

Capital market implications of the new reporting requirements in the UK life industry

**Charles Garnsworthy**

**Mike Lamb**

**Rakesh Tanna**

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#### Agenda

- Market background
- New capital requirements
- Raising debt capital and constraints
- Valuations
- Specific issues for closed books
- Conclusions

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Market background

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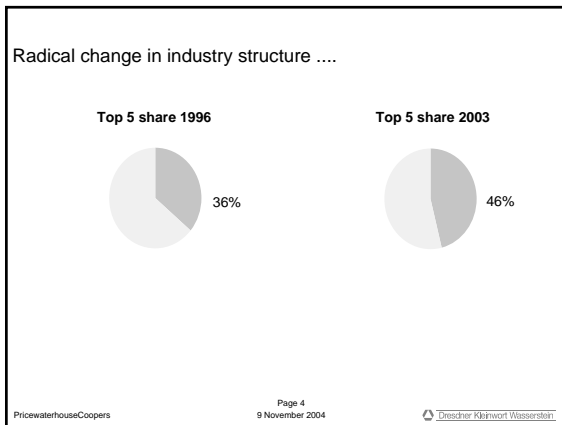
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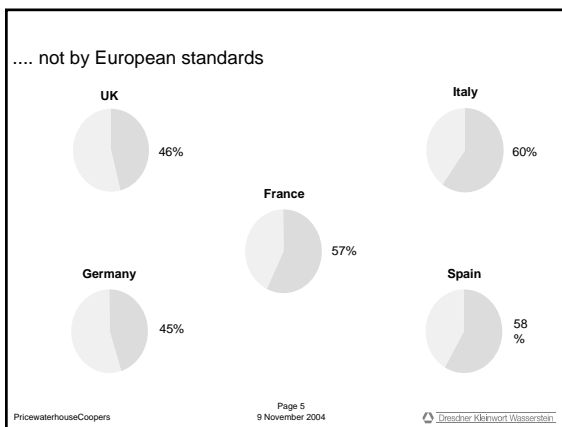
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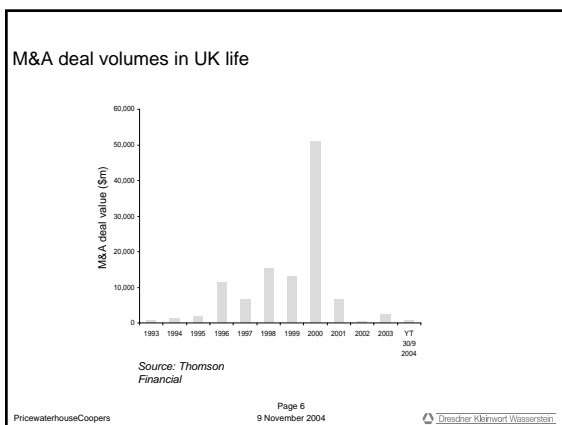
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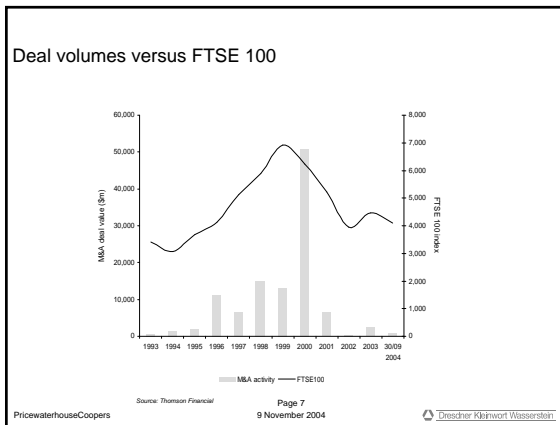
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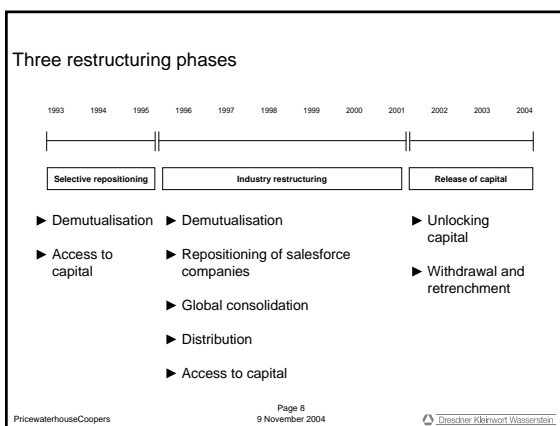
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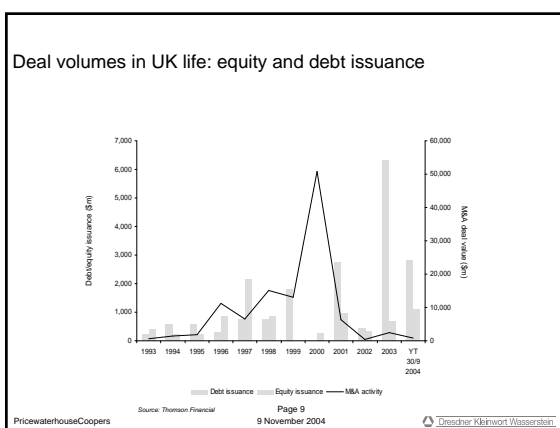
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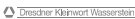
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New capital requirements

