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Insurance profit reporting: Why can't anyone tell me how much we actually made?

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with insight from Andrew Sinclair BA-ML

12 November 2013

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2

Agenda

Section

Strategic thinking

External profit reporting

Aligning reporting to strategy – external reporting

Aligning reporting to strategy – internal reporting

Future regulation

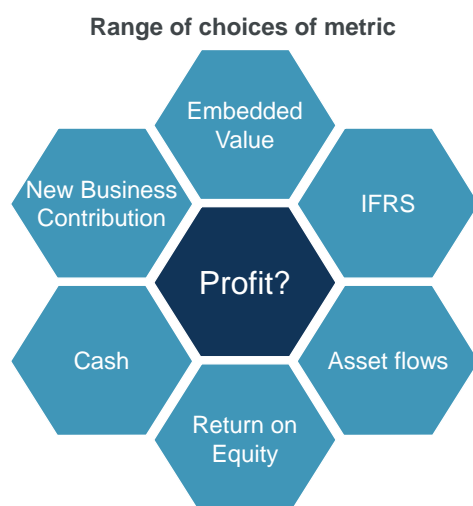
Questions



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3

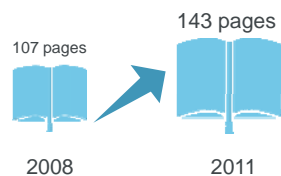
Barriers to understanding



Variability within metric

- Operating profit
- Non-operating profit
- Impact of tax
- Net or gross flows

Finding the result



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4



Hallmarks of a good strategy

Clarity

- Well articulated vision for future plans.
- Easily explained.
- Realistic.
- Demonstrates understanding of and builds on important drivers of current performance.

Consistency

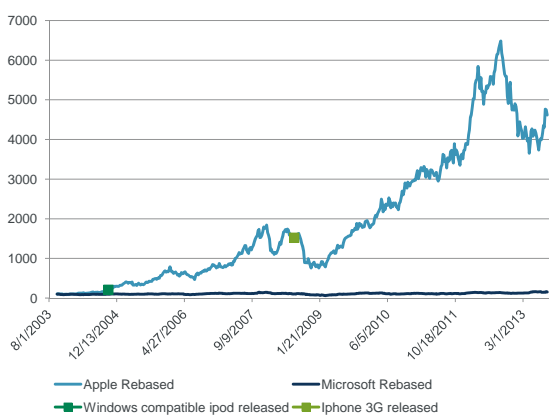
- Consistent application of strategy over time.
- Changes clearly signposted.
- Reflective of external environment.

Measurable

- Progress against strategy highlighted.
- Supported by relevant, quantifiable metrics that reflect the business to measure progress, e.g.:
 - Flows for a growing asset business
 - Cash generation for a closed book

Benefits of investor buy-in to strategy

Example: Microsoft vs. Apple



Clear product strategy

- Breakthrough technology
- User friendly
- Clear product image
- Drip-feed of technology
- Regular releases

Well-defined market

- High-end products, mass-market appeal
- Recognisable and consistent brand
- Dedicated customer-base

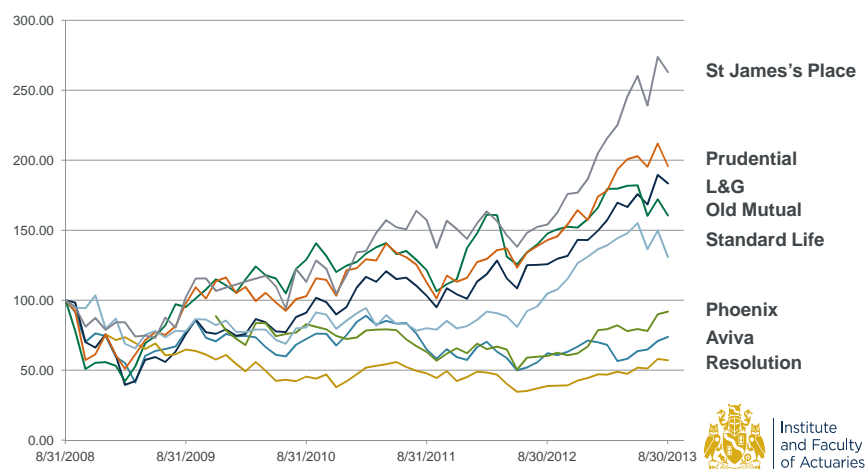


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7

Benefits of investor buy-in to strategy

FTSE 350 Life Insurance: Relative Share Performance



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Clarity and consistency



Prudential 2009

CEO Statement in press release accompanying FY09 results



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9

Clarity and consistency



Prudential 2012

CEO Statement in press release accompanying FY12 results



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“However beautiful the strategy, you should occasionally look at the results.”

