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Valuation of financial intermediaries: Greater transparency through transfer pricing

AUTHORS: LARRY RUBIN AND RANDY TILLIS

Insurance companies may not receive fair valuation in the capital markets due to a lack of transparency on how and where they make money. Larry Rubin and Randy Tillis explain how transfer pricing can help provide analytical tools for comparability relative to other financial institutions, and describe how future reporting requirements will increase the availability of information to perform transfer pricing analysis.

VALUATION OF FINANCIAL INTERMEDIARIES: GREATER TRANSPARENCY THROUGH TRANSFER PRICING

Insurance entities are not typically valued like other enterprises. Their 'price' in terms of book or market multiples is often much less than other institutions. Based on historical price/Earnings per share (EPS) data from SNL the insurance multiple was 12x to 14x over the past year prior to the recent quarter's market reactions.

The current, traditional, US reporting structures (STAT and GAAP) provide information on what enterprises have made in aggregate, but do not present information to judge the underlying source of the earnings. We believe that, by using the transfer pricing principles and looking deeply into the functions provided, an insurance company may be able to present a rationale for the value inherent in the company. It will be able to demonstrate to the market that its strengths on the asset and liability side entitle it to be measured similarly to other organizations and receive similar price considerations or multiples. Using such a transfer pricing process can demonstrate the asset, liability, and risk management fees or earnings produced by the company. The following industry example, based on embedded value, comes from information provided by Swiss Re in its public reporting package.

Transfer pricing as measurement

In the first quarter of 2008, Swiss Re disclosed its fund transfer pricing reporting system, 'Economic Value Measurement' (EVM). Swiss Re's EVM system has created one 'replicating portfolio' that mimics the company's insurance liabilities' characteristics. The value of the replicating portfolio reflects the present value of insurance cash flows arising from underwriting activities (without any investment), discounting at a margin that reflects the risks or costs in pure underwriting activities. Then, the replicating portfolio is 'lent' to asset managers as their 'liability.' The replicating portfolio also becomes the benchmark for the asset management performance measurement. To the extent that asset managers purely invest in the replicating portfolio, there is no economic value adding, as the same effect will be offsetting on both the liability and asset side. To the extent that asset managers could beat the benchmark at a risk-adjusted basis, they are adding value to the company. Swiss Re's EVM system is a powerful tool that has served as one integrated framework in the company's performance measurement, strategy forming, planning, and other management activities (see Figure 1 overleaf).

By creating a transfer pricing paradigm that captures benefits from decisions or actions, be they Risk-adjusted return on capital (RAROC), market consistent embedded value (MCEV), or something in between, a track record can be established to show how well the different functions have performed. This information then can be summarized to present to management or the market how the liability and risk management function has performed. This information may supplement the risk and capital management disclosures, thereby providing a more complete view of the enterprise.

Future valuation

There are several regulatory events on the horizon that may encourage this functional view.

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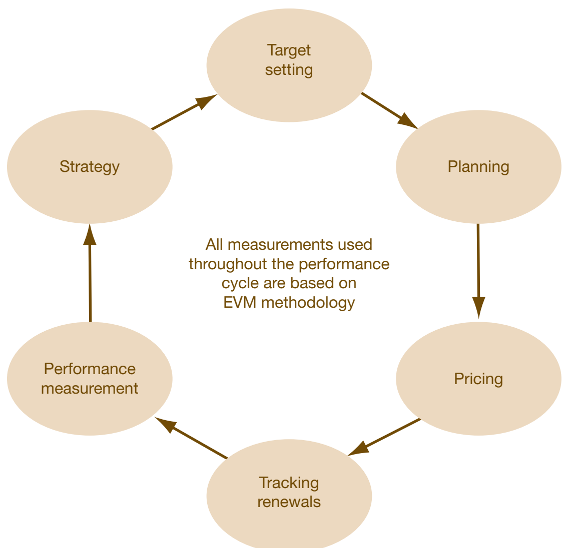
Figure 1 Swiss Re's 'Economic Value Measurement'



Source: Swiss Re

The recent CFO Forum decisions on adopting MCEV and the IFRS discussion paper on insurance contracts are just two examples of a future where insurance companies will be required to calculate a market value of insurance liabilities separate from assets. While there may be some disagreement on the final approaches for reporting or recognizing the profit from liability activities, it does appear that there will be distinct capturing and reporting of the liability side of the balance sheet. Once this information is provided, it would be a short step to produce earnings related to the asset and liability functions. Thus, a transfer pricing framework would provide a view of how earnings are created.

Holistic view

Currently, most insurance entities are considered hard to value because of the lack of information or transparency on how they make money. With increased awareness of enterprise risk management and internal offsetting risk profiles, companies are leveraging their liability expertise to increase earnings, while reducing their overall risk profile or capital needs. While this full company or holistic view is gaining momentum, the need for measurement of the risks and earnings by source becomes even more important. As recent credit market turmoil has shown, if an insurance company manages risk well but the investment area does not, then the company suffers. Transfer pricing is a tool for distributing the risk premiums earned.

Summary

Over the long run a company can become perceived as a risk manager, an asset manager, or something in between. Accordingly, breaking down earnings into component pieces and aligning them with the company's underlying skill sets would add value to management, potential investors, and shareholders. The concepts behind transfer pricing will enable this kind of analysis, which will lead to more transparency in the source of earnings and more comparability between insurance entities and with the other financial institutions. This increased comparability should then translate into better multiples or valuation of the company. □

AUTHORS

Larry Rubin
Partner, Actuarial and Insurance Management Solutions (AIMS)
PricewaterhouseCoopers (US)
Tel: 1 646 471 4017
larry.rubin@us.pwc.com

Randy Tillis
Manager, Actuarial and Insurance Management Solutions (AIMS)
PricewaterhouseCoopers (US)
Tel: 1 312 298 3379
randy.tillis@us.pwc.com

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