Buying an insurance company in Taiwan

These are difficult times for insurance worldwide, but especially in Taiwan where the guarantees of products sold in the past are now a burden with the current low interest rates. **Mr Hassan Scott P Odierno**, Principal and Actuary of Mercer Zainal Consulting Sdn Bhd, shares that while an insurance company on the island might be purchased comparatively cheaply today, one has to know what exactly is being bought and what the hidden risks are.

If you are buying something "real" such as a house, you can see exactly what you are buying. When buying a house it is easy to get the value, and most people would get the same value for the house. When buying an insurance company you are buying the value of future cash flows of the company, where these cash flows can be stretched over 50 or more years in the future and with very uncertain assumptions. If two different people calculate the value of the insurance company, they could get very different values.

Determining the value of an insurance company

An insurance company can be split into three pieces:

- The shareholders equity (profit) of the company as of the valuation date, which is the profit as of right now;
- The value of the business already sold by the company;
- The potential of the company to sell new business in the future.

The current profit of the company represents the current position of the company, the profits which can be "seen and touched". This is called net asset value, and includes other sources of current value, such as unrealised gains from property

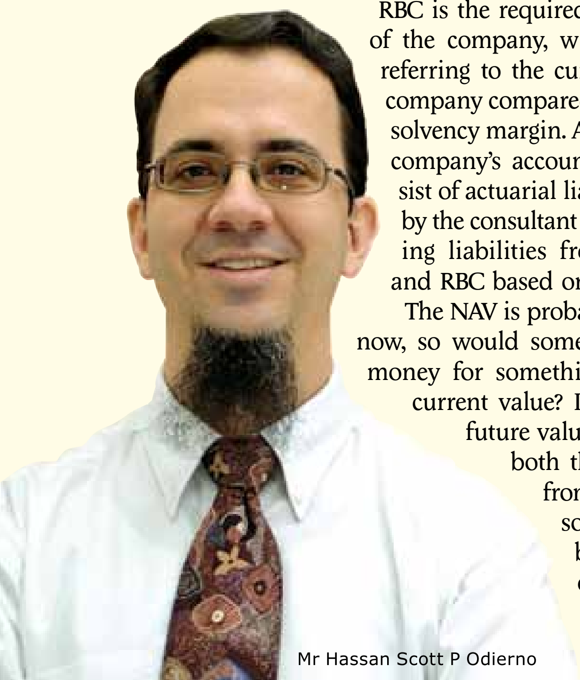
Net asset value

The net asset value (NAV) can be calculated as:

NAV = Assets – liabilities – RBC + unrealised gains

RBC is the required solvency margin of the company, with the RBC ratio referring to the current profit of the company compared to the calculated solvency margin. Assets are from the company's accounts; liabilities consist of actuarial liabilities calculated by the consultant as well as accounting liabilities from the accounts, and RBC based on a 200% ratio.

The NAV is probably negative right now, so would someone pay a lot of money for something with negative current value? It depends on the future value of the company, both the value expected from business already sold, and the future business that the company will sell.



Mr Hassan Scott P Odierno

Embedded value

The value of business already sold is called embedded value. An actuary makes a number of assumptions in order to project the yearly cash flow (profit or loss) for each type of plan sold by the company. These projections can be 50 years or more in the future.

The assumptions an actuary makes include:

- Discount Rate
- Investment Return
- Dividend Rates
- Crediting Rates
- Lapse Rates
- Mortality Rates
- Loss Ratios for Cancer, Dread Disease, Hospitalisation …

The discount rate is used to get the present value of future cash flows, and is generally similar to the rate used for the cost of capital. For a long-term plan this can be extremely sensitive, with changes in discount rates sometimes changing a profitable plan into an unprofitable one.

There are several ways to determine the appropriate discount rate:

- Follow the discount rates used in similar transactions
- Follow a Capital Asset Pricing Model (CAPM)

Dividend and crediting rate assumptions are used in the pricing of certain types of insurance products and would need to be consistent with the investment assumptions.