Winston Churchill



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11



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External profit reporting

A brief recap

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Overview of metric

Embedded Value Metrics

Overview	
EV = Shareholder Net Assets + PV of future profits on inforce business <ul style="list-style-type: none"> Up to 2005 - Traditional EV 31 December 2005 – European EV adopted (CFO Forum principles) June 2008 – Market Consistent EV principles released October 2009 – inclusion of illiquidity premium in MCEV September 2012 – no longer mandatory, due to SII uncertainties 	
Positives	Negatives
<ul style="list-style-type: none"> + Reflective of shareholder value of business + Captures long-term nature of new business profits + Increases focus on long-term value generation 	<ul style="list-style-type: none"> - Market and investor credibility - Lack of comparability due to variety of methods and assumptions used - Linkage to cash and capital - Significant subjectivity - Level of transparency - Ease of communication

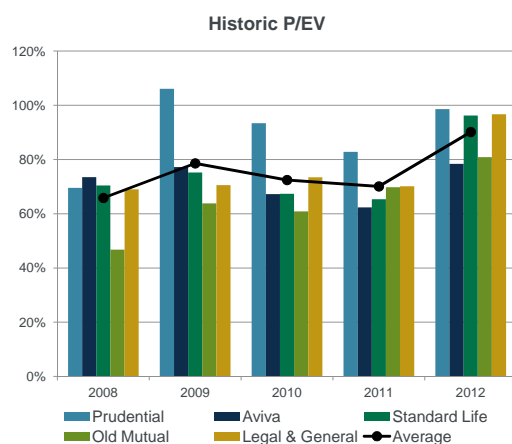


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13

Current metrics: Embedded Value

Credibility



Theoretical expectations

- Consistent across time
- Changes in line with shift in fundamental property of company
- P/EV > 100%

Reality

- More volatile
- General market trends visible
- P/EV < 100%

Challenge

- Does the market view EV as credible?



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14

Overview of metric

IFRS

Overview	
<p>Measure of accounting profit. Increasingly popular with UK life insurers as the primary measure of reported profit – less focus on “below the line” items. Significant focus on “operating profit” related to management controlled profitability. Different rules apply to different types of contracts (e.g. IFRS 4 for “insurance” contracts and IAS39 for “investment” contracts). Earliest IFRS 4 Phase II implementation date 1 January 2018.</p>	
Positives	Negatives
<ul style="list-style-type: none"> + More “cash-like” than EV measures + Lower subjectivity than EV measures 	<ul style="list-style-type: none"> - Comparability restricted by use of Local GAAP for insurance contracts - Inclusion of intangibles, such as DAC and DIR reduces consistency with cash - Not fully reflective of long-term value of contract



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15

Current metrics: IFRS

Case study: “Cash-like”?

Intangibles

- Recognition of some intangible assets, for example:
 - Deferred Acquisition Costs (DAC)
 - Deferred Income Reserve (DIR)
 - Deferred Tax Assets
- Reduces link to “cash” and can distort P/E ratios in event of change in methodology.
- For example, within H1 2013 results, St James’s Place recognised DAC on NB of £20m compared to £70m in the equivalent period of 2012 as a result of impact of RDR.

IFRS 4

- Allows for use of existing reporting standards when reporting for “insurance” contracts.
- Resultantly some companies continue to recognise a VIF asset on their IFRS balance sheet.
- Impacts on comparability, particularly between companies in different countries.



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16

Overview of metric

Cash

Overview	
<p>Reflection of money in, money out in the organisation. Can be linked to "net asset" part of Embedded Value calculations, making it easy to calculate an "operating" profit. Reflective of the cash pressures in an organisation, includes all items like sales costs, expenses etc. Can be explicitly linked to dividends payable through the ratios like dividend coverage.</p>	
Positives	Negatives
<ul style="list-style-type: none"> + Direct link to generation of cash and clear link to dividend affordability + Not subjective + Comparable + Reflects short term progress on e.g. expense reductions + Increasing focus in volatile times 	<ul style="list-style-type: none"> - Not relevant for NB profitability, as does not reflect future profits - Can be distorted by "one-offs"



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17

Current metrics: "Cash is king"?

Case study – Changing CFO attitudes

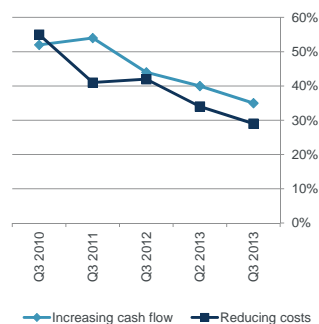
Q4 2008

- Top 4 themes in Q4 Deloitte CFO Survey related to:
 - Maximise **cashflow** and **liquidity** (96%)
 - Improve **investor confidence** (96%)
 - **Reduce** operating **costs** (90%)
 - **Reduce** capital **spending** (77%)
- Cash generation an appropriate measure for these aims.

