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Seeing the wood for the trees

How a rethink of internal and external financial reporting could help insurers to communicate a more coherent strategy and rebuild investor confidence.

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Introduction

What does your reporting say about your business?

The last decade has been tough for investors in the European insurance sector. While this is principally a reflection of economic uncertainty and market volatility, financial reporting has also played a part, especially for life and composite insurers. Here, confusing and disjointed reporting has made it difficult to judge the company strategy and discern the true value being created within the business.

Investors' underlying concern is that a plethora of seemingly unconnected disclosures and reporting bases may be symptomatic of poor management information and a lack of strategic coherence. When combined with an exceptionally challenging market and economic backdrop, it's not hard to see why the price/earnings and price/book ratios of many European insurers have fallen to low and undifferentiated levels. The lack of investor conviction in insurance business models has exacerbated the extent to which share prices are driven by short-term market movements (in other words, many insurers trade far more as leveraged 'macro plays' than on economic fundamentals).

This isn't a new problem and the search for a solution has been ongoing for many years. Yet, there is now a growing realisation that the hunt for a 'magic metric' for reporting has been unsuccessful. The complex nature of insurance business demands a 'dashboard' of multiple measures, consistently applied throughout the business, with an improved understanding of the links between operating performance, risk and capital generation. Nonetheless, not all insurers have embarked on this path. Even for those that have, developing the right metrics and fully embedding them within the business is still very much work in progress.

Fixing reporting won't in itself overcome any problems in the business model. But it will make sure that the objectives of the business and performance against them are clear to people within the organisation, as well as to analysts and investors. Achieving this strategic clarity will also make it easier to differentiate the business and cut through to the real drivers of shareholder value. When combined with a reassessment of what differentiates insurers and what are the real sources of competitive advantage, companies can start to shift the market from 'macro play' to focus on sustainable value creation.

Drawing on detailed analysis of current reporting and how it could be improved, this report looks at how insurers can bridge the information gap to generate sustainable value by enhancing reporting and strengthening investor confidence.

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Realising your full potential

The poor stock market performance of almost all European insurers in recent years suggests that many investors have lost faith in the sector's potential.

Most of the blame for disappointing share price performance clearly lies with the continuing economic, market and regulatory uncertainty. However, disjointed and inconsistent financial reporting has also been a contributory factor, especially for life and composite insurers, making it difficult to judge the strategy and true strength and potential of the business. Over the years, numerous PwC surveys have highlighted equity analyst frustration over how a myriad of measures serves to undermine investor understanding and confidence. Analysts see pages of numbers that they believe fail to tell them what is actually happening within the company and might not even reflect the perceptions of management and what they use to run the business.

The problems with reporting are, of course, not new. On the life side in particular, there has been a long search for a credible, relevant and consistent metric that can be used for internal steering and external reporting. Yet, this 'holy grail' of reporting remains undiscovered. Like earlier versions of embedded value, 'market consistent' embedded value (MCEV) has suffered from a lack of industrywide consistency in its calculation and underlying assumptions. An even bigger concern for the capital markets is that each of the different embedded value approaches may overvalue some product types, while undervaluing others. In this respect, advocates of MCEV would suggest that this is economic reality – but investors are only too aware that there is no single version of the truth.

The difficulties many insurers face in presenting clear, coherent and compelling messages to analysts and investors are highlighted in our analysis of 20 leading insurers in eight key areas (our approach and a summary of the results are set out on page 6 in 'Rating Insurance Reporting'). The key points that emerge are as follows:

- Insurers are increasingly aware of the need to focus on a 'dashboard' of different measures of value creation for life insurers, especially around free capital generation, analysis of IFRS life margins and a more comprehensive view of new business profitability. However, there are still plenty of insurers that haven't taken their reporting forward. Even among those that have, the metrics need to be more reflective of the way the business is managed, and linked together in a far more coherent way.

- While non-life reporting doesn't suffer from anything like the same problems, we still see significant room for improvement here too. For example, the data in non-life reserve triangles needs to be put in context and more effectively explained, especially as current disclosures can easily lead to an overly negative interpretation being placed on limited information.