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Realistic balance sheets

- More responsive approach to solvency monitoring
- Regulatory peak relaxed; important realistic solvency peak
- Aligning management of funds to policyholder expectations
- Forces companies to capture policyholders obligations **today**
- Driver for restructuring
  - Bonus philosophy, investment strategy
  - De-risking balance sheet
  - Capital structure
- Readiness for sale

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Individual Capital Adequacy

- Internal assessment of capital requirements
- Will Pillar 2 really be higher than Pillar 1?
  - R&SA life £500 compared to £650m
  - Abbey £375m compared to £589m
- Driver of restructuring activity
- Smaller companies ICA levels may be higher
- Varying degrees of readiness and still subject to ICG
- Acquirers are still factoring in uncertainty

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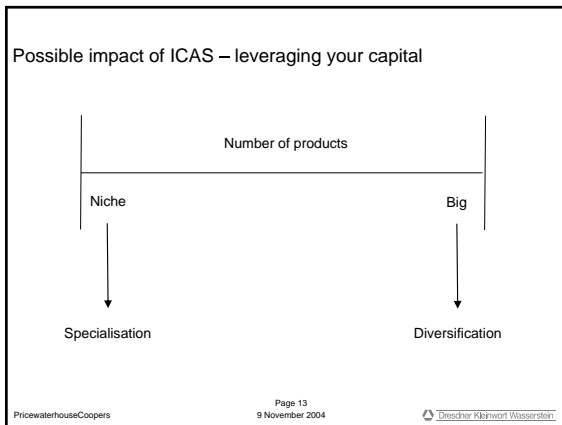
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FRED 34: Capital

- Capital position statement and sensitivities
  - Of interest to providers of finance
- Uncertain impact on bancassurers' VIF
  - No longer use equity and liquidity risk premiums
  - But can reduce risk discount rate?

