OLIVER WYMAN

Financial Services

Return of the King

How insurers can find the right balance between cash and value

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Introduction: Tension growing; trust eroding

Cash is back. Executives in the insurance industry – particularly life insurers – are facing growing tension in their relationship with shareholders over when to reinvest available cash back into the company and when to distribute it to investors. Insurers are in the business of managing long-term risk and return; the nature of their product demands that they think in decades as well as quarters. They count on investors also taking the long view, committing capital for the long-term to support value creation and potentially waiting years to collect the reward. But shareholders are becoming wary, more conscious of the inherent risks of investing and more proactive in protecting their interests. The result is demands for accelerated and more substantial returns of cash.

In this context, Chief Executives and other executive decision-makers are looking to the CFO and finance team to help them navigate the complex waters of cash versus value trade-offs. It's not easy, and many CFOs admit they're struggling. This paper offers some new tools and approaches to support fact-based decision-making and productive dialogue among stakeholders – and to ease the tension.

Investors' preference: Cash today, not a promised tomorrow

There are clear indications that insurance company shareholders have an increased preference for cash today over promises of value at a later date. Recent Morgan Stanley investor surveys[1] show that about 80% of investors would prefer insurers to use their surplus cash to pay dividends or buyback shares rather than retaining it, spending it on M&A, or otherwise reinvesting in the business. And in the last few years, a number of insurers have announced plans to deliver cash to the market as illustrated in Figure 1.

Figure 1: Selected recent share buyback announcements by insurance groups

Date	Company	Action taken
Nov 2006	Munich Re	Buyback of €1 BN in ordinary shares (completed Feb 2007)
Feb 2007	Zurich Financial Services	Buyback of CHF1.25 BN in ordinary shares (completed July 2007)
Mar 2007	AIG	New $8 BN share repurchase authorisation with plans to repurchase $5 BN Permanent 20% increase in dividend under ordinary circumstances
Apr 2007	Swiss Re	Repurchased approximately half of GE's $2.4 BN holding arising from Swiss Re's acquisition of GE Insurance Solutions Additional authorisation for buybacks of CHF4.2 BN
May 2007	Munich Re	Announcement of further buyback programme of €5 BN in shares (along with €3 BN in dividends) by 2010
Oct 2007	Old Mutual	Buyback of £350 MM in ordinary shares

Source: Factiva, company news releases

Positive share price reactions appear to reward this behaviour. However, some market commentators argue that these moves have not been sufficiently far-reaching:

The sector's lowly rating reflects a growing feeling that "investors just can't win with insurance." The cost of capital is now at crisis levels. Better disclosure of asset risk and liability exposures is needed, along with a clear way of conveying how value is created and monetised into cash.

Citigroup, "EV Accounting – Death or Resurrection", [Under Cover – Issue 254, 18 February 2008]

1 Morgan Stanley, *European Insurance, What the Market Thinks – An Investor Survey (Vol. 4)*, April 2008

Recent announcements by several prominent insurance groups of huge sub-prime losses have further eroded investors' confidence and reinforced the view that cash in hand is worth more than a promise of future value. Unfortunately, the losses also mean that many insurers currently have less cash available to deliver to the market.

It's become more urgent than ever for insurers to make a compelling case to investors that their interests will be served by keeping the cash in the business and using it to grow long-term shareholder value. This is an uphill battle, for two reasons.

First, there is a problem of perception. Investors' preference for cash today in part reflects their limited comprehension of the intricate workings of the financial institution whose shares they own. Insurance is a relatively complex, long-term business. Most investors, particularly on the buy-side, are non-specialists and simply lack the time and technical background to understand it well.