- For all insurers, capital and solvency disclosures can come across as arbitrary and not linked to the way the business is run. In turn, risk disclosures tend to be boilerplate in nature, with very little analysis of the 'real world' impact of different stresses and scenarios.

- Segmental analysis of IFRS balance sheets often fail to reflect a meaningful view of the capital in the business. As a result, divisional results often fail to give a clear view of underlying operating performance and returns.

Standing back from the detail, an overriding problem is the inability to 'join the dots' between different reporting metrics to analyse the performance of the business in an integrated way and to cut through the escalating complexity of disclosure. Reporting becomes longer and longer each year, with a tendency to bolt on more and more data rather than hone in on what is important. As a result, most Annual Reports and investor presentations lack clear links between strategy, performance and shareholder value. A clear question is whether you are doing enough to articulate the direction of your business and your specific investment story?

Investor concerns over a lack of clear direction and the information to support it go beyond external disclosure to the heart of the business itself. Analysts are asking, 'If we're finding it so difficult to fathom the strategy of the business and how it's performing against this, are management any clearer than us?' It's certainly reasonable to ask boards, 'What metrics do you manage the business to, are you reporting these and if not, why not?' Similarly, if there are measures that analysts view as important, which are not being reported internally, could these be used to help manage performance?

Taking the initiative

While there have been real efforts to improve a number of aspects of reporting, these are still evolving. From our analysis of sector reporting, we think all insurers have the ability to significantly improve the quality of their disclosure.

There are a number of reasons why progress has been patchy. Many companies started to build systems supporting economic steering of the business (often based on MCEV), but found that this approach came unstuck during the credit crisis. More recently, almost all insurers have needed to put the priority on the systems, reporting and operational changes needed for Solvency II and have had little time to devote to the broader topic of internal and external reporting. Others are holding out for the new IFRS insurance contract standard (IFRS Phase II) as the solution or are simply waiting for economic conditions to improve and hoping that equity values will rise with them.

A further dilemma is keeping pace with what appears to be constantly shifting analyst and investor expectations. Do they want embedded value, cash or IFRS?

While these concerns are all understandable, we think that insurers should use the challenging business and market conditions as a catalyst for improvement:

- In a volatile market, analyst doubts about prevailing disclosure standards can only heighten economic uncertainty, making it even more important to convince investors that the business is in better shape than it is given credit for.
- Assessing what metrics are important should be a key objective irrespective of the timing of IFRS Phase II since these activities are independent of future changes in accounting. Furthermore, waiting for an industrywide solution to emerge may not fit with management time horizons.
- With the end in sight for the Solvency II design and build phases, insurers should be starting to ask themselves what they are going to use this data for, how to embed the information within the running of the business and what to disclose externally. Could this information be used as a new basis for reporting value?
- The experience of the financial crisis has shown companies and investors that they need a reporting framework capable of explaining current developments and providing a forward-looking perspective in an integrated way. Accepting that the precise metrics and their degree of importance may vary, many insurers will need to look more closely at how to develop a framework to meet these demands.
- By taking the initiative on reporting, insurers can help to fill the 'vacuum' that has led to ever-changing analyst requests and ways of valuing the business.

These issues are worth addressing even if the focus is only on how to improve the external reporting part of the equation. However, the real value for insurers will come from reassessing what is important within the business itself. In particular, it would help to make sure that management information is sufficiently coherent, consistent and ultimately more useful in making business decisions.

Insurers should use the challenging business and market conditions as a catalyst for improvement.

Putting your reporting on track

There is no easy or instant solution. Companies that are successfully addressing these issues are initiating a pragmatic 1–2 year strategy to improve and refine reporting, which will also provide an effective platform for IFRS and Solvency II.

We believe that the key priorities are identifying the right suite of metrics needed to run the business, establishing external reporting as a subset of this view, while concentrating on the factors that have the greatest influence on share prices. Having established which metrics are required, companies can jettison any superfluous measures. The resulting rationalisation will not only make reports briefer, more accessible and more intelligible, but will over time help to reduce the workload for finance functions, cut reporting production costs and allow staff to spend more time supporting the business.

