Partnering for Success

SAPIENS

Introduction to Embedded Values

January 28, 2014

Stuart Hayman

Stuart.Hayman@Sapiens.com

For more information, please contact us at info.sapiens@sapiens.com.

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1 Background and Objective

Life companies generally report their results in published financial statements, on the basis of the statutory requirements of Insurance Company legislation.

Under such legislation, the assumptions and methodology used to value assets and liabilities are principally concerned with the company's solvency. Therefore, the resulting statutory solvency profits may not provide the best measure of a company's profitability.

Although suitable for solvency reporting and testing, the statutory approach – charging the cost of new business to revenue while ignoring the future profit stream attributable to that business – fails to display a meaningful account of the trading activity for a particular period.

The application of statutory solvency principles means that writing a new business policy typically results in a loss the first year, which should then be recouped by profits arising in later years. The total statutory solvency profit will therefore be the sum of profits from existing policies and initial losses from new policies written in the year. This may depress the solvency profits of a rapidly growing company writing significant new business volumes. Conversely, the profits from existing business may mask non-profitable new business.

This measure is being superseded by a new, more meaningful measure, known as **embedded value accounting**.

1.1 What is an Embedded Value?

An embedded value is an actuarially determined assessment of the value of a life company, excluding any future business that may be written.

1.2 How is it Calculated?

The first component is known as the net worth.

The second component involves complicated techniques applied to cash flows (discounted) and assumptions on surrenders, lapses, mortality, morbidity, expenses, investment returns and taxation. Values for each of these categories are typically derived from the company's own experience.

The value derived is then discounted to a single present value, commonly known as Value of In-Force (VIF). The value of the VIF will be impacted significantly by management costs, which include IT and Operational costs. Because any change in assumptions is capitalized, changes can have a significant effect on the VIF.

One of the areas requiring assumptions is maintenance expenses, a term used to include a number of “costs,” including IT and Operational costs. A reduction in maintenance costs will be realized when legacy platforms are de-commissioned and the overall cost per policy is reduced.

1.3 Sapiens Closed Books

Sapiens Closed Books, a purpose-built solution for the management of legacy business, is a strategic model that will deliver a significant reduction on IT and Operational costs through the decommissioning of multiple legacy platforms and the consolidation of portfolios to the single, Closed Books platform.

The consistency of operational processing realized through the single operating platform delivers significant operational savings, thus improving your company’s overall operational effectiveness.

These savings can release significant reserving required for profitability and solvency reporting purposes.

1.4 About the Author

Stuart Hayman is a successful executive with over 25 years of experience in Life and Pensions. His most recent roles have focused on sales and business development, new contract negotiation and solution design. Feel free to contact him at Stuart.Hayman@Sapiens.com.

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USA
395 West Passaic Street
Rochelle Park, NJ 07662
Tel: +1 201 820 3500

Canada
10 Kingsbridge Garden
Mississauga, ON, L5R 3K6
Tel: +1 905 507 9700

United Kingdom
Pierhead St., Cardiff Bay
Cardiff CF10 4DQ
Tel: +44 29 2044 8600/1

France
27, Avenue de l'Opera
75001, Paris
Tel: + 33 1 70 38 53 21

Israel
Azrieli Center
Holon, 588 5800
Tel: + 972 3 790 2000

USA
4000 CentreGreen Way,
Cary, NC 27513
Tel: +1 919 405 1500

Australia
111 Elizabeth Street
Sydney, NSW 2000
Tel: +61 2 8222 3100

United Kingdom
1 George Street,
Uxbridge, UB8 1QQ
Tel: +44 1895 464 000

Belgium
Brusselstraat 59, 2018
Antwerp, Belgium
Tel: +32 3 3040800

Japan
Queen’s tower C 11F
2-3-5 Minatomirai, Nishi-ku
Yokohama 220-6211
Tel: + 8145824777