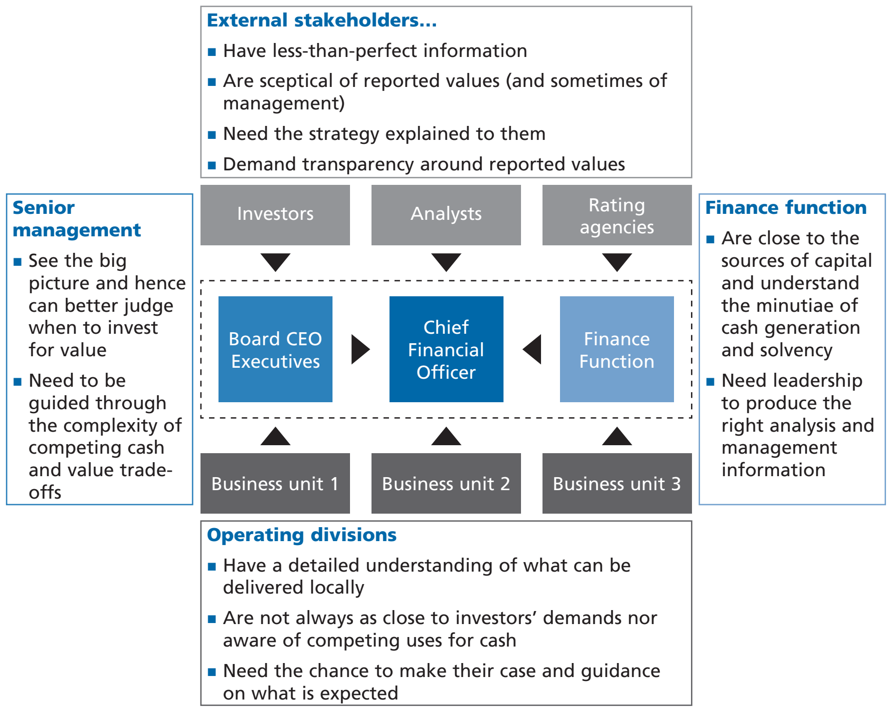
Recent developments in financial reporting may improve transparency somewhat by bringing financial measures closer to the underlying economics of the business (or perhaps just by forcing more disclosure). However, these measures are themselves complex and their volatility is hard for both investors and insurance executives to comprehend. That the insurance industry has not been able to agree on a consistent, well-defined method of value-based reporting only makes matters worse.

It's no wonder, then, that many investors prefer cash, which they understand and trust. They also see that insurers have improved their capital and cash flow positions markedly in recent years. For many investors who stayed faithful through the painful years of 2000-2003, now is payback time.

Second, we believe that investors' perceptions that they are not getting maximum value for cash reinvested in the business might, in fact, have a solid basis in reality. The complexity of the industry is not just an issue for external observers. It also plays out in the lack of alignment among insurance executives as to where best to invest for value creation. Leaders of business units may have a strong (albeit limited) view based on their operational understanding of their part of the business. Corporate leaders have a broader view of the business, the market and shareholder expectations, but may not have sufficient data to assess accurately the trade-off between reinvestment and returning dividends to shareholders.

In this situation, all eyes turn first to the CFO for leadership. His or her challenge is to do the financial analysis and provide the right management information. The follow-on challenge – perhaps even more daunting – is to find ways of packaging and presenting this information that communicates meaningfully with all stakeholders. Only then can productive dialogue among decision-makers and with shareholders take place. Figure 2 shows the range of stakeholders surrounding the CFO, and illustrates how each group have different perspectives and needs.

Figure 2: The CFO driving alignment among stakeholders



Easing the tension: “No safe havens”

The insurance industry as a whole has begun to respond to growing shareholder demands by investing in better communication and disclosure. Unfortunately, too many of these efforts have had little impact. In this section, we look at tools that are succeeding both in informing executive decision-making on how to use cash productively (as well as when to return it to shareholders) – and in explaining those decisions to investors. We see three steps to this transparent, “no safe haven” approach to cash management:

Step 1: Determine where the cash is and why it’s there

Step 2: Understand how to unlock or accelerate that cash

Step 3: Make informed deployment versus payout decisions

Step 1: Determine where the cash is and why it’s there

One might assume that knowing how much free cash[2] the company has would be a “given” for any CFO. For insurers, this is not always so straightforward, since most cash is tied up in supporting the capital and reserving requirements of business operations, and in positive cash flows that are yet to emerge (as future premium and fee income in excess of future claims and expenses). In other words, most cash is out of reach or is yet to come. The majority of accounting systems, however, don’t take into account the emergence of cash over time and therefore don’t reflect the full picture.