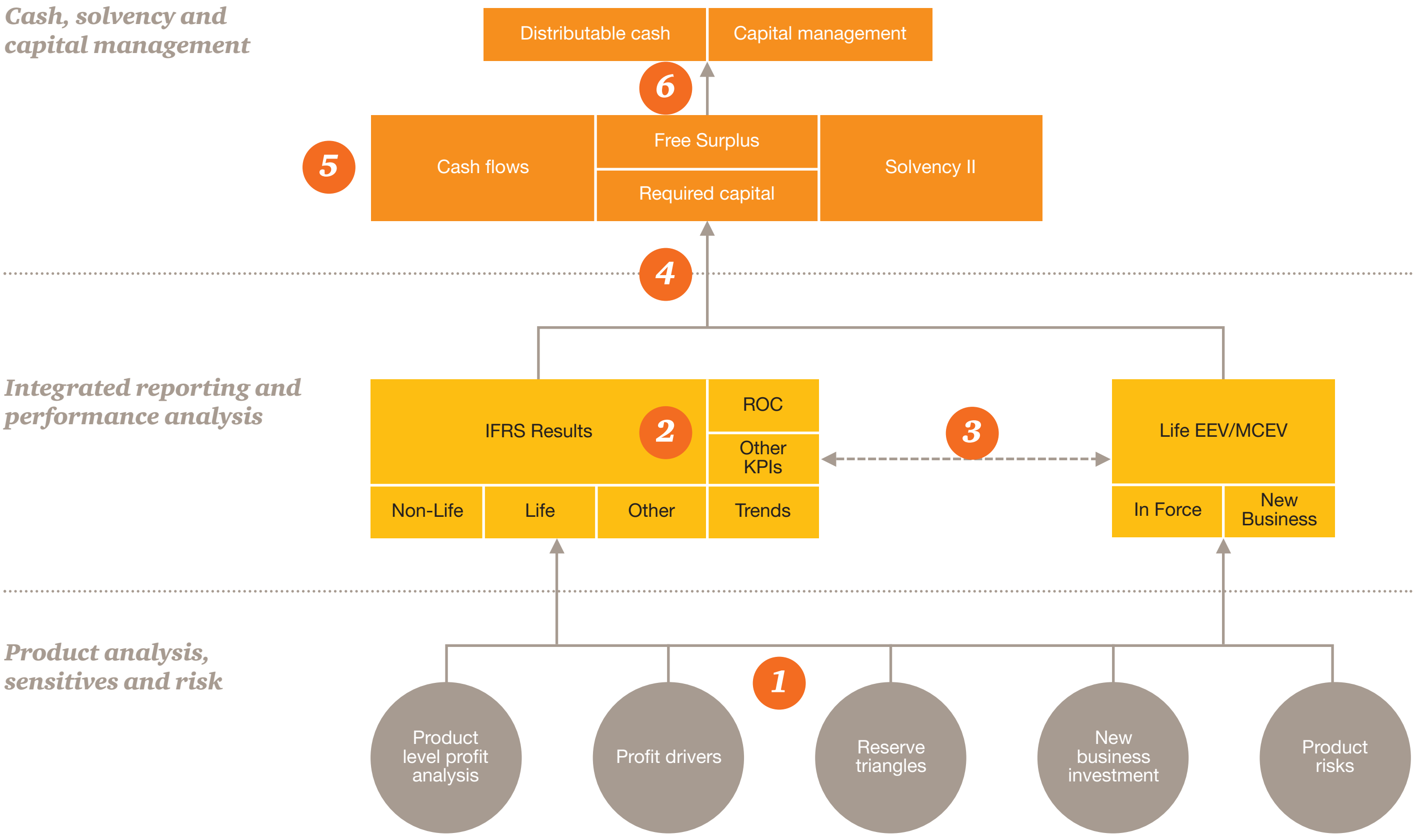
Figure 1 sets out our vision for the way forward for composite insurance groups, which is built around an integrated framework combining short- and long-term perspectives and providing clear links between value, cash, capital and risk.

