

Embedded value enhances transparency

Meaningful figures for life insurers

How much do annual reports from life insurance companies actually tell you? This highly debated question has a simple answer - the actual profits of a life insurance company as reported to shareholders can be easily calculated using embedded value. This value provides the basis for determining the long-term earnings outlook for a company.

Short and long-term assessment

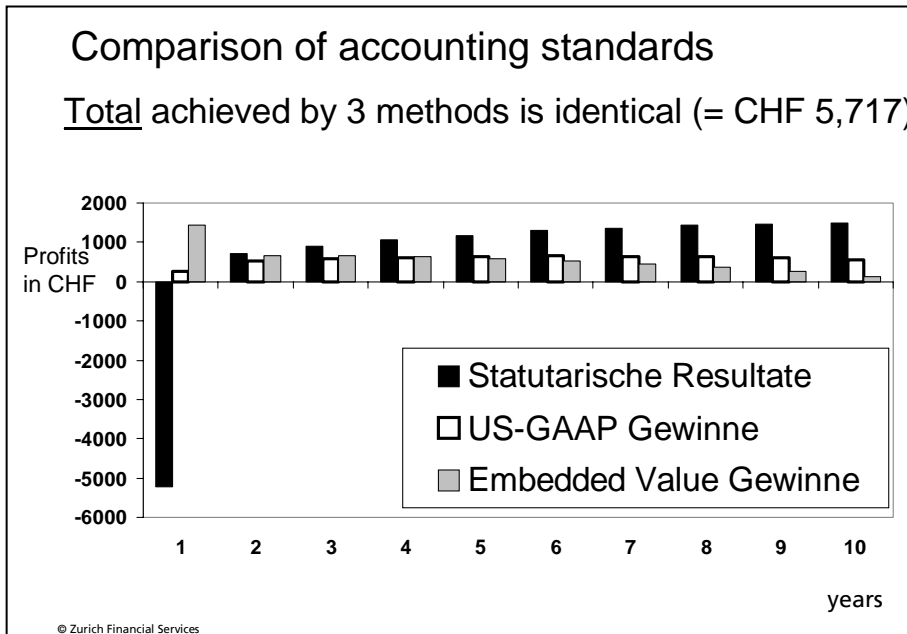
Profit trends in the life insurance business differ greatly from those of other sectors as life insurance policies are generally based on long-term contracts. The company makes an initial investment (acquisition costs, commissions for agents, legally prescribed reserve accumulations), which is normally paid for over the coming years by its earnings. Within a larger portfolio of life insurance policies, the profit from the old portfolio in one calendar year is sufficient to finance the initial costs of new policies. If, however, the company is currently in a growth phase and is taking on lots of new business, then the reported earnings do not reflect the “real” results. As profit will not be realized until sometime in the future, the results will initially be negatively impacted by the large number of new policies. In the longer term, however, the company will profit from the growth of its portfolio.

Goodwill not included

Results can also be misleading for another reason – the early surrender of a policy. While a certain deduction is made when a policy is surrendered in order to cover the past investment at least in part, no profit will be earned in the future; and a cancelled policy is not profitable for the company when viewed over the entire term of the policy. Thus the company’s earning may rise if a large number of policies are cancelled in the reporting year due to deductions for the surrendered policies, when in reality the value of the portfolio drops. A *statutory* income statement primarily reflects country-specific laws and is geared to the solvency of the company, not to its long-term earnings outlook. In order to gain a realistic picture of the business, international standards of accounting (e.g. IAS or US GAAP) are used, where the statutory results are adjusted according to certain regulations. In particular, life insurance companies have difficulties interpreting the American GAAP in an European environment. What’s more, the results fluctuate with realized capital gains. This is why IAS or US GAAP cannot be used to *measure the actual performance* of a life insurance company. For this reason, the concept of embedded value was developed several years ago in the Anglo-Saxon world. Embedded value represents the value of the life insurance portfolios for the shareholders, although future new businesses (sometimes designated as goodwill) is not included in the calculation. It is equal to the adjusted net asset value (incl. the value of unrealized capital gains that can be allocated to the shareholders) and the realistic (best estimate) present value from projected statutory annual profits from the existing portfolio which can be distributed in the future. The equity costs – which serve to ensure the solvency requirements – have already been offset¹.

Various ways to determine profit

The following are profit “profiles” of the three different accounting standards when applied to a life insurance policy with an annual premium payment and a 10-year term of policy (see graph).



Replace in Graph: Statutory Profits / US-GAAP Profits / Embedded Value Profits

What is remarkable here is the different times at which profit was recorded: in the first policy year, embedded value attributes large earnings (economic view) to added value (policy sales), but the other standards do not show large profits until later years. The total amount of profit (sum), however, is identical for all three standards.

The increase in embedded value (incl. dividends) defines the return on equity. An analysis of the change in embedded value is a useful management tool as it demonstrates where value is being created or destroyed within the company. In Anglo-Saxon countries, embedded value is often included as additional information in the appendix of the annual report. It also enables more effective comparisons to be made between the performance of life insurers, even across borders. The Zurich Financial Services Group already began publishing more detailed information on embedded value for the life insurance business in its 1999 annual report (incl. basic assumptions for calculations). This type of transparency is becoming increasingly important in a market that is becoming ever more complex, and it will not be long before other insurers follow this example. Swiss Re just recently published the embedded value of its life insurance portfolio.

¹ a more precise actuarial definition can be found at www.actuaries.ch/deutsch/b/embd-val.pdf

Author: Jon Bardola, Head of Life & Financial Services Zurich Financial Services Group

First published: March 2, 2001 edition of the *NZZ*