Structural value

The other aspect of future value is the value of future new business. This value is called structural value as well as goodwill. It represents the ability of the company to sell profitable business in the future.

Structural value reflects how well the company will be able to sell business in the future. It reflects:

- The strength and abilities of the distribution force such as agents;
- The product lines the company specialises in;
- The quality of the systems in place;
- The abilities of the people in the company;
- The strength of the brand name.

Thus the total value of the insurance company is the NAV plus the embedded value plus the structural value. A final comment on calculating the value of the insurance company is that before getting into all the details of the calculation you need to ask yourself, why is this company selling? Am I comfortable with this?

Identifying hidden obligations and risks

These are very difficult times. It would be nice if we could simply buy insurance companies where the RBC ratios are above 200%, all products already sold are profitable, and there are no hidden risks or obligations. Unfortunately this is not the case.

If the company's RBC ratio is currently below 200% then it will be your responsibility to bring it to 200%, which means injecting more capital. Even if the ratio is currently above 200%, the closer it is to 200% the greater the chance you might need to inject more capital later.

Past products sold

If the company is older there are most likely products which were sold in the past which are unprofitable now. In the past the pricing investment returns were as high as 8% p.a, compared to only 2% p.a. now. Cancer products sold in the past tend to be unprofitable as well. There could be future injections required for this business either in the near future or in the longer term.

Due to the current financial crisis, what kinds of products are the company selling? Are there hidden risks? For instance, unit linked products do not have the guaranteed returns of ordinary life products, but there is a risk that policyholders decide they do not want the investment risk and lapse their policies to move to other investments. In this case the value of the cash flows, and thus the amount paid for the company, is overstated.

Similarly for products such as annuities which give yearly crediting of returns, there is a risk of the crediting rate being below what the policyholder can get elsewhere and thus policyholders lapsing.

There are many more potential risks regarding the policies being sold, such as policies with low pricing returns being sold now and later lapsing once interest rates increase, or policies with flexible premiums the policyholder might pay less premiums (premium holiday) than assumed in the projections. These risks can be thought of as options, with these options being very difficult to price and impossible to hedge. It is difficult to list all such potential options, with finding and highlighting these risks being part of the value added abilities of the consultant.

The potential for synergy value

When buying an insurance company, 1 plus 1 does not equal 2! You will bring your own expertise into the company. Perhaps you have specialised investment capabilities. By contributing this expertise to the insurance company you are increasing the value of the company. Similarly, the insurance company might be using a large agency force to sell the products. If you have other strong distribution channels such as being related to a bank or perhaps a sister company with a large number of employees that the insurance company can gain access to, new business will be larger than before.

Should you be considering several insurance companies, they are likely to fit differently with your own company. This is why different companies bid very different prices for the same insurance company. The greater the synergy, the greater the price you would be willing to pay.

The effects of restructuring on the value of the company

Once the deal goes through, it is likely there will be a restructuring of operations or a merging into your own operations. It is vital that you increase or at least maintain the value of the company. For instance, the structural value is dependent on the ability of the people in the company to continue to contribute to the success of the company. If the top employees leave then this value is likely to disappear.

Similarly if the agency force moves to another company the structural value will again disappear. In restructuring, timing will be extremely important. On a more positive note, putting your own people into key positions for the new company where they have more expertise will increase value for the company. In many cases this will also include replacing some of your own staff, so your operations as well will likely be restructured.

Conclusions

Insurance companies are being sold very cheaply today, with some even being given away! What exactly are you buying though? This is where having actuarial consultants with knowledge and experience is vital, as well as access to other experts such as investment consultants. Before you purchase a company you need to understand the risks as well as the future capital injections which will be required.

Not all insurance companies are the same. Companies with the potential for higher synergy value will be much more valuable to you than companies with less potential synergy. Once you purchase the company, you need to be extremely careful that you maintain this value or even increase value, through the use of the expertise of human resource consultants.