REINSURANCE REVALUED – THE WAY FORWARD

The growing use of economic-value-based metrics will greatly benefit longstanding reinsurers, according to **Denis Kessler**, Chairman and CEO of SCOR.

Economic value is the new black in insurance and reinsurance. A growing number of (re)insurers have started to supplement their traditional financial disclosures – mostly based on IFRS 4 and US GAAP accounting standards – with economic-value-based metrics, such as the value of new business written, capital generation and economic profitability.

The amount of effort, energy and resources that (re)insurers devote to these developments, along with their extensive communication in this regard, show that the topic is at the top of the agenda for our industry.

But the growing focus on economic value creation is not just a new fad. On the contrary, the development of economic valuation and financial reporting is the way forward for (re)insurers.

Leapfrogging from a "flow approach"

The metrics that the (re)insurance industry has been using for years to measure and report financial performance – combined ratio in P&C, technical margin in Life, net income, return on IFRS equity – have three main limitations.

First, they rely on a non-economic valuation system, which may be deceptive inasmuch as it does not accurately reflect the value (and the change in value) of the assets and liabilities of (re)insurance companies.

For instance, the accounting book value does not fully recognise the value of the future cash-flows associated with long-term exposures such as general liability, longevity and mortality business. For this reason, current accounting metrics tend to significantly underestimate the value of Life risk carriers, whose portfolios usually embed a sizeable amount of future profits.

Current accounting metrics largely take a "current year-only" view, in the sense that the yearly financial performance does not fully capture changes to the expected cashflows of in-force business in future years.

This short-sighted "flow perspective" is not an issue for short-tail business such as property cat but is largely inappropriate for long-tail business.

Second, profitability indicators based on current accounting standards do not explicitly reflect the underlying assumed risk of the business, and therefore do not provide a risk-based view of the financial performance.

Finally, these metrics mix contributions from different underwriting years, making it impossible to clearly separate earnings generated by new business from those generated by in-force business.

Economic value frameworks aim to address these shortcomings, by measuring risk carriers' value and financial performance against economic principles. To do this, the economic approach takes a "stock / holdings perspective", through the fair and consistent valuing of all the assets and liabilities on the balance sheet.

The aim is to reflect, for each balance sheet item, a market value, representing what a rational, knowledgeable and willing third-party would pay to take the item on. Items on the balance sheet for which there is an observable market price are simply "marked-to-market".

The value of other items is estimated with a valuation model. Liabilities are usually valued as the net present value of all expected future inward and outward cash flows, adjusted for uncertainty through a capital cost element that represents the risk premium for holding this liability until extinction. The risk associated with the liability is therefore "encapsulated" in the value of the liability.

In such a framework, value creation is measured – in accordance with Hicks' approach for defining income – as the change in the company's economic value over the considered time period. This change in value is attributed to different drivers, the main two being the impact from the evolution of economic parameters – such as interest rates and exchange rates – and the value generated by the business. The latter may be further split between the value created by the unwinding of in-force business, and the value created by the underwriting activity of the year in question – called the Value of New Business (VNB).

The switch from the "flow approach" of current accounting standards to the "stock approach" of economic value frameworks represents a true paradigm shift. Both approaches are incommensurable in a Kuhnian sense, meaning that they fundamentally rely on radically different worldviews and conceptual schemes.

A slow but progressive convergence

There is a long tradition for Life companies of trying to calculate their economic value with different forms of embedded value concepts. But the recent trend towards an economic view of the world, for Life, P&C and composite companies alike, was initiated by (re) insurance regulatory regimes.

The use of economic-based valuation principles for the purpose of assessing (re)insurers' solvency dates back more than 10 years. The Swiss Solvency Test introduced in Switzerland in 2006 was arguably the first supervisory framework to rely on an economic balance sheet approach.

Solvency II, which came into effect in the European Union in 2016, built on this first landmark and made a further significant step forward, giving much more visibility and momentum to the concept. Since then, Solvency II has inspired the design of several regulatory regimes around the world that rely on an economic approach.

This regulatory change has been a major springboard for the development of value-creation indicators. Solvency II numbers have been used by many European (re)insurers to this end. Although Solvency II was not initially intended to measure financial performance, it has provided European (re)insurers with a natural reference and starting point for measuring and reporting economic value creation, notwithstanding the fact that it arguably includes some non-economic features as a result of regulatory conservatism or political compromise.

Financial analysts have also been quite eager to better understand Solvency II capital generation numbers, in order to account for the change in European (re)insurers' solvency ratios. They have understandably pushed for the introduction of such metrics as they have become acquainted with Solvency II valuation principles.

On the accounting front, current valuation and performance measurement rules are also being overhauled to take a more economic view than present standards. This process will culminate in January 2022 with the introduction of the new IFRS 17 and IFRS 9 standards.

IFRS 17 and IFRS 9 will represent a very significant change in the industry's financial analysis and reporting, making some currently widely-used metrics obsolete and requiring all stakeholders to get their heads around a completely different conceptual scheme for performance measurement. So, a progressive convergence between regulatory and accounting frameworks towards economic valuation is occurring, even if there will still be some conceptual and calibration differences between Solvency II and IFRS 17.

