# SHAREHOLDER REPORTING IN LIFE INSURANCE


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## ABSTRACT

Shareholding reporting is an important business requirement for all companies having shareholders. For life insurance companies, it is always challenging because the nature of business is complex and more often than not, the analysts and the market may not completely understand the life insurance business dynamics due to long term nature, impact of actuarial assumptions, actuarial models, regulations, policyholder behaviour, business risks and actuarial methodology on the financial results. It is vital for a life insurance company that shareholders understand the true value of the company so that they can take appropriate investment decisions as well as participate in the decision making process of the company. This paper illustrates shareholder expectations so as to enable life insurance companies to match shareholder reporting with shareholder expectations.

## Introduction

**SHAREHOLDERS:**In a companyshareholders are considered as “firm owners” or “principals.” They hire managers to represent and work for their interests and in turn these managers act as agents to them. This principal-agent relationship gives rise to agency problem as it involves delegation of decision-making authority from principal to agent. As per Agency theory, management and shareholders have information asymmetry and management has access to superior information as compared to shareholders. Agency problem in its essence is the possibility of opportunistic behaviour on the part of the agent that works against the welfare of the principal. Shareholder reporting tries to reduce the extent of agency problem by reducing the level of information asymmetry between Management and Shareholders and thereby giving shareholders the opportunity to effectively control the organisation and check whether management is working efficiently and fortheir interests.

When it comes to financial services in particular, Life Insurance reporting plays a key role in reducing information asymmetry, as other ways of getting information about the operations of firm is very limited. Given the importance of reporting for life insurance sector, disclosing information about each and every aspect of operations, strategy etc., is neither feasible nor beneficial for the company and its shareholders. Therefore, reporting requirements should be aligned with shareholders’ expectations by the management.

## Shareholders Expectations

For a Life Insurance company,shareholders’ expectations are in the form of:

- Return on Capital (ROC): This will include their desire to earn appropriate returns on capital employed while taking into consideration the past, present and future trends of the same.
- Risk Appetite: Considering overall level of riskiness of operations
- Governance (Including technical provisions calculations)
- Embedded Value
- Goodwill
- Risk Adjusted Return Maximization

Shareholders are the lifeblood of any business. They are the ultimate risk takers investing their funds into a business and placing their trust in a board of directors to keep their investments safe. But this comes with their expectation that their wealth will increase via share price and dividend streams faster than inflation, interest rates or real estate growth.

If the business is going poorly or the shareholders wealth incremental curve is not meeting expectations they will simply cut their losses, cash in and flee the market. Normally shareholder turnover provides a reasonable guide to the health of a business with high

churn rates indicating a business not meeting shareholder expectations in terms of dividend and wealth creation levels.

The expectations of shareholders are met from the analysis of available reports and their perception of management performance.

## Return on Capital (ROC)

Return on Capital Employed is a financial ratio that measures a company's profitability and the efficiency with which its capital is employed. It is calculated as:

| **ROCE = Earnings Before Interest and Tax (EBIT) / Capital Employed** |
|---|

The “Capital Employed” as shown in the denominator is the sum of shareholders' equity and debt liabilities; it can be simplified as: Total Assets – Current Liabilities. Instead of using capital employed at an arbitrary point in time, analysts and investors often calculate ROCE based on “Average Capital Employed,” which takes the average of opening and closing capital employed for the time period.

ROCE measures profitability after factoring in the amount of capital used. A high ROCE indicates that a larger chunk of profits can be invested back into the company. The reinvested capital is then expected to be employed again at a higher rate of return, which will help to produce a higher earnings-per-share growth. A high ROCE is, therefore, a sign of a successful growing company and shareholders thus study the past and present ROCE trends while investing in a company. Also the present ROC trends can be used by shareholders to assume future ROC movements, for example if the current return on capital for a firm is significantly higher than the industry average, the forecasted return on capital should be set lower than the current return to reflect the erosion that is likely to occur as completion responds