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Insurance group solvency requirements

| Amounts in £m                | Current position |
|------------------------------|------------------|
| Tier 1 capital resources     | 100              |
| Tier 2 capital resources     | 0                |
| Inadmissible assets          | (50)             |
| Total capital resources      | 50               |
| Capital resource requirement | 45               |
| Surplus / deficit            | 5                |

Top Co

Life Co

Significant debt financing

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### Insurance group solvency requirements

| Amounts in £m                | Current position |
|------------------------------|------------------|
| Tier 1 capital resources     | 100              |
| Tier 2 capital resources     | 0                |
| Inadmissible assets          | (50)             |
| Total capital resources      | 50               |
| Capital resource requirement | 45               |
| Surplus / deficit            | 5                |
| Impact of senior debt        | (100)            |
| EEA ultimate surplus/deficit | (95)             |

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Life Co

← Significant debt financing

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### UK banks: a special case

**Current approach**

- ▶ EV as tier one
- ▶ Achieved profit earnings

**Fundamentally impacted by:**

- ▶ Basel II
- ▶ Groups directive
- ▶ IAS
- ▶ PS 04/16

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### Raising debt capital and constraints

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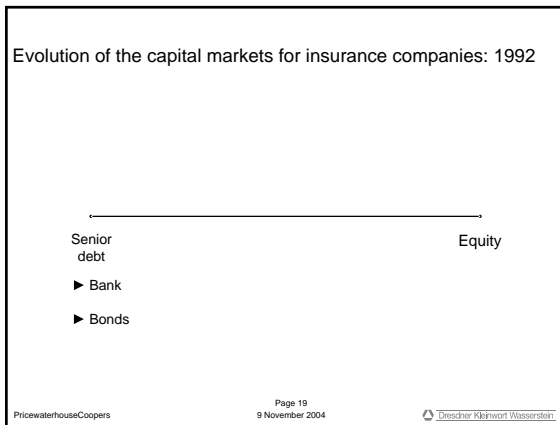
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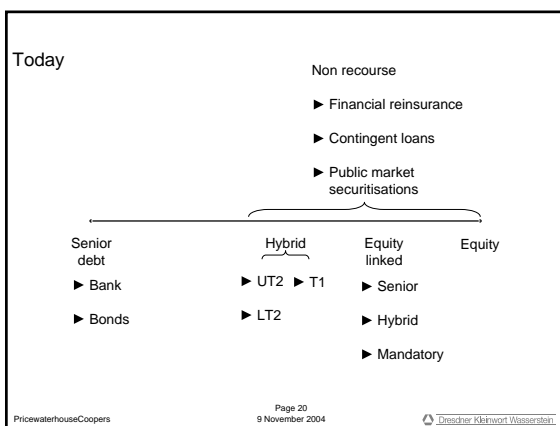
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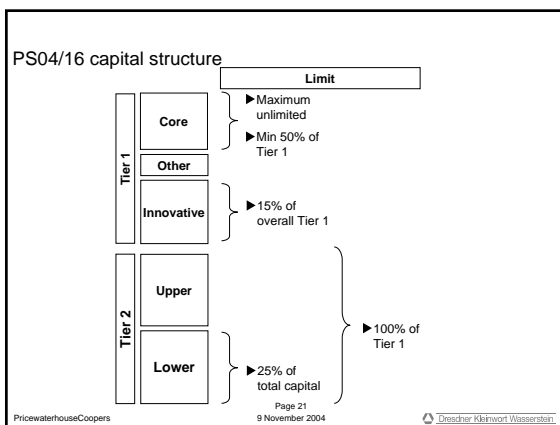
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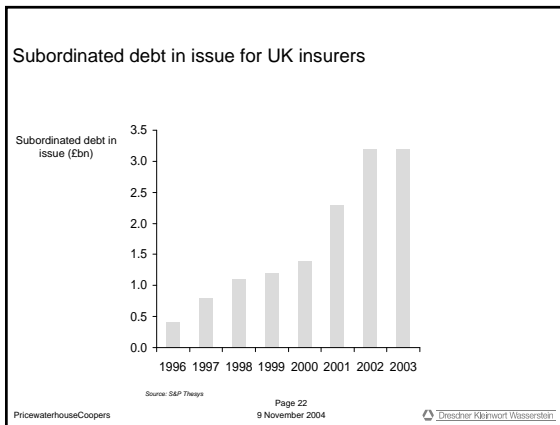
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- New capital rules will lead to balance sheet restructuring**
- ▶ Reducing role for use of senior debt
  - ▶ More regular issuance for sector: tighter spreads?
  - ▶ Need to recycle capital tied up as in force
  - ▶ Degearing of balance sheets to market risks
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**Valuations**

