rates of Return

Some options for EV reporting in this new world



- Discounted Free Cash Flows to Shareholders

Advantages

- Theoretically pure
- Factors in all constraints on cash (regulatory, Four Funds Tax, Companies Act, Dividend policy)
- Consistent with projecting future balance sheet positions

Problems

- Complex and new
- Not consistent with IFRS or SAM or Tax bases
- Challenges for new business value and segment measurement

Some options for EV reporting in this new world

- Discounted Future Profits on an IFRS Basis

Advantages

- Consistent with standardised, audited Earnings
- Potential for consistency across countries
- Creates a neat “Forward P/E” ratio metric

Problems

- No theoretical base
- Value will change as accounting standards + policies change
- Adds further complexity to Contractual Service Margin modelling and run-off

Some options for EV reporting in this new world

- Adjusted SAM Balance Sheet

Advantages

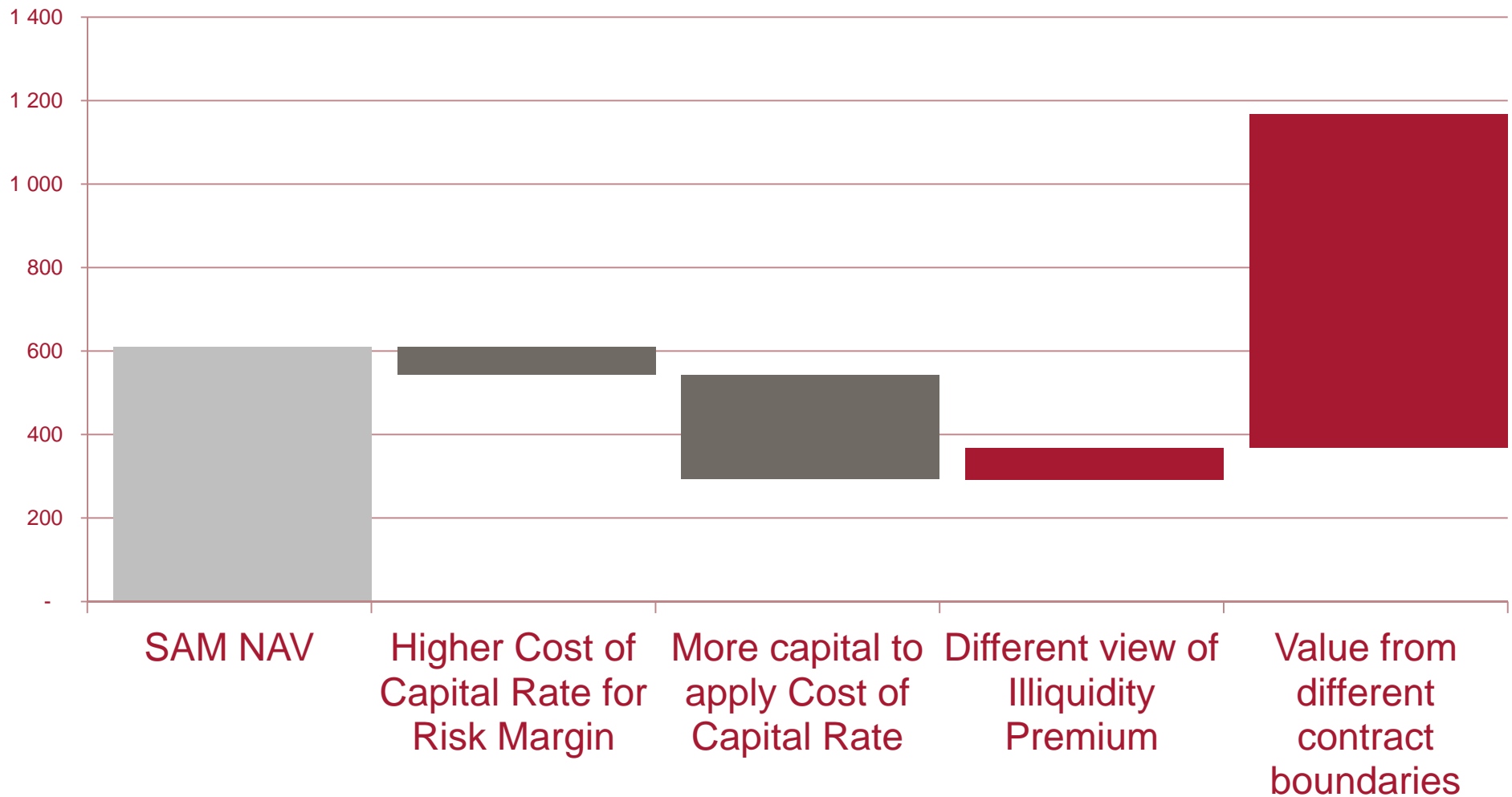
- Market Consistent
- Builds on an existing basis
- Most adjustments trivial
- Could be internationally understood
- May simplify some hedging decisions
- Ties into ORSA
- Arguably most consistent with current EV
- Reconciliation might be requested any way