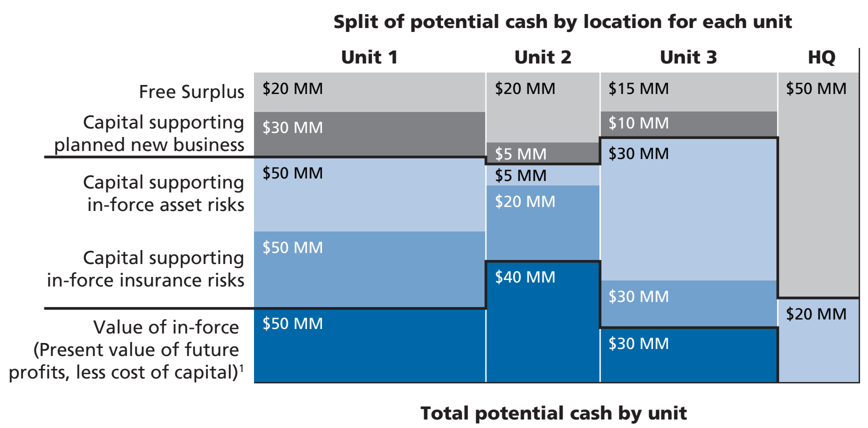
Thus, for insurance company CFOs, the first step is to fully understand where this potential cash resides and how much of it there is. Initially, this is likely to be a forensic exercise, as this management information is seldom readily available. Capital is often allocated by groups to business units on the basis that it is needed to write planned new business or other business activities, without regard to what risks it will support and when, or even whether, it will be returned.

2 By “cash” we mean not just assets invested in very short-term or instantly realisable assets, but also any funds not immediately required to back liabilities or support the capital requirements of the business.

The second step is to determine why the cash is tied up. Investors might be very surprised by some of the reasons. In many cases, very little of it is used to support insurers' most productive activity: the writing of new business. The bulk is required to support the warehousing of insurance risks (sometimes, but not always, considered part of the insurer's core business) and the assumption of discretionary market risks (arguably the business of a hedge fund). At one insurance group, less than 10% of the total capital resources (on an economic basis) were needed to write the next year's new business, while conservatively 50% were occupied in supporting market risks that could be mitigated without particular difficulty. This is not unusual.

Figure 3 below shows the map that insurers are able to draw once they have identified and classified their sources of potential cash.

Figure 3: High-level map of where potential cash is located and for what use



1 Value of in-force broadly represents the excess of the regulatory reserve requirements over the best estimate liability or "economic reserve"

This map is a useful snapshot of the current position, showing present values of cash tied up. Across the European insurance industry, the total amount of potential cash embedded in free surplus and in risk-bearing capital is likely to exceed €100 BN (of which at least €50 BN is free surplus or used to support discretionary asset risk). The amount of cash located within the value of in-force is additionally worth well in excess of €100 BN. Total potential cash on the table is therefore, conservatively, in excess of €200 BN.

To obtain a full net cash flow overview, other factors must be taken into account as well: the speed at which the cash tied up in each place will emerge on its own without intervention from management, the expected release of cash, and the expected new business which will reabsorb some of the released cash.

The transparency provided by this analysis, the essence of which is neatly packaged in Figure 3, assists insurers in thinking critically about the purposes and lengths of time for which they tie up resources. In particular, it allows debate about the common approach of running “capital heavy” (and therefore “cash-hungry”), with significant exposures to investment risks that shareholders might be able to find elsewhere in a more targeted way.

While the CFO and senior management may have to position and manage this work as a special project the first time it’s done, our view is that the determination of potential cash tied up needs to become a core, business-as-usual housekeeping activity, ideally occurring prior to annual planning dialogues. We suggest that an understanding and analysis of the sources and applications of cash should form part of the primary financial management reports.

