Demutualisation – prizes and pitfalls

For members, the bonanza may be better than a bonus

Demutualisation, a trend notable recently in life insurance companies, enables members to realise the value of membership and others to acquire equity. WAYNE LONERGAN reports that, given the large size of some of the mutuals, the demutualisation process will have a significant financial impact on investors who make the right decisions. However, accounting issues are critical.

Mutual organisations have existed since the eighteenth century, formed usually to bring together groups with a common interest, such as providing life insurance coverage for members. The organisations are generally companies limited by guarantee. Unlike a traditional limited liability company, a company limited by guarantee does not have share capital and members are liable only for the nominal amount that they have guaranteed under the memorandum of association. Since they are not required to contribute capital, members cannot trade their interests in a mutual.

The entitlements of members are categorised into the rights they receive as members and the rights they receive as policyholders (while members and policyholders are not always identical groups, this paper refers to “members” for the sake of simplicity). The rights of members vary among mutuals and are set out in the articles of association. Members generally have the rights to attend, speak and vote at general meetings, and to receive a share of surplus assets in the event of a winding-up of the mutual. These rights are generally more apparent than real, as most members consider themselves as customers rather than owners and relatively few members actually attend or vote at meetings. Further, the likelihood of a mutual life company being voluntarily wound up is remote.

The articles of association of a mutual generally provide no facility for its directors to distribute profits or other surpluses to its members other than by way of bonuses, premium reductions or reduced charges. Surpluses retained to increase a mutual’s financial strength and to benefit present and future generations of policyholders may represent substantial asset accumulations.

However, mutual structures are increasingly seen as inappropriate for large financial institutions. The trend towards their demutualisation can be explained by their commercial disadvantages, including:

▼ the inability to raise equity capital;
▼ inflexible “capital” structure;
▼ the perception that member supervision and oversight of directors and management is less rigorous than in a conventional public company;
▼ the inability of members to access their financial interests in the mutual.

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organisation, other than (and generally to a relatively limited extent) as policyholders; and a lack of focus on profitability.

These constraints can be a significant hindrance to business development. For example, many mutual life companies require new capital to enable them to maintain or increase their financial strength (eg, for rating purposes), to finance growth (generally referred to as new business strain) and, in some cases, to fund operating losses expected while the agency, distribution and overhead structure is made more efficient in the face of competitive pressures.

Conversion from a mutual organisation to a more common form of corporate ownership can only be effected if members believe the proposal is in their best interests and vote in favour of the change. Demutualisation requires individuals to surrender their rights as members of the mutual (but not as policyholders) in exchange for ordinary shares, usually in a newly formed company which acquires the whole of the assets.

The process involves the recognition of the intrinsic worth of the life company — this worth, often referred to as the appraisal value, is the value that the company, or its holding company, seeks to provide to its eligible members by way of the share issue. Demutualisation is generally implemented through a scheme of arrangement, although it may be possible to demutualise by other means, such as by changing the articles.

Life company structure
Under a mutual structure, members have an interest in the assets of the mutual as policyholders. Mutual life companies consist of a number of statutory funds and a general fund. The Life Act requires that statutory funds be used for the receipt of all premiums and the holding of investments for the benefit of policyholders. Any surplus existing in the statutory funds or general fund belongs to the mutual, which owns all the assets in those funds. Although the relevant policyholders have reasonable expectations that they will receive bonuses in future years, these expectations do not necessarily increase because of the presence of a surplus in the statutory funds. The surplus does, however, provide greater security that reasonable policyholder benefit expectations will be met.

Broadly, there are two types of policies: participating ("with profit") policies; and non-participating (non-profit) policies. Participating policyholders share, at the discretion of the directors, generally by way of bonuses, in the profits generated in excess of the amounts set out in their policies. Non-participating policyholders do not receive any of the profits above their contractual entitlements. Non-participating businesses consist mainly of term insurance, disability insurance, annuities being paid over time and investment-linked business.