## Risk Appetite

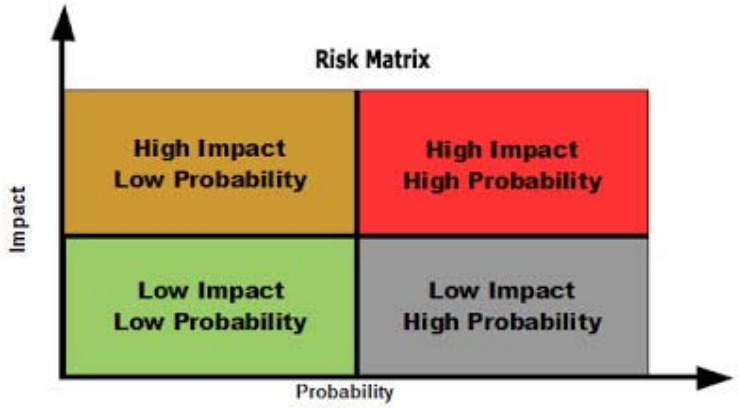
Risk appetite is the degree of risk, on a broad-based level, that a business is willing to accept in pursuit of its objectives. It helps defining the company strategy and risk management framework for the organization.

Risk appetite sets the boundaries within which risks can be taken and in doing so manages shareholder expectations by defining the risks that they are exposed to.It helps the company in framing the portfolio of products to be offered for sale and evaluating whether each risk has been appropriately priced for in the contract. Also a clearly defined risk appetite helps the company in defining and implementing their reinsurance requirements.

It leads to the assessment of the investment options, so as to ensure the company's risk taking lies within the company's framework.

Once the life insurers have identified the major areas of risk for the company, a risk matrix is developed based on probability of occurrence (y axis) and severity of occurrence (x axis). Each identified risk is then classified into low or high risk based on probability and severity of occurrence, and based on this an opportunity matrix is developed for the corresponding identified risks.

## Risk Matrix




There are basically two approaches to determine risk appetite that are used by life insurers, namely:

- Top Down Approach
    - Under this approach risk appetite is determined by the board of directors and cascaded down to the organization.
- Bottom Up Approach
    - Under this approach expressions of risk appetite are developed at the ground level, refined through risk management meetings and then aggregated to develop an overall risk appetite for the organization.

Risk appetite disclosures help shareholders to analyse if the company is taking risks at a higher or lower level compared to industry standards, that is, its competitors. It provides an insight into whether, looking at the company's performance, their strategy is over aggressive in respect to their ability to honour obligations. It assists measurement of risk adjusted return and incremental risk acceptance based on incremental return.From the

view point of shareholders risk appetite is basically an insight into the level and capacity of risk a company undertakes and thus the amount of risk their investments will be subject to.

## Governance

For many insurance companies, the concept of governance has long focused on controlling costs, minimizing the risk of sudden or unexpected financial shocks and avoiding regulatory costs. In recent years, this task has become more complicated due to a rapidly shifting political and regulatory environment both domestically and overseas. This new environment is compounded by an increasingly informed and empowered activist shareholder community that has changed its expectations in terms of oversight, strategy and leadership – all of which have changed the way companies approach governance oversight.
The UK Corporate Governance Code requires boards to present a fair, balanced and understandable assessment of the company's position and prospects including an explanation of the basis on which the company "generates or preserves value over the longer term." Alongside this a broader definition of "going concern" would give shareholders a longer-term picture from company disclosures.

Shareholders and regulators alike expect measures that provide greater transparency into day-to-day operations, help to identify potential risk exposures, especially those in overseas jurisdictions and enable companies to react swiftly and accurately to emerging risks.

Another aspect of governance that shareholders are interested in and form a major part of their interests is the technical provisions calculations.Shareholders aim mainly at maximizing investment returns, while the technical provisions are there to ensure (as far as possible) that the insurance company can cater for future liabilities so as to maintain a healthy solvency position.

While technical provisions are an essential for an insurance company, their calculations might appear over prudent for shareholders. A higher amount locked in, in terms of reserves might be perceived as lesser money for investment and thus lower investment returns for them.

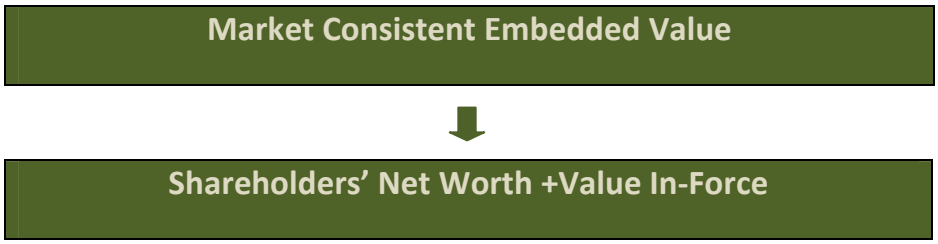
## Embedded Value

The Embedded Value (EV) of a life insurance company is the present value of future profits plus adjusted net asset value. It is a way of reporting the value the life insurance business companies have for their customers.