Two UK insurers, Prudential and Friends Provident, have recently begun to innovate in the disclosure of their cash position. Each did something specific to its needs, but both approaches were well received by the market.

The January 2008 news release accompanying the results of Friends' recent strategic review includes the expected emergence of statutory profits by product from its in-force book.

Figure 4: Friends Provident cash disclosure

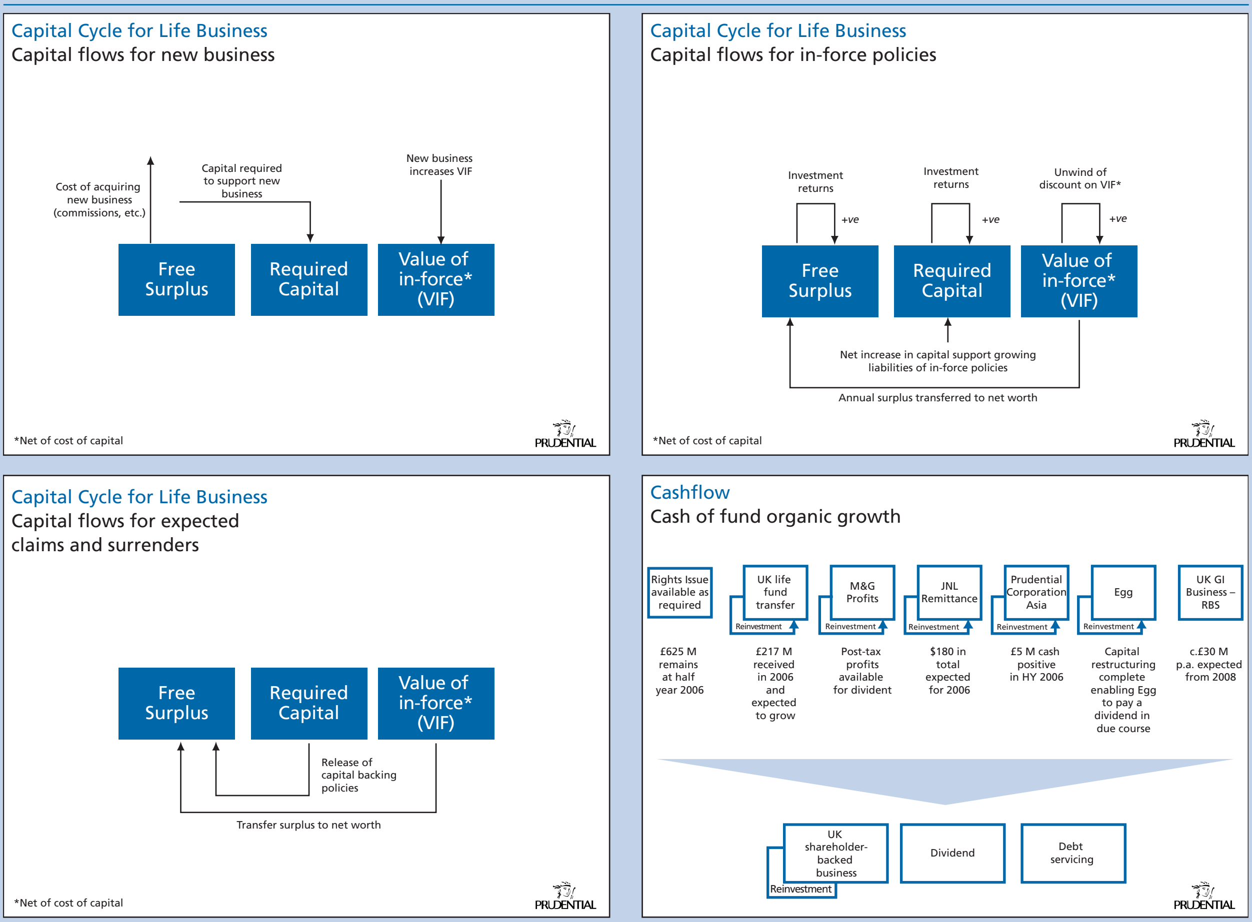
Value of in-force by maturity (31 December 2006 (£MM))