This version of 'integrated' reporting may not be applicable to all insurers. Pure life insurers may look to prioritise different metrics; for example, run-off companies may look to emphasise free capital generation as the key driver of value creation. Equally, while non-life insurers may believe that the metrics they report are the right ones, they may focus instead on whether their reporting really helps to explain their strategy, and differentiate the business in a way that plays to the company's strengths.

In this respect, what companies seek to emphasise should reflect their business model, strategy and priorities – while using reporting to drive internal and external clarity of focus and purpose. (We focused on this topic for wholesale non-life insurers in our report 'Daring to be Different', published in September 2011.)

Pure life insurers may look to prioritise different metrics, and companies focused on run-off may well look to emphasise free capital generation as the key driver of value creation.

Figure 1: One view of 'integrated' reporting



1. Radical overhaul of disclosures, particularly for life insurers
2. Improve clarity of segment reporting; work to narrow inconsistencies
3. Achieve consistency between IFRS/EV reporting framework
4. Improve linkages from value reporting measures to cash/capital
5. Retrospective and prospective analysis of free surplus generation
6. Clear linkage from Solvency II view to 'real world'; proper scenario analysis

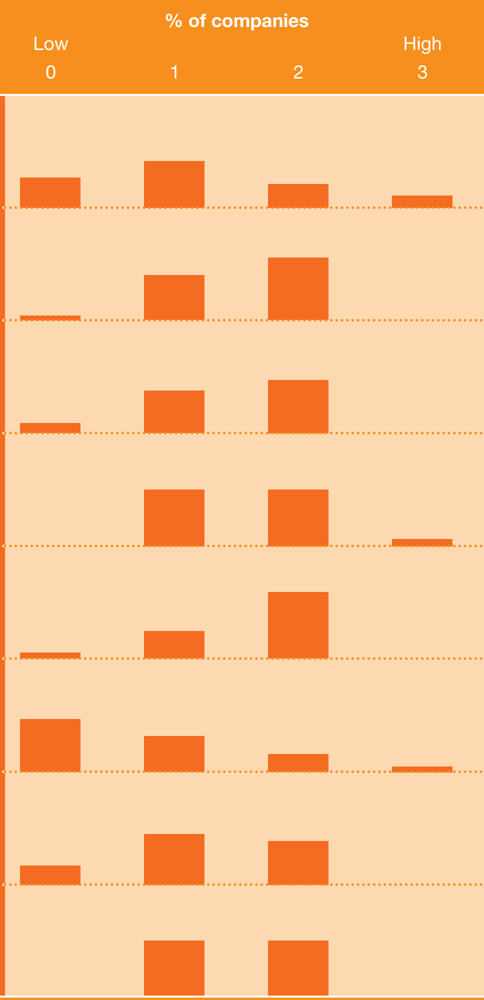
Source: PwC

Rating insurance reporting

Sector experts from our market reporting team carried out a detailed assessment of reporting by 20 leading insurers.

Our focus was principally on quantitative disclosures rather than on qualitative factors. Each company was rated 0–3 for each of the eight areas set out in Figure 2, with our analysis determined by the following considerations: 0 No information provided, 1 'Bare bones' data only, 2 Covering the basics, 3 Good quantitative analysis.

Figure 2: Rating in each category



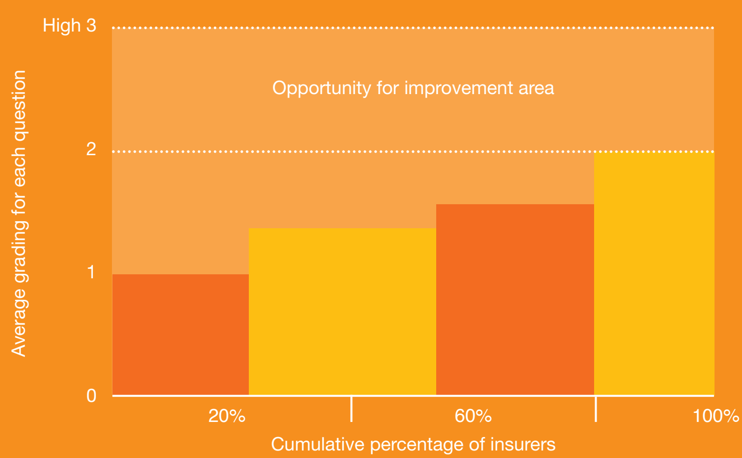
	Themes emerging
Free surplus and cash generation analysis	Significant recent improvements for some, but many lagging behind. Definition of 'cash' remains unclear.
Solvency data	Economic capital measures used by only a limited few companies.
Data on solvency movements in stress scenarios	Very limited solvency sensitivity information, normally based on equity, not capital.
IFRS segment balance sheet data	Segmental equity is a better reflection of real world capital where there are distinct, very separate businesses.
Embedded value reporting	Minimum levels of EV reporting are being met, some good examples of regional/product analysis and commentary.
IFRS life margin analysis	One company provides to a product level, many provide very little information and the link to profit drivers is difficult to see.
New business metrics	Some provide regional analysis, however improvements could be made in sensitivities and link to risk disclosures.
Non-Life reserve triangles	Calendar year only available from some, opportunity to improve through greater explanation of patterns over time.