Q3 13

- Key priority of **growth**
- **Increasing cashflow** still important, but...
- **Less important** than previous quarters.

Changing priorities



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Aligning reporting to strategy

External Reporting

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What do investors want from profit reporting?

Confidence in dividend stream/return on capital

- Is the current dividend supported by emerging profit?
- What is driving profitability – is it repeatable?
- What are the risks to future dividends?

Clear strategy for future profits

- Do I understand what the company's strategy is?
- How and when will the strategy deliver?
- Is the company able to demonstrate progress against strategic aims?

Information on changes in year

- What has changed since the last set of results?
- Single-year drivers:
 - New Business
 - One-offs

All balanced by a desire to restrict the release of commercially sensitive information.



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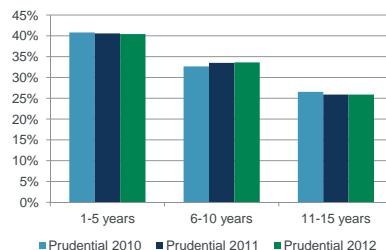
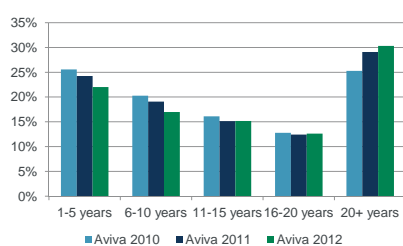
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What do investors want?

Supportability of dividend stream

Aviva and Prudential VIF emergence

- Breakdown of VIF asset – showing expected emergence of profits over time.
- Useful tool for understanding business profile (and changes in profile)
- Highly dependent on assumptions
- Important to understand limitations and reasons for profile



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21

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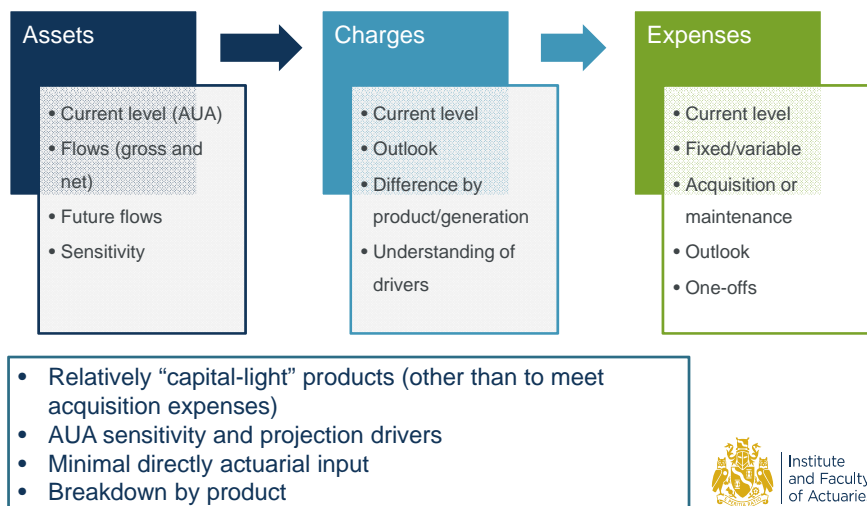


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22

What do investors want?

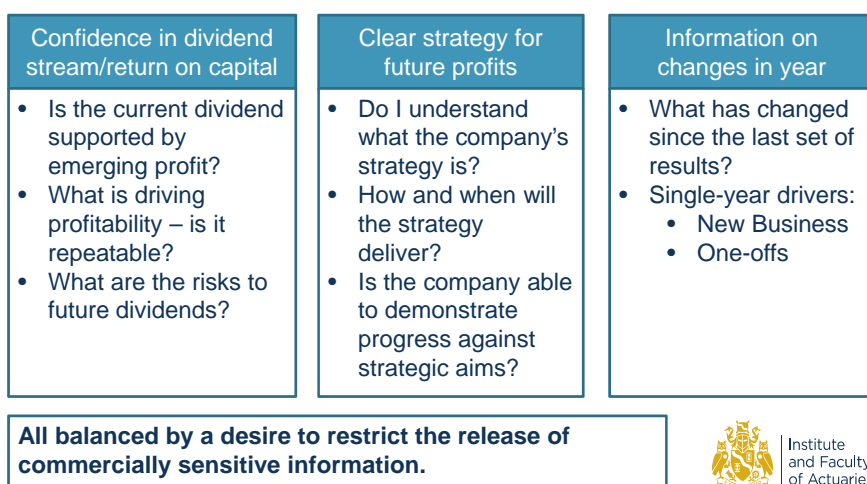
Link to strategy: unit-linked



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23

What do investors want from profit reporting?