			Year of emergence of surplus								
		Total	**1-5**	**6-10**	**11-15**	**16-20**	**21-25**	**26-30**	**31-35**	**36-40**	**41+**
UK	With profits fund	386	188	116	47	22	9	3	1	0	0
	Protection	379	250	83	30	11	4	1	0	0	0
	Investments	188	72	59	30	15	7	3	1	1	0
	Pensions	436	127	116	86	56	31	14	5	1	0
	Annuities	29	25	2	1	1	0	0	0	0	0
	UK other	73	32	28	12	1	0	0	0	0	0
	Total	**1,491**	**694**	**404**	**206**	**106**	**51**	**21**	**7**	**2**	**0**
			47%	27%	14%	7%	3%	1%	0%	0%	0%
International	FPI	212	116	56	26	10	3	1	0	0	0
	Lombard	328	129	76	49	30	19	11	7	4	3
	Total	**540**	**245**	**132**	**75**	**40**	**22**	**12**	**7**	**4**	**3**
			46%	24%	14%	7%	4%	2%	1%	1%	1%
	Total VIF	**2,031**	**939**	**536**	**281**	**146**	**73**	**33**	**14**	**6**	**3**
			46%	26%	14%	7%	4%	2%	1%	0%	0%

Source: Friends Provident news release on Strategic Review, 31 January 2008

Prudential is a good example of an insurer that has gone to some lengths to explain the behaviour of cash in its business.

Figure 5: Prudential plc cash disclosure



Source: Prudential plc 2006 Interim Results Presentation, 28 July 2006

Understanding where the cash resides and how it will emerge is an important first step. Finding simple, clear ways of packaging and presenting this information allows the dialogue among stakeholders to begin.

Step 2: Examine methods to unlock or accelerate the cash

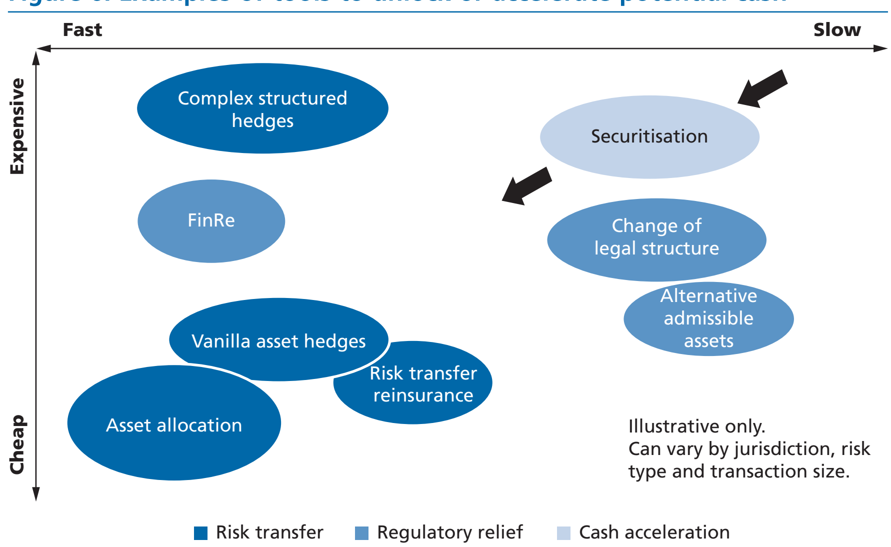
The second step is to understand how to access the cash. Broadly speaking, there are two types of cash: future cash which has not yet been received, and cash which is on the balance sheet today but is trapped. For the former, the question is how to accelerate its emergence. For the latter, the question is how to unlock and make it available. The solution will usually depend on the reason why the assets are trapped in the first place (as well as on the requirements of the regulatory jurisdiction):

- Some will be tied up supporting the economic capital requirements of risks being run
- Others will be tied up due to allowances for prudence in statutory regulations that exceed what is strictly necessary from an economic viewpoint (e.g. in technical reserving rules, in statutory solvency requirements, or in asset admissibility rules)

There may also be intangible assets that are not strictly encumbered but that may be more difficult to monetise than financial assets.