Source: PwC

The results of our analysis in Figure 2 show that the lowest scores relate to IFRS margin disclosures, new business metrics and free capital analysis, which are, for the most part, life insurance issues. Many of the broader issues – around segment reporting, reserve triangles and capital/risk – are relevant to non-life insurers. And for composite insurers, this combination of issues is a real factor behind the conglomerate discounts evident in current share prices.

Comparing the results at a company level (see Figure 3), what is evident is that some companies are doing significantly better than others overall. However, even those insurers covering the basics reasonably well are still doing little to provide either a properly joined up view across different value 'lenses' or qualitative information that would help link performance across the eight areas we focused on and to group strategy more broadly. Put more simply, a score of '3' may be 'best in class', but there is still considerable scope for improving reporting, particularly in developing a coherent 'dashboard' approach.

Figure 3: Analysis of insurers – average grading



Source: PwC

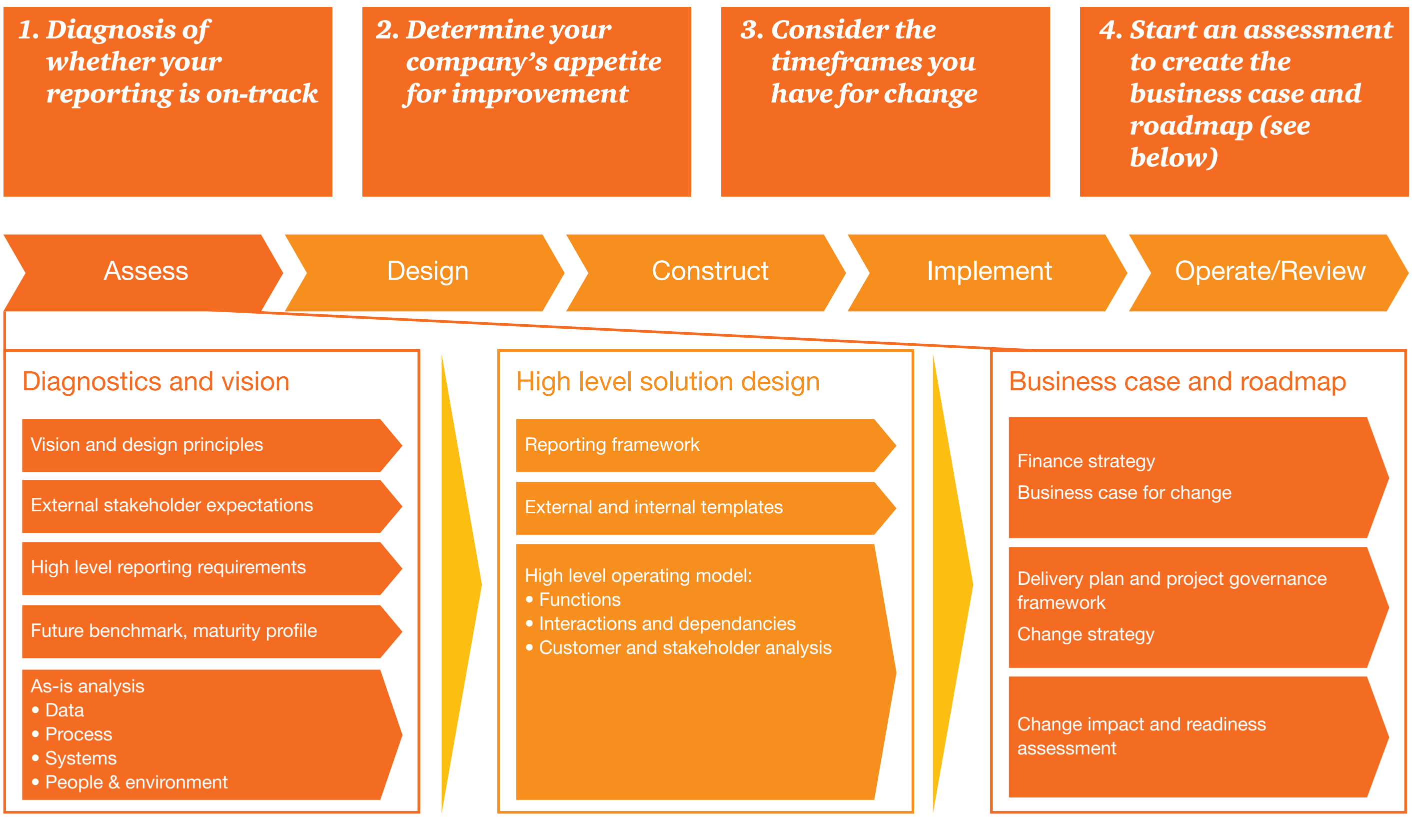
On the front foot

Improved reporting can't overcome the impact of a fragile economic and market outlook. However, it can put your business firmly on the front foot by helping to crystallise and convey the strengths and key value drivers within the business.

It can also reinforce performance management and provide strategic clarity, as well as making it much easier to articulate and communicate where the company wants to be and how it intends to get there. In turn, the company can convey a more coherent statement of its strategic intent to analysts and investors and provide them with the telling information they need to track and rate progress.

Our analysis highlights the information gaps facing insurers and the hard work ahead if they are to create a distinctive message and move the market beyond 'macro play' concerns. However, it also shows that forward-looking firms are beginning to address these issues and should be in a much stronger position to bring investors with them as they continue along this journey.

Figure 4: Where to go from here