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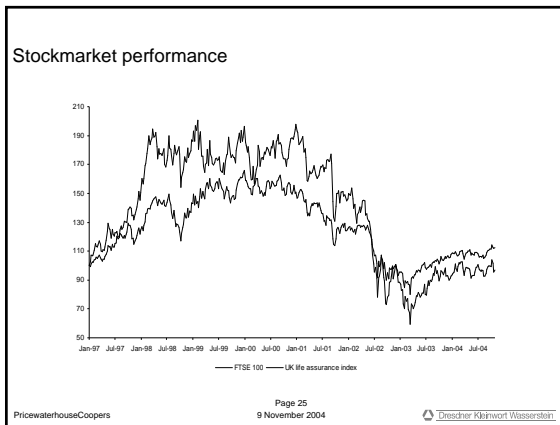
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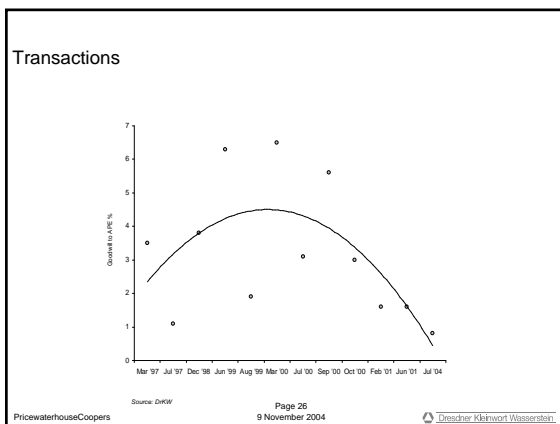
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### What has changed in transaction valuations?

- ▶ New business multiples declined
- ▶ Increased discount rates
- ▶ Emphasis on cash flow
  - ▶ gearing capacity, dividend
- ▶ Cost of guarantees
- ▶ Increased cost of solvency margin
- ▶ Mis selling risk – trade more cautious than stockmarket

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Changes in reporting standards

US GAAP

UK GAAP ->  
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IFRS

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Changes in reporting standards

US GAAP

UK GAAP ->  
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Understanding cash flows is key

IFRS

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Placing a value on the cash flows

- Used to be traditional embedded value
- ...but does not allow for important options & guarantees
- Choice of methods:
  - Market consistent EV
  - European EV
- According to Smith Barney, MCEVs are 8% to 16% lower for Aviva, L&G, FP, Pru
- However R&SA and HHG reported higher numbers

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### EV users – Analysts love it!

Most Investment Bank analysts use published EV as their starting point for company value comparisons....

*"If you throw away embedded value there is no adequate replacement".*

*"We believe that the embedded value accounting framework comes closest to capturing the profit dynamics of long-term products such as life insurance".*

(Bear Stearns – European Insurance, 22.10.02)

*"Embedded value methodology has conceptual integrity".*

(Morgan Stanley – European Insurance – 01.03.03)

### EV users: Analysts ~~love~~ like it..

Perhaps it is just the best of a bad bunch...