Generic examples of tools that can unlock or accelerate cash are shown in Figure 6.

Figure 6: Examples of tools to unlock or accelerate potential cash



With the analysis of where potential cash is trapped in hand, and ideas about possible tools in mind, an insurer should be able to identify a list of more concrete potential actions, like those shown in Figure 7.

Figure 7: Specific actions to unlock sources of cash

Asset-related	Insurance-related	Other sources
■ A one-off rebalancing of the investment portfolio (e.g. of the shareholder fund or general account) ■ Changing the reinvestment strategy for new net cash flows ■ A derivative block deal on the in-force book ■ A policy of purchasing a one-off hedge package at sale of certain types of new business ■ A dynamic hedging programme for products with "fast-moving" liabilities and complex risks (e.g. variable annuities)	■ Reinsurance of biometric risks on the in-force book ■ Reinsurance of certain risks on sale of new business ■ Securitisation of part of the in-force book to release cash already trapped ■ Establishment of vehicles to provide capacity for future business to be written in a capital-lean way ■ Bespoke over-the-counter transaction with a financial institution (e.g. Investment Bank) ■ Product redesign to reduce capital requirements of new business	■ Drawing down of lines of credit available from banks ■ Issuance of debt instruments

The next step is to prioritise, looking at each pool of cash and the actions that would be required to unlock it, then assessing the opportunity based on size, speed of transaction, probability of success, total cost and the amount of effort required. Figure 8 shows a simplified example of how each source of cash might be rated against these dimensions.

Figure 8: Illustrative prioritisation of sources of cash

Option	Potential size	Time to completion	Likelihood of success	Execution cost	Complexity and effort	Description
#1	200m	3 months	High	0.05%	Low	"Treasure chest" A large and cheap source of potential cash that can be released relatively quickly with high likelihood of success
#2	50m	1 month	High	2.00%	Low	"Emergency lifeline" A very fast and reliable solution, but expensive and does not release a great deal of capital. Could be used as a short-term emergency measure
#3	500m	6-12 months	Medium	0.50%	High	"Hidden treasure" A very large amount of cash available at a reasonable price. But plenty of effort over an extended period required, and success not guaranteed
#4	20m	3-6 months	Low	1.00%	Medium	"Non-starter" A small pocket of capital, with a relatively low likelihood of success and relatively expensive to unlock.

■ Very attractive ■ Very unattractive
■ Somewhat attractive ■ Somewhat unattractive

Source: Oliver Wyman analysis

Some pockets of cash will be non-starters. Others will be small and expensive and useful only as "lifelines" in an emergency. The pockets of cash that are likely to be of greatest interest to management are:

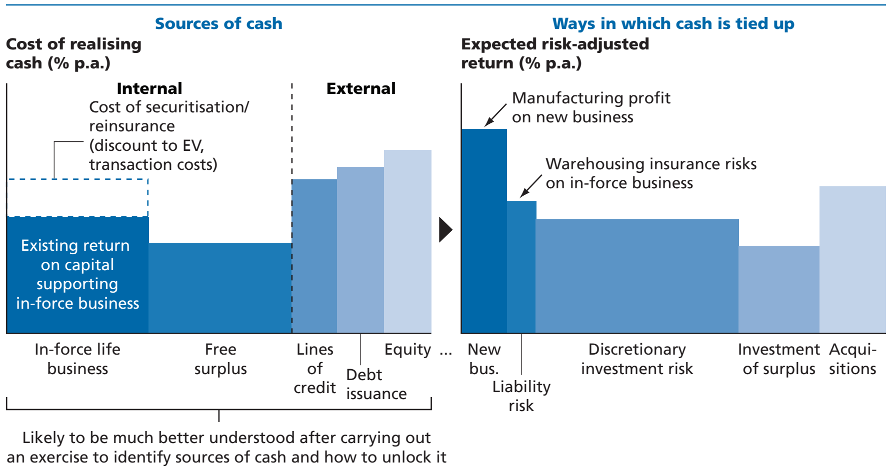
- **Treasure chests**: These can be easily and cheaply mobilised to pursue opportunities tactically as they arise. The CFO is likely to dip into treasure chests first and unlock other sources of cash only once these chests are exhausted
- **Hidden treasure**: This term refers to a large and complex release of cash that is likely to be undertaken for a specific purpose, such as a major acquisition, share buyback, or strategic change in the insurer's capital structure