For non-participating businesses, the statutory funds have to maintain assets sufficient to meet policyholder liabilities and capital adequacy and solvency margins as required by the Life Act. For participating businesses, the statutory funds have to maintain those assets and a further amount to yield profits sufficient to meet supportable future bonuses (or other policyholder benefits). Any surplus over these amounts for participating policies may either be retained or distributed. If distributed, it must be shared between policyholders (at least 80%) and shareholders (at most 20%).

It is important to note that in a demutualisation the question of allocating the surplus of a mutual does not arise. What happens is that the nature of the company is changed and policyholders/members receive shares in exchange for their rights as members, without the underlying assets ever leaving the group.

The capitalisation of surplus as equity has little practical impact on members as policyholders. At first this might sound counter-intuitive, since every dollar allocated to equity must result in a reduction of the amount out of which bonuses might theoretically be paid to policyholders. However, general industry practice has been to declare bonuses which are broadly comparable to those of competitors, rather than directly related to profits earned. Where demutualisation is proposed:

- policyholders' reasonable expectations of receiving bonuses in the future remain unchanged;
- there is little, if any, practical likelihood of the present policyholders receiving the benefit of any surplus (other than reasonable bonus expectations) as the surplus is generally retained in the mutual; and
- the present generation of policyholders do participate in some of the surpluses built up over time in the mutual by the process of capitalising that surplus through the issue of shares.

Bonuses
The amount declared as bonuses each year is determined at the discretion of the appointed actuary and the directors. Effectively, it is a form of profit-share for participating policyholders. Once declared, a bonus (or to be more technical, the present value of the bonus) becomes a liability of the fund.

Historically, policyholder "reasonable expectations" were based on the pattern of past bonus declarations. In today's...
more competitive environment, bonus declarations are more performance-oriented or competitor-driven, although bonus declarations still tend to be a smoothed reflection of longer-term earning rates.

In determining the bonus declaration directors have generally been constrained by:

- the requirements of the Life Act;
- the recommendations of the appointed actuary;
- the legitimate reasonable expectations of policyholders; and
- the need or desire to maintain and increase the surplus for the benefit of current and future policyholders.

The last-mentioned influence has, in many cases, led to temporal inequity - the transfer of benefits created from investments financed by one generation of policyholders to other generations of policyholders. Some of this temporal inequity is an inevitable result of the long-term nature of many life insurance products. Temporal inequity has manifested itself in a number of ways including:

- the creation of large surpluses in some mutuals;
- the use of previously created surpluses to subsidise losses incurred on new products, eg, some capital-guaranteed products; and
- examples of spectacularly successful and spectacularly unsuccessful investment strategies which have added to or dissipated accumulated surpluses.

One advantage of demutualisation should be a reduced impact of temporal inequity on policyholders who also become shareholders. Further, the application of margin-on-services reporting will result in the separate identification of policyholder and shareholder interests.

**Statutory funds**

The assets of the statutory funds are held on behalf of policyholders but registered in the name of the company. They are governed by the statutory protections of the Life Act, the fundamental aim of which is to protect the rights of policyholders over the (often long) life of the policies. Effectively, policyholders have preferential rights as creditors and the aim of the Life Act is to protect these rights.

Some commentators have found it convenient to liken statutory funds to trust funds but this is not technically correct. Policyholders do not own the assets in the fund, either directly or by way of trust. However, they do have pre-emptive rights under the Life Act.

The assets of the funds are the assets of the life company and for financial and reporting purposes, should be shown as such. Under the proposed accounting standard ED 73 Financial Reporting of Life Insurance Business, the assets are considered to be "controlled" by the life company and are therefore effectively assets of the company in the same way that assets are consolidated in the accounts of other companies. Another rationale for this treatment is that the value of the assets controlled by the life company have "leverage" implications for the company's future financial performance. As a natural corollary of the treatment of assets, policyholder entitlements should be shown as liabilities.

