IN-FORCE VALUE OPTIMISATION ENHANCING VALUE FROM THE EXISTING BUSINESS

Focus on the "top-line" in terms of growth in (as well as the absolute quantum of) new business premium income has been a key performance driver for many insurance company managers since the opening up of the industry in 2000. However, with more than ten years in operation for many companies, shareholders (and potential new investors) are now also eager to get a reliable picture of the value generated by their past investments in the business. This leads logically to a pertinent question that the management of all companies must ask themselves: "In addition to growing our new business volumes, what can be done to extract greater value from our existing business?"

Drivers for a shift in focus

Before delving into the possible value optimisation opportunities, it is relevant to first consider the key drivers for shifting primary focus from new business growth to better management of existing business. There are several reasons why companies may look towards in-force portfolios as valuable assets providing reliable and steady source of earnings and therefore, ought to make conscious efforts in maximising this:

First and foremost, the actual experience of many companies, particularly in respect of expenses and persistency has turned out very differently to that originally priced for at the time of product launches or that shown in the initial business plans when obtaining capital infusions from the share-holders. This has led to the very real risk that even if the future experience for existing policyholders turns out to be perfectly in line with the *current* best estimate assumptions (revised since the time of original pricing based on actual experience), the overall value generated over the lifetime of the remaining policies may not reflect the expectations of the returns shareholders may have had originally. This inevitably presents two choices to the management: to re-price and sell increasing volumes of new business reflecting current view on margins or to revise expectations, look inwards and put in place concerted management actions aimed at cutting down on the operational inefficiencies and improving experience to "get back on track" – to the extent that this is achievable.

The former option above is indispensable for a going concern. However, in the current scenario, this option is increasingly constrained by the significant pressure on new business volumes seen in recent years (the annual growth in weighted APE written by private life insurers was a negative 4% in FY2012-13, negative 18% in FY2011-12 and negative 17% in FY2010-11). Moreover, the macroeconomic as well as industry specific challenges facing life insurers currently are expected to remain for the rest of FY14 and the immediately foreseeable future.

High new business margins seen previously are also being challenged by the regulator with increased focus on transparency and greater value for the customer. Consequently, whilst insurers must continue to write profitable business in order to maintain their operations in the long run, they must also recognise that existing in-force portfolios are valuable assets that if managed appropriately can yield significant returns. This is particularly true for larger players that have been in operation for more than ten years and have established a substantial in-force book. For these, even **very small improvements** in margins earned on in-force portfolios could have **substantial impact on earnings**.

Optimisation opportunities

For any business, one can think of any number of innovations that could lead to improvements in efficiency and add value to the organisation. However, it is the "big wins" – items that are relatively straightforward to implement in a reasonable timeframe but can have a significant impact on earnings – that would stand out to the management and potential investors. Within the context of the life insurance industry and the current operating environment for many companies in India, we can identify several such opportunities. Assimilating these into a structured framework provides a five dimensional targeted approach to extracting greater value from existing portfolios by implementing the necessary management actions.

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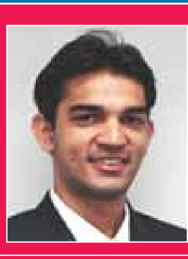

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Highlighted below are some key areas where it might be possible to achieve some quick wins – if an optimisation program is carried out in a structured way with appropriate buy in from the senior management.

Targeted customer management

This refers to managing existing customers through the individual life-cycle in order to extract the greatest value possible, for example through effective retention management. 5 year persistency ratios for several companies are currently appalling (based on public disclosures) with 61st month premium persistency rates of well below 20 - 25% being the norm rather than an exception. Significant gains can be achieved through a concerted persistency management programme. Further benefits can be achieved relative to implementation costs if efforts are targeted towards retaining high value clients if the top-end products/clients contribute to the bulk of the surplus generated in the business. Some rudimentary statistical tools (including basic predictive modelling) can be used to provide rich insights into the experience data and provide competitive advantage by ensuring that retention targeting is not just carried out at a blanket company level, but that the right customer is provided with the right incentives. A sophisticated persistency management program will necessarily rely on a robust communication and customer service strategy but it might also be time that companies begin to think about more innovative loyalty schemes, for example how about offering reward points on renewal premiums to eligible high value clients. A successful program will be able to deliver solutions that are practical to implement but at the same time underpinned by a deep understanding of the portfolio profitability across segments and reflect both the short term and *lifetime* value of a customer, across all current and *potential* product holdings.

Retention and persistency is only one aspect of customer management, which encompasses wider areas including amalgamating effective customer service models with value generation. For instance, recognising high value customers and delivering commensurate levels of customer service can potentially create an unbeatable value proposition for customers with high end services offered to premium customers. At the same time medium value customers can be moved to low cost service channels whilst low value customers moved to self-service channels. A similar proposition can be extrapolated to agents and other distributors, in addition to direct customers.

Operational management

At the heart of operational management lies improving cost efficiency and implementing expense reductions. There are examples in the industry today of companies still suffering from maintenance expense over-runs despite being in operation for more than a decade. If managed under the supervision of an experienced expense reduction practioner focussed on insurance industry, a well thought out cost reduction program can result in a guaranteed 5-10% reduction with potential of up to 25-30% savings as well. However, such a program requires strategic assessment of each reduction opportunities – to ensure one does not end up cutting corners with core competency areas whilst at the same time achieving the desired reductions that would be value drivers without compromising on business growth.