Is your reporting on-track?

Building on our understanding of analyst expectations and integrated view of reporting outlined in Figure 1, we believe that these are the key considerations that senior management will need to address as they look to get their reporting on-track:

Meeting market expectations

- Are you confident that the market understands your strategy and what makes your business successful, and is this being conveyed effectively enough?
- Does external reporting reflect the way the business is run?
- Does your reporting provide a clear and transparent link between value, cash, capital and risk?
- Have you identified and conveyed the right suite of metrics?
- Are key components of what makes your business successful missing from external reporting?

Managing the business

- Are there significant differences between the metrics used within local businesses, or between the metrics used by local business units and group head office?
- How confident are you that the metrics used to steer the business are integrated and 'joined up'?
- Do you have a sufficiently clear view of how economic measures translate into cash?
- How much of the management information that is produced is actually used?

Risk reporting

- Are you sufficiently clear about how Solvency II will affect your capital strategy and the way you run your business?
- Have you identified how you are going to embed Solvency II with your wider reporting on an integrated and joined up basis?
- Have you decided your Solvency II external disclosure strategy?

The right operational environment

- Are the demands of producing the numbers leaving too little time for generating useful business insights?
- Do your risk, finance and actuarial teams collaborate sufficiently?
- Are manual interventions impeding efficiency and control?

How PwC can help

PwC is working with a range of insurers to improve their internal and external financial reporting. If you would like to discuss any of the issues raised in this paper, please contact the authors listed here:

Brian Purves
PwC (UK)
+44 (0) 207 212 3902
Email: brian.purves@uk.pwc.com

James Quin
PwC (UK)
+44 (0) 207 212 5173
james.b.quin@uk.pwc.com

Kirsty Ward
PwC (UK)
+44 (0)207 804 2999
kirsty.a.ward@uk.pwc.com

pwc.com/insurance