**Criteria for assessing best interest**

In assessing whether or not demutualisation is in the best interest of members it is necessary to consider whether it will enhance the overall financial interest of members, by class if appropriate. Relevant factors include:

- whether reasonable benefit expectations of members (ie, supportable bonuses), in their capacity as policyholders will continue to be met;
- the effect of demutualisation on the security of policyholder benefits;
- the existing and proposed rights and benefits of members;
- the means of achieving effective access to any surplus;
- the effect on the value of the shares that members will receive of the issue of any other securities;
- whether any practical alternative exists that offers members a preferred outcome, such as to continue as a mutual, implement a trade sale, liquidate, close the mutual to new business, or enhance member benefits;
- the likely market value of the shares offered in return for the exchange of members' rights;
- the prospect of receiving dividends and the impact of dividend policy on the expected share value;
- the current and future capital needs of the company; and
- improved corporate governance and profit performance as a result of greater performance orientation and closer scrutiny of performance by shareholders.

Given the inability of members in a mutual to receive the benefit of any surplus (other than the amounts allocated as bonuses), the generally favourable income tax concessions likely to arise on demutualisation, and the capital requirements of many industry participants, it will generally be the case that demutualisation is a significantly more attractive proposition for members than remaining as a mutual. In other circumstances, however, alternatives such as a trade sale may have more merit.

**ACCOUNTING AND REPORTING ISSUES**

A number of accounting and financial reporting issues need to be appreciated...
in considering the merits and risks of investment in the ordinary shares of life companies.

Life companies may issue a variety of policies, each with unique profit implications for the issuer. Further, the companies have different business mixes, varying from an emphasis on traditional whole-of-life type business to a dominance of non-participating investment-linked business or even pure risk business.

Many life policies are very long-term in nature. A traditional whole-of-life policy may remain in force for more than 50 years and be capable of generating profits for almost the whole of this period.

**Asset values**

In contrast to the practice of most listed (and unlisted) companies, all life insurance company accounts and reported results reflect the application of present value concepts to all material assets and liabilities. Sadly, conventional reporting by most other industries is a long way behind this conceptual position.

Consistent with the concept of present value, the investments of life insurance companies are stated at market value. While the concept of mark-to-market value accounting is widely accepted by corporate treasurers and for decision-making purposes by most financial institutions (although not for their published financial reports), a number of significant implications arise from its application in financial reports and the determination of reported profit.

Interestingly, a series of “checks and balances” exist in the traditional historical-cost-based financial reports used by most companies. For example, traditional accounting (in theory at least) constrains asset revaluations by disclosure requirements, the carrying value test in AASB 1010, and s.294(4) of the Corporations Law. However, no specific checks and balances have been developed for mark-to-market accounting.

All investors are aware of the controversy surrounding the accounting treatment of goodwill. Yet under mark-to-market accounting a life insurance company which owns another life insurance company (eg, AMP and Pearl, National Mutual and its Hong Kong subsidiary) recognises internally generated goodwill. Accounting standards prohibit the recognition of internally generated goodwill in non-life companies. Further, not only is internally generated goodwill recognised under mark-to-market accounting, but movements in the value of that goodwill are included in the annual profit result. (It is noteworthy that the proposed accounting standard ED 73 does not require the separate disclosure of such movements.)

To put this matter in financial perspective:

- National Mutual’s spectacularly successful investment in National Mutual Asia has generated since 1986 some $A2.5 billion in unrealised capital gains which (subject to the amounts allocated to policyholders) would be and should be included in profit under mark-to-market accounting.
- National Mutual’s reported consolidated restated forecast results for 1996 of $198 million include $43.8 million unrealised gain largely due to the increase in the value of its investment in National Mutual Asia (page 33 of share offer).
- AMP’s reported results for 1995 of $1.9 billion included $455 million increase in the value of its investment in controlled entities ($2,844 million compared to $2,389 million – page 57 of annual report).

(Note that both AMP’s and National Mutual’s profits are stated before declaration of policyholder bonuses.)

Most life offices in Australia have not shown in their published accounts the value of policyholder liabilities (rather, the focus was on solvency). They included in the balance sheet the funds available to meet the liabilities rather than the actual liability itself. There was a presumption, and indeed a requirement under the Life Act, that the fund had assets greater than the liabilities to policyholders. Generally, movements in that liability from year to year and the movements in the excess of the fund over the required liability were not disclosed. As a result, the annual results did not reflect the true performance of the life company or the fund. Thus a major element of the build-up of surplus within life companies or the running down of that surplus was not apparent from the accounts.