Key enablers of a high quality assessment that will be able to 'deliver the goods' are sufficiently granular details on expenses and operational metrics, identification of areas of potential cross subsidies and ensuring sufficient management buy in to see through the project. For the actuary to be an enabler – and indeed a key actor – through such a program, one would need to have an intimate understanding of the expense analysis, including accurate details of fixed versus variable costs; initial versus renewal costs; recognition of arbitrary allocations and approximations in the analysis and building robust capacity models. Often, the reasons for high costs in a particular department are very different to that originally anticipated by the management and efficiencies are usually possible in all of the areas of people, processes and systems. This can be a startling and valuable insight for the management, but requires a good diagnostic approach with a mixture of actuarial, strategy assessment and change management skills.

Finance management

A potential big-win for many existing insurers can be achieved by improving investment performance through better focus on the mix of asset, liabilities and achievable investment returns. This involves not just the appropriate asset selection but also devising potentially high return investment mandates for the fund managers. Skilful asset allocation reviews and dynamic ALM strategies can deliver flexible mandates with the possibility to invest in high return instruments without breaching the risk appetite limits of the company. Insurers in India are typically restricted by regulations as well as convention, investing predominantly in orthodox asset classes. Identification of "new" assets providing higher returns can be a critical driver of value, given the large volumes of assets under management for insurance companies.

Capital management

Capital management involves identifying and then releasing/removing capital trapped or blocked within the organisation or certain specific lines of business, for example through reinsurance, re-design of corporate structures or even through release of (more than required) prudent margins in the reserves held. This could potentially be a one-off exercise but could deliver reasonable gains for the shareholder. However, a word of caution is necessary: in releasing excess reserves, the actuary needs to be particularly attentive to the requirements of the relevant regulatory provisions and practice standards. Nevertheless, it is not uncommon for some companies to infuse disproportionate levels of prudence within their reserving methodology and assumptions, which can be to the detriment of both the shareholder and the policyholder. An honest review of the reserving margins might lead very defensible arguments for an acceptable release of capital previously blocked in the business. At the same time, and to avoid arbitrary changes in reserves from one year to the next, companies can specify explicit reserving guidelines based on risk appetite and confidence levels and determine reserves based on established capital determination methodologies. For example, define appropriate target level of security – say 90^{th} percentile or 75^{th} percentile (in line with the risk appetite of the company whilst having due regard to policyholder interests) and then determine reserves at the required target level. This would ensure excess capital is not locked into the business and also provide a justification for the use of chosen MADs in the reserving basis. The ability and the extent to which reserves can / should be released depends critically on the current practices and requires very careful consideration to ensure appropriate compliance as well as not jeopardise policyholder interests.

Computational integrity

A number of companies have already started publicly reporting their internal estimates of embedded value. There is further interest in the valuations of insurance companies given a number of transactions – both actual and potential – in the Indian market in the recent years. Further, some promoters are keeping a keen eye out for a potential public listing as soon as an appropriate opportunity presents itself. All of these factors combined mean that the reported valuations are gaining prominence for shareholders, analysts as well as potential investors. Therefore, it is essential that the computation of embedded value (EV) is robust and accurate. For the actuary computing these (whether internal to the company or an independent expert), it is essential that all sources of value are appropriately captured and valued using suitable methodologies. There is an inherent tendency amongst actuaries – by training and/or nature – to err on the side of caution and be conservative in their estimates. It is not unheard of that even within the *best estimate* assumptions there is an element of prudence concealed. It is essential that such areas - where judgement plays a critical role in the calculation of value – are appropriately highlighted and reflected in the shareholder/investor communications. Whilst (hidden) potential prudent margins in *best estimate* assumptions may be relatively easier to salvage, there are often additional - less obvious - areas where implicit margins may found. A good example is in the number of modelling assumptions and approximation that are typically made when setting up product models. Many legacy cash-flow models were typically built originally for the purpose of statutory reserving and then later adapted to calculate best estimate cash-flows for EV purposes as well. An unintended consequence of this is that there are inevitably a fair number of modelling approximations that were made to be characteristically prudent (such as timing of certain cash-flows or charges / computations of certain ages and durations etc.) and may appear to be trivial or driven by convention at first sight, but could potentially lead to surprisingly material differences in value when modelled more accurately. A further question that a discerning practitioner must ask is whether *all* sources of value have been appropriately captured in the computation of VIF. For example, are there any global (unmodelled) provisions that are inadvertently missed in the calculation of the company level embedded value? Equally, have all possible margins in each provision been recognised appropriately?

Clearly, the above factors with respect to computational integrity are not sources of *true* value for the company but could definitely be significant items in the *reported* value – which is inevitably the metric markets and potential investors can see and measure the company against.

Final remarks

In order for in-force optimisation programmes to be successful, significant buy-in is required from senior business leaders as such programmes typically require cultural change within the business. Moreover, the management needs to be committed to see through the entirety of the program as well as ensure that recommended actions are thoroughly embedded within the organisation for the benefits of such programmes to be realised. Moreover, the responsibility for in-force business is often delegated to technical or BAU departments with an enormous imbalance between in-force focussed employees new business focussed employees. We have seen several large multinationals across the globe being proactive in recent years in building high profile teams with responsibility and accountability for in-force portfolio optimisation and one can fully expect that companies in India will surely follow suit as it is in their best interest to get most out of what they already have. Clichés become clichés because they are true: a bird in the hand is worth two in the bush.

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