Having been through this exercise, the CFO will have a good idea of how much cash can be mobilised, and through what means.

Step 3: Make informed deployment versus payout decisions

Choosing among possible options requires another layer of analysis. Now that the CFO has internal sources of cash identified as possible alternatives to traditional external sources, it's important to understand how the cost of accessing internal funds compares with the cost of alternatives such as raising new debt or equity as shown in Figure 9. The cost of the various sources of cash can then be considered against expected risk-adjusted return on possible uses.

Figure 9: Sources and uses of cash



Source: Oliver Wyman analysis

With full information about both the sources and uses of cash, the CFO can facilitate a rich debate about where cash can best be sourced and about how the insurer's total resources can be steered towards the most productive activities.

Our view is that the key to this dialogue is understanding the opportunity cost: the potential benefit that the insurer foregoes by tying up cash in a certain way and, as a consequence, being unable to pursue the best alternative use for that cash (Figure 10).

Figure 10: Applying opportunity cost logic

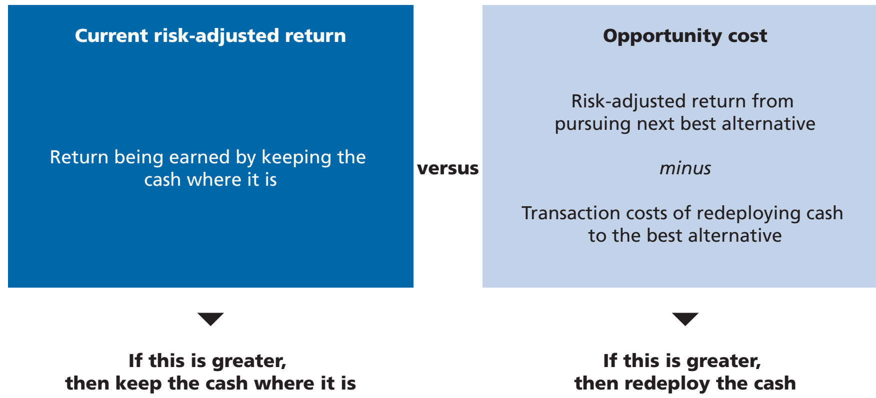
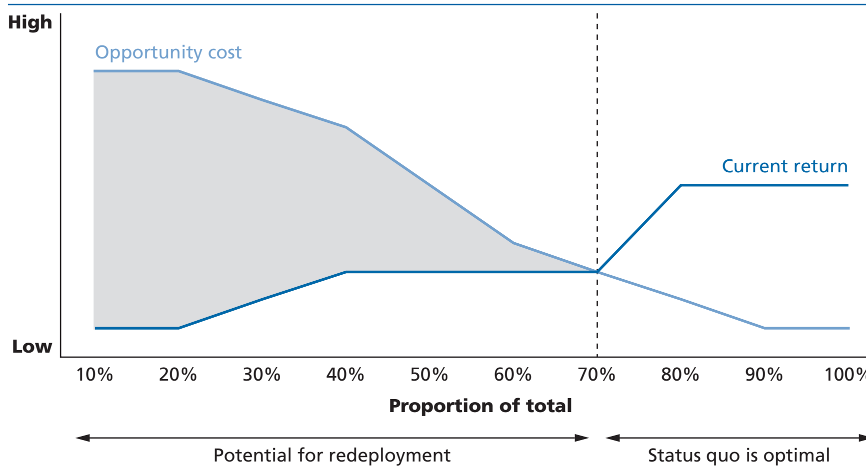