It was often argued that this accounting treatment was in the best interests of policyholders, since full disclosure of surpluses would put undue pressure on the life company to make excessive distributions in boom times and cause undue concern about the financial position of the company or the fund in periods of poor investment performance. The accounting treatment was also in accordance with the then prevailing statutory requirements.

However, given the current expectations of users of general-purpose financial statements, and the push for “representation neutrality” – telling it like it is – it is necessary that profits and losses are reported as and when they occur and that results are comparable between companies. The fundamental problem with the past approach was that the performance of life offices was not disclosed to external users of the accounts or, in many cases, to management. Neither therefore had the information necessary to make decisions about
the allocation of resources. Consistent actuarial standards and consistent accounting standard requirements (although still in exposure-draft form) have been developed which will enable users to better evaluate performance of life entities.

**Valuation of policy liabilities**

The movement in policy liabilities from year to year is an important element of the calculation of a life company’s profitability. The liability is determined at least annually by the appointed actuary on a “best estimate” basis. That is, the value of the expected future payments to policyholders is calculated on the basis of the best estimate that can be made at reporting date of future income (eg, premium receipts) and future outgoings (claims, bonuses, declarations, etc).

The valuation principles also provide for the systematic release of profits over time, again on a best-estimate basis. The objective is to release profits as they are earned from the provision of services and/or receipt of income under the policies (these are referred to as “profit carriers”).

The policy liability in the accounts of life companies now therefore reflects the sum of the best-estimate liability and the present value of the profits expected to be released. The profit margin for participating business includes provision for future bonuses (the policyholders’ share of future profits) and the expected shareholder profit margins. In the case of non-participating business, the shareholders are entitled to any expected profits (or losses) that are earned.

For simpler products (eg, investment-linked products) the accumulation approach may be used to determine policy liabilities and profits. For more complex products, the prospective approach should be used.

**Margin on services**

Most life companies now use the margin-on-services (MOS) prospective approach for calculating liabilities under the policies they have written. MOS is based on a mathematical projection of future cashflows using realistic best-estimate assumptions about investment earnings, mortality, morbidity, surrender rates, tax, expenses, inflation and other relevant criteria. Because it uses a best-estimate approach, MOS avoids the excessive conservatism built into older-style actuarial valuations.

A problem in a very long-term business such as life insurance is that while, when the policy is written, the present value of premium income (including investment earnings) should exceed the present value of claims and expenses, the actual outcome will not be known until the contract has expired, matured, been surrendered or been the subject of a claim. Under MOS the present value of the expected future cashflows is not recognised as profit when the policy is issued (ie, sold to the customer). Rather, it emerges over time as premiums are received and services are provided to the policyholder.

The simplified example in Table 1 demonstrates the principle of MOS.

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<th>Table 1: Margin on services</th>
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<tr>
<td>Present value of expected premium</td>
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<td>Present value of expected payout</td>
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<tr>
<td>Present value of sales commission</td>
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<td>Present value of office expenses</td>
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<td>Present value of expected profit (ie, 10%)</td>
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Under MOS, rather than book the present value of the expected profit when the policy is issued, a special item is included in the calculation of policy liabilities equal to the present value of the profit margin contained in the premium. In this case, if premium income was the profit carrier and premium income in the first year was $1,000, then 10% of that premium ($100) would be earned. As each subsequent year’s premium is received the 10% profit margin in that premium would be recognised as profit.

MOS differs from the method adopted in the general insurance industry where the estimate of liabilities is based on market-determined risk-adjusted rates of return plus (usually) a prudential margin. Although MOS does not explicitly incorporate a prudential margin, an additional margin could be introduced by using a more conservative discount rate. Most actuaries would oppose this as being inconsistent with the philosophy of using the best estimate.

**Premiums**

Life offices currently disclose all premiums as revenues regardless of whether