*"While we can find some imperfections in the concept of embedded value, it is without doubt a significant improvement over statutory accounting, IAS or U.S. GAAP".* (Bear Stearns – European Insurance, 22.10.02)

*"One of the strengths of the embedded value methodology... is that any variances between actual and assumed experience in calculating the PVFP go through the embedded value profit"* (Lehman Brothers European Insurance Report – 9.6.03)

*"Amid all the concerns, we have yet to see a better way to appraise insurance companies".* (ABN Amro – Insight – 10.3.03)

### ...or do they?

*"There is a rising tide of scepticism about the assumptions underlying embedded values (EVs), which are a crucial part of the valuation methodology for European insurers, but little clarity as to what is wrong or by how much." A blended discount rate is a blunt way of allowing for economic risk* (Lehman Brothers European Insurance Report – 9.6.03)

*"Our...valuation methodology... seeks to value the companies after taking account of embedded options in the liabilities and the full cost of carrying economic capital, both of which are ignored in standard embedded values."* (Fox-Pitt, Kelton – UK Life Insurers Paying the Piper – 18.2.03)

*"Deterministic valuation techniques such as embedded value fail to value options/guarantees properly, since they only consider one set of cashflows".* (Bear Stearns – European Insurance 22/10/02)

*"While the embedded value methodology is spreading rapidly across continental Europe, we suggest that the real comparability of existing embedded value disclosures is poor". "We note, additionally, that the integrity of embedded values themselves should perhaps be questioned".* (Morgan Stanley – European Insurance 01/03/03)

Issues for the practitioner

**Improved clarity**

Policyholder payouts

Improved governance (eg SarbOx)

**Other Deal issues**

Retrospective review of the sales process, eg

- Mortgage endowments
- High income bonds

Staff pensions deficits

Fair treatment of customers?

Tax

**Remaining uncertainty**

Future capital needs

- ICG
- Operational risk
- Insurance risk
- Annuities
- Guaranteed health

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Specific issues for closed books

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Entering a new era

**Closed books**

- ▶ £190 billion of total assets
- ▶ Growing number of acquirors
- ▶ Realistic vendor expectations

**Shakeout of strategically challenged**

- ▶ Capital
- ▶ Margins
- ▶ Scale

**Global mergers**

- ▶ Valuation environment
- ▶ Market convergence
  - ▶ product
  - ▶ investor

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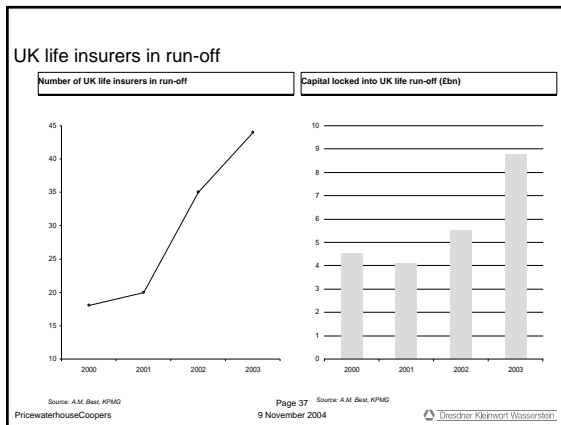
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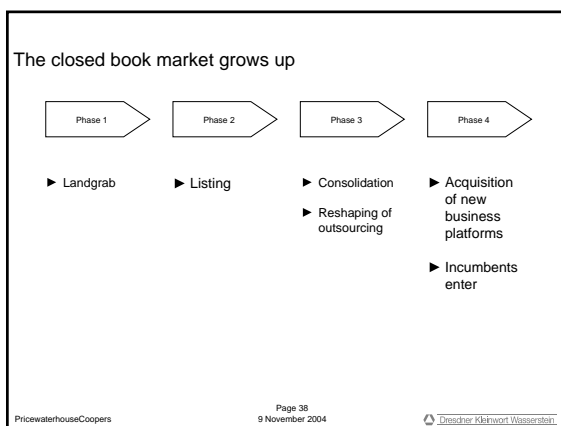
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### Conclusions

Source: A.M. Best, KPMG  
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**Our key messages**

- ▶ New capital and reporting requirements to change the structure of industry and company funding
- ▶ Deeper, cheaper, more sophisticated markets
- ▶ Shrewder valuation techniques supported by better IT
- ▶ New era of consolidation driven by closed books and commercial pressure in UK and outside

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**Presenters**

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