Figure 11 shows a stylised example of the opportunity costs and current risk-adjusted returns on the cash currently tied up in an insurance company. By repeatedly applying opportunity cost logic, the insurer can unlock the least productive sources of cash and redeploy them to the best marginal opportunities, driving up overall returns and value. The shaded area on the left side of the figure represents the additional value that could be extracted by doing this.

Figure 11: Optimisation and potential gains



Source: Oliver Wyman analysis

To illustrate the potential impact of this way of thinking about deployment of cash, consider that if the 20% of lowest-performing cash is currently earning a risk-adjusted return that is 5% below opportunity cost, this is equivalent to 1% per annum on the entire stock of available cash that the insurance industry has at its disposal. Based on a cash stock of €200 BN, that translates into €2 BN of shareholder value foregone each year.

Throughout this exercise, one of the possibilities for redeployment is to return cash to investors. It is therefore necessary to have some idea of what a return of cash is "worth" in terms of opportunity cost. Shareholders apply a range of approaches to determine their required rate of return from investing in an enterprise. But in some cases this would have regard to the various "frictional" costs associated with investing in an insurance company – double taxation, cost of potential financial distress, agency costs, for example, and could be at least 3% or more above the risk-free rate.[3] Shareholders may also take into account considerations such as their tax position and the alternative investment opportunities available to them. In practice, this may be an externally imposed hurdle, below which the investors have no appetite for their cash being tied up in the business.

The strategic planning and capital allocation process is the natural forum for this dialogue and these decisions. We suggest that the executive-level "cash vs. value" dialogue starts from the assumption that the default outcome is the immediate return of all cash to shareholders as quickly as possible. In this "no safe haven" scenario, each business unit leader presents the opportunities he or she sees for the deployment of cash to generate value, making the case for each dollar of cash they propose to hold longer than the minimum amount of time possible. The onus is on them to show that the returns they will earn by retaining cash exceed the opportunity costs of re-deployment. Changing the mindset that currently dominates most insurance annual planning – "status quo with minor adjustments" – makes for more rigorous and creative debate.

In this way, the efficient use of cash to either provide payouts to shareholders or create future value is institutionalised, and ideally reinforced through incentives that reward businesses for creating genuine value and returning cash that cannot be deployed effectively elsewhere.

3 Chief Risk Officer Forum, *Market Value of Liabilities for Insurance Firms – Foundation elements for Solvency II*, May 2008

Conclusion: Finding the balance; creating trust

Paying out all the cash all the time is not the answer. There are many examples of insurers who have successfully invested in the profitable growth of their business and have been rewarded for it. A balance needs to be struck between:

Providing cash to investors in timely fashion; being capital-lean	and	Retaining sufficient earnings to grow and exploit value-generating opportunities
Bringing cash out of less value-accretive activities as soon as possible	and	Maintaining some strategic and operational stability
Feeding parts of the business that add the most value; starving or fixing those that don't deliver	and	Persevering with strategically important projects or lines of business

There are important qualitative elements to consider in getting the balance right. But in today's context of investor anxiety, methods of ensuring that the cost of locking cash into the business is measured and charged to those responsible will be critical. There must be transparency about the price being paid and the trade-offs made in each case.

Increased transparency will not magically make shareholders believe management promises and value a promised future return over hard cash, but it will enable dialogue and greater trust. An executive team that has worked through a rigorous decision-making process informed by the right tools and accessible management information can talk far more convincingly to investors about how their resources are being used. They can demonstrate that withholding of cash is not arbitrary, but rather driven by deliberate decisions to invest in opportunities that provide risk-adjusted returns in excess of the opportunity cost.

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