Changing how re/insurers are perceived, valued and managed

Of course, economic-value-based frameworks are not the "alpha and omega" of financial analysis for the industry. First, they rely on numerous parameters – discount rate, cost of capital, diversification measurement, allocation of expenses, etc – whose calibration embeds some subjectivity.

Furthermore, one of their main limitations is to completely ignore the liquidity aspect, as economic valuation puts a cashflow occurring this year and a cashflow occurring in 10 years' time on an equal footing (after discount).

Complementing the economic value view with a cashflow perspective to understand the profit signature of the portfolio, and hence manage the liquidity position of the company, is therefore critical. Incidentally, economic valuation concepts should actually facilitate this analysis (more than e.g. IFRS 4), as the fair valuation of liabilities in the first place requires the derivation of expected cash flows (best estimates) and their stochastic distribution.

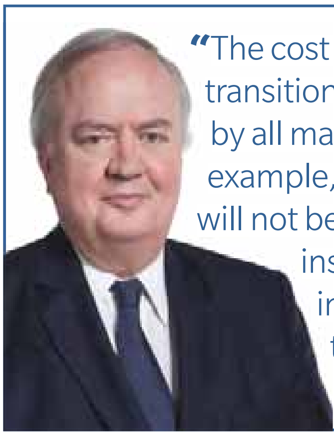
The switch to IFRS 17 and IFRS 9 will also be a challenging and costly transition, with far-reaching consequences for accounting and financial functions and processes, actuarial tools, financial communication, information systems, databases, remuneration policy, and so on. The cost of this huge transition will not be borne by all market players – for example, the new standards will not be applied by (re)insurance companies in the US sticking to the US GAAP framework.

This is raising legitimate questions in terms of fair competition and a level-playing field within the industry, at least in the short term. The comparability gap between both sides of the pond will increase.

Notwithstanding these issues and challenges, I strongly believe that the switch to value-based financial indicators is quite a positive trend and at the end of the day a welcome development for all the (re)insurance industry's stakeholders.

First, these indicators give a more faithful and accurate picture of the true value that the company creates for the long-term benefit of its shareholders. Second, value creation metrics provide a holistic basis for the measurement of financial performance, which may be used across long-tail, short-tail, P&C, Life & Health lines of business and investments alike. Hence, they allow us to consistently compare the performances of investment and underwriting activities with very different features.

Third, they provide a detailed analysis of financial performance by disentangling the contributions made by the different value-creation drivers. Distinguishing between in-force and new business is a significant improvement that allows us to track the performance of business carried over from previous underwriting years and to capture – thanks to the VNB – yearly value creation capability through new business issuance, which is a very useful indicator of a company's franchise value.



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Furthermore economic-value-based frameworks naturally inform strategic decisions and business development, with the aim of maximising the company's fair value. Hence, value indicators measure performance in a way that is geared towards the best interests of shareholders, unlike accounting metrics which may introduce management behaviour biases.

In other words, an economic-value-based approach ensures that the company is managed and steered – within the boundaries defined by its risk appetite framework – in a way that maximises long-term shareholder value. Last but not least, the convergence between the prudential approach and the accounting framework is a very positive development.

In a nutshell, the emergence of economic value-based metrics is a welcome breakthrough in terms of (re)insurers' financial performance measurement and reporting. It will result, all things being equal, in greater transparency for analysts and investors, and will also provide risk carriers with the right framework to assess business developments and allocate capital in the best interests of shareholders.

A better recognition of value creation capability

The switch from a "flow approach" to a "stock / holdings approach" is even more relevant and welcome for our sector in the sense that reinsurance is intrinsically an "accumulation" industry – characterised by the length of its production cycle – and not a "transactional" industry. Today's results are the consequence of underwriting choices made over the past few decades. A good underwriter is very often a seasoned, hence old underwriter!

Furthermore, the quality of the franchise is a key commercial strength in reinsurance, maybe even more so than in most other industries. To paraphrase game theory, reinsurance is a "repeated game". Its business model has always relied on and still relies on long-term relationships, which allow traditional reinsurers, year after year, to always have a (preferred) "seat at the table" and hence to benefit from a Noria effect in terms of repeatedly writing profitable new business and continuously generating new value.

And when results are deteriorating, the franchise allows a true discussion to take place between the parties to assess the situation and renegotiate terms and conditions.

Besides, it should be emphasised that, while property cat risks have largely been commoditised over the last few years with the development of Insurance-Linked Securities, these risks only represent a very small subset of the entire risk universe to which traditional reinsurers have access. Traditional reinsurers may access risks and hence pockets of value that are inaccessible to financial market participants, especially since barriers to entry have been constantly increasing in the sector, particularly on the Life side.

From this perspective, the economic approach, which captures reinsurers' full in-force business value and truly recognises their franchise value, is the most suitable one for the sector's business model. The introduction of economic-value-based metrics should eventually lead to a general re-valuation of the industry. The impact of the (expected) re-valuation of in-force business is even greater for risk carriers with a significant Life portfolio, who naturally have sizeable amounts of future profits embedded in their book.

The switch to value metrics will be of even greater benefit to the industry's "old-timers", for two main reasons. First, they have built a significant stock of value over the years, which is larger than that of most risk carriers in both absolute and relative terms. And second, "old-timers" benefit, as market leaders, from a superior franchise value. Their unique ability to access and globally write all types of profitable new business provides them with superior value-creation capability. Value-based metrics will eventually make this fact even more prominent.