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24

What do investors want?

Single year factors

New Business	
Volumes	<ul style="list-style-type: none"> Some measures subjective (e.g. PVNBP) APE difficult to compare across companies with different product mixes. Often simple disclosure of single premiums received and overall increase in annual premium
Payback Period	<ul style="list-style-type: none"> Demonstrate when capital deployed will be recovered Long payback period increases risk and reduces attractiveness to investors
New Business Contribution	<ul style="list-style-type: none"> Assumption based Reflective of longer term profitability Margin by product

One-offs
<ul style="list-style-type: none"> Understand drivers of one-offs – repeatable? Aggregate assumption changes



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25

What do investors want from profit reporting?

Confidence in dividend stream/return on capital	Clear strategy for future profits	Information on changes in year
<ul style="list-style-type: none"> Is the current dividend supported by emerging profit? What is driving profitability – is it repeatable? What are the risks to future dividends? 	<ul style="list-style-type: none"> Do I understand what the company's strategy is? How and when will the strategy deliver? Is the company able to demonstrate progress against strategic aims? 	<ul style="list-style-type: none"> What has changed since the last set of results? Single-year drivers: <ul style="list-style-type: none"> New Business One-offs

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26



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Aligning reporting to strategy

Internal Reporting

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Aligning to management priorities

Link to strategy: “risk” products

Recognition of capital constraint

- Demonstrate understanding of capital requirements of business, particularly if capital constrained
- Reflect availability of capital in reported metrics, e.g.:
 - Return on Capital Employed
 - EV New Business Contribution reflects cost of capital requirements
 - Reporting of level of capital requirements coverage (understanding changes)

Sources of profit

- Recognise multiple sources and drivers of profit. Split between key drivers, such as underwriting, investment and guarantee cost profits.

Cohort profitability

- Profit emerges across number of years, but often only consider profit at POS at any sort of granular level.
- Ability to demonstrate ongoing profitability of a book of business, tracking assumption changes.
- IFRS 4 Phase II may drive this.

Aligning to management priorities

Delivering the right Management Information

“One version of the truth”

- **Consistent with externally reported metrics** – supporting understanding of emerging externally reported results. Avoids shocks at point of reporting, “true-ups” and late changes.
- **Comparison against plan/target** and reasons for differences – no need to “sugar-coat”

Embedded across organisation

- **Clear and consistent focus** on “right” information across organisation. Drive understanding of behaviours that will support a good result.
- **Remuneration for staff aligned to metrics** regularly reported and monitored e.g. sales staff remunerated on “right” volume measure and management remuneration in line with key reported metrics. This is likely to increasingly include “long-term” measures, reflecting increased focus on continued performance.

Right information, presented in the right way

- Sufficiently high-level to provide overview of business performance (“headline” numbers)
- Splits should be consistent with way management thinks of business (not how finance thinks)
- Demonstrates performance of underlying profit drivers (e.g. Scheme profitability)
- Ability to drill into lower level detail where required – understand real performance



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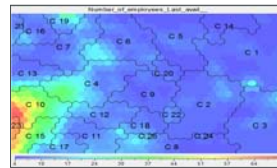
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29

Driving understanding of profit

Segmentation

- Consider segmenting existing business using internal and external data to drive understanding of profitability
- For example, pension schemes can be segmented by number of members, “riskiness”



Dynamic MI

- Visual representations of profitability
- Allows management to drill into profitability
- Dynamic representation of changes over time
- Supports management to ask the “right” questions



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30



Impact of new regulations on reporting

Changes to regulations will impact future reporting

Solvency II

- Potentially increasing constraints on capital – shift to “capital” style measures of profit?
- Important to demonstrate consistency of profit reporting with modelled results for “Use Test”
- Relevance of embedded value metrics going forward?
- P&L requirements include need to understand movements in Basic Own Funds

IFRS 4 Phase II

- Significant change to IFRS reporting for “insurance” contracts
- Should improve comparability between companies (and countries)
- Inclusion of Contractual Service Margin, offsetting t=0 profit – less like cash
- 54% of Insurers believe new IFRS/US GAAP will give a better picture of their business that we be relevant for investors’ decisions

Source: Economist Intelligence Unit survey, on behalf of Deloitte





Questions



Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.