Problems

- Market Consistent
- Not consistent with IFRS earnings
- Some adjustments complex
- Non-SA Subsidiaries won't necessarily have SAM starting point
- Adjustments may be too fundamental
- Still complex

SAM adjusted to Shareholder Value

SAM adjusted to Shareholder Value



Adjusted SAM Balance Sheet

- Forward projections / Analysis of Change from
 - (New business)
 - Ex Boundary New Business
 - (Real world expected returns)
 - (Transfers from Ex Boundary Business)
 - Unwind on Ex Boundary Business
 - Unwind of different risk margin
 - Unwind of different illiquidity premiums

*How different is
this from current
AoEV?*

Adjusted SAM Balance Sheet

	SAM NAV	Ex Boundary	CoC	Illiquidity Premium	Total
Opening	610.0	800.0	-316.7	75.0	1 168.3
New Business	50.0	35.0	5.0	3.0	83.0
Risk Neutral expected return	42.7	56.0	-22.2	5.3	81.8
Real world Adjustment	24.4	32.0	-12.7	3.0	46.7
Transfers	120.0	-120.0	-	-	-
Unwind of CoC + LP	-	-	20.0	10.0	30.0
Closing	847.1	803.0	-336.5	96.3	1 409.9

An Aside: Profitability reporting

Is a 4% New Business Margin good?

No way to tell.

- Is it VNB / APE or VNB / PVNBP?
- Is it Risk Business or Savings Business?

Introducing New Business Margin on Revenue



- $NBMR = VNB / PVFR$
- $PVFR =$ Present Value of Future Revenue
 $=$ PV of [Risk Premiums + Fees + Charges]
- $NBMR =$ What percentage of each future component of income to shareholders is profit

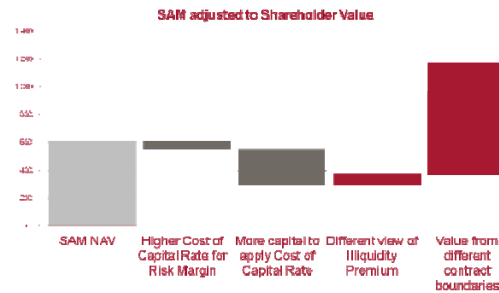
$$VNB = APE \times [PVNBP/APE] * [PVFR/PBNBP] * [VNB/PVFR]$$

$$VNB = APE * DPT * RPP * NBMR$$

What's Next?

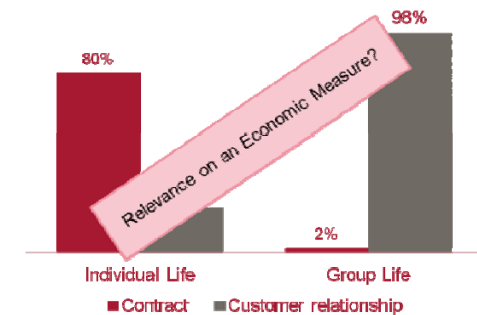
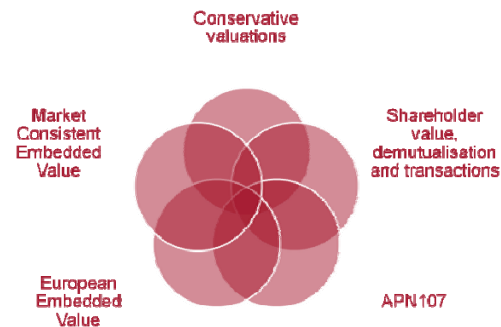
- In Progress...

- A full paper
- More detailed analyst / stakeholder views
- Working in your input



	SAM NAV	Ex Boundary	CoC	Illiquidity Premium	Total
Opening	610.0	600.0	-316.7	75.0	↑ 166.3
New Business	50.0	35.0	5.0	3.0	83.0
Risk Neutral expected return	42.7	58.0	-22.2	5.3	81.8
Real world Adjustment	24.4	32.0	-12.7	3.0	46.7
Transfers	120.0	-120.0	-	-	-
Unwind of CoC + LP	-	-	20.0	10.0	30.0
Closing	847.1	803.0	-336.8	96.3	1 409.6

Advantages	Problems
<ul style="list-style-type: none"> Market Consistent Builds on an existing basis Most adjustments trivial Could be internationally understood May simplify some hedging decisions Ties into ORSA Arguably most consistent with current EV Reconciliation might be requested any way 	<ul style="list-style-type: none"> Market Consistent Not consistent with IFRS earnings Some adjustments complex Non-SA Subsidiaries won't necessarily have SAM starting point Adjustments may be too fundamental Still complex



- New standards, new pressures
 - SAM and IFRS4 Phase 2 are changing existing measurement standards for Insurers