**MCEV:**

Market consistent embedded value (MCEV) is the valuation of ordinary shareholders' interests in the long-term life insurance part of the business (called "covered business"). It represents the present value of future earnings distributable to shareholders from the

covered business, where the earnings are adjusted for risk in a consistent manner to the valuation of financial instruments in deep and liquid markets.
MCEV does not make any allowance for future new business. This would need to be incorporated in order to arrive at a complete valuation of a company which still writes new business.




Where,

- Shareholders' Net Worth = Free Surplus + Required Capital
- Value In-Force = Present Value of future profits – (Cost of residual non hedgeable risks + Frictional Cost of required capital + Financial options and guarantees)

From the perspective of the shareholders of life insurance companies, embedded values have the following advantages:

- They enable the shareholders to assess the value of a company and the performance of the management more accurately than traditional accounting indicators or other valuation techniques.
- Embedded values can also be considered as the shareholders' value of life insurance companies and therefore represent the shareholders' interests in a life insurance company.
- Also in merger and acquisition situations, embedded values can provide a suitable basis for determining the value of the target company. This can prevent shareholders' interests from being detrimentally affected.

## Goodwill

Goodwill for a life insurance company is the value associated with new business the company is expected to write in the future. Shareholders will expect a high value of the goodwill of the company.

Its quantification requires the company to put a fair assumption of the new business it is expecting to write in future (i.e. the revenue assumptions). Also since it requires the cash flows to be projected in the future, the company is required to evaluate the economic and the non – economic assumptions pertaining to:

- Mortality
- Investment Returns
- Expenses
- Withdrawal rates etc.

Apart from these the value of Goodwill also depends on:

- Reputation of the firm
- Types of distribution outlet (e.g. broker, direct sales, mass marketing etc.)
- Quality, size and maturity of distribution outlet
- The expected growth rate in future sales

## Risk Adjusted Return

The concept of risk adjusted return can be used to compare the returns of portfolios with different risk levels against a benchmark with a known return and risk profile. This concept refines an investment's return by measuring how much risk was involved in producing that return, and is generally expressed as a number or rating.

Some of the popular risk adjusted return measures are Sharpe, Treynor and Jensen's Alpha.

The measures used for calculating risk-adjusted return areSharpe, Treynor and Jensen's Alpha. The Sharpe Ratio has become the industry standard for such calculations.

- Sharpe Ratio

$$Sharpe\ Ratio = \frac{R_p - R_{rf}}{\sigma_p}$$

$R_p$ = Expected portfolio/asset return

$R_{rf}$ = Risk-free rate of return

$\sigma_p$ = Portfolio/asset standard deviation

- Treynor Ratio

**Computation:**

$$T = \frac{r_i - r_f}{\beta_i}$$

where: $T \equiv$ Treynor ratio,

$r_i \equiv$ Portfolio's return, $r_f \equiv$ risk free rate $\beta_i \equiv$ portfolio i's beta

- Jensen's Ratio

Jensen's Measure is calculated as:

$\alpha_p = \overline{r_p} - [\, r_f + \beta_p(\, \overline{r_m} - r_f \,) \,]$

Where:

$\overline{r_p}$ = Expected total portfolio return

$r_f$ = Risk free rate

$\beta_p$ = Beta of the portfolio

$\overline{r_m}$ = Expected market return

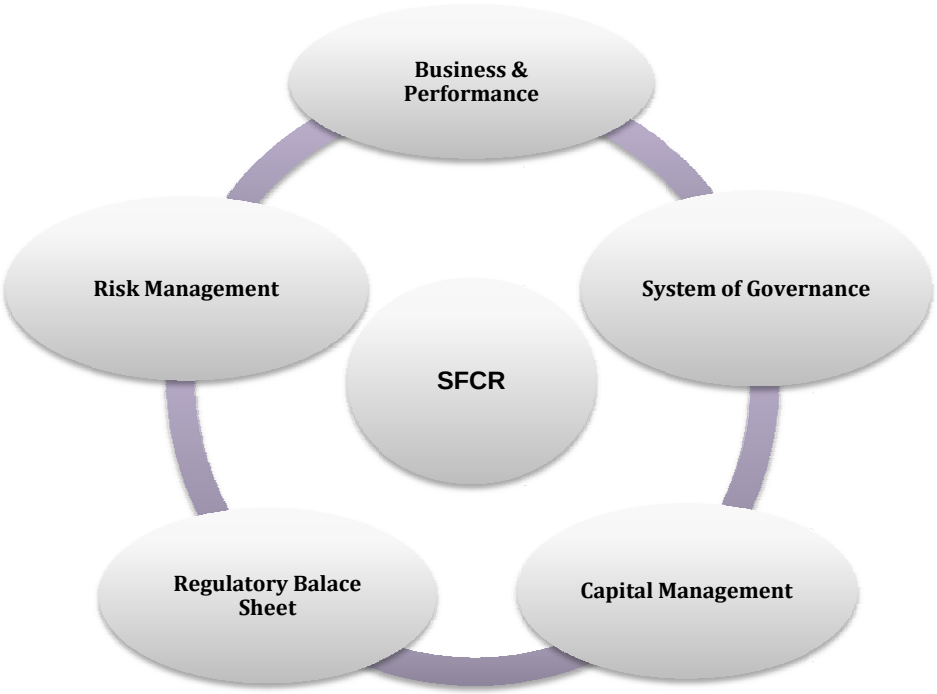
## Shareholder Reporting in Reference to Shareholder Expectations

Shareholders' and their expectations are very important to all businesses and the extent to which these expectations are being met can be directly linked to the company's performance. One of the main means for shareholders to see if their expectations are being realized or not is through reports issued by companies.

For life insurance companies, these reports are published under solvency II, pillar 3.

### The Solvency and Financial Condition Report (SFCR)

This report is a public disclosure that follows the prescribed structure developed by the Committee of European Insurance and Occupational Pensions Supervisors(CEIOPS). It covers the following major areas:


Business &
Performance
Risk Management
System of Governance
SFCR
Regulatory Balace
Sheet
Capital Management

:

## Business and Performance

This aspect of SFCR discloses information regarding the following:

- Business and External Environment
- Performance from underwriting activities
- Performance from investing activities
- Operating/ other expenses

- The Performance from underwriting activities aspect discloses information regarding premiums, claims, expenses and reasons for high level of reinsurance cover based on the insurer's various lines of business as well as geographical location.

- This help's shareholders gather information regarding the business's growth, diversification and stability in respect to the various lines of business.

- The Performance from investing activities aspect discloses an analysis of the company's investment returns. Shareholders will be particularly interested in this part of the report as it will give them an insight into the investment returns earned by the company and in turn the returns earned by their investments. It could be taken as an indicator of their dividend expectations.

- The performance from underwriting activities and operating/ other expensesalso entrusts the shareholders with better information regarding the capital employed, which in turn provides them with an insight into a prospective return on capital (ROC).

## System of Governance

This aspect of SFCR discloses information regarding the following:

- General Governance Arrangements
- Fit and proper
- Risk management system
- Own Risk and Solvency Assessment (ORSA)
- Internal controls
- Internal Audit
- Actuarial functions
- Outsourcing

- The general governance aspect gives the shareholders a greater insight into the structure of the firm's administrative and management bodies and thus catering to their needs for higher transparency.

- An assessment of system adequacy and disclosure of material changes, which is a part of thegeneral governance aspect will also help the shareholders meet their transparency needs as well as help them gain better knowledge of the regulatory costs they might encounter. Another aspect that general governance arrangements throw light on is the consideration of remuneration policies which helps in highlighting the relationship between risk and remuneration.

- The risk management aspect will help shareholders assess the risk taking level and strategy of the company in compliance with its risk appetite, thereby making clear what is the true risk exposure of the company. Knowing the true risk exposure of the company is very important for shareholders.

- In general this aspect of SFCR helps incatering to shareholders' transparency needs in respect to the various functions of the company.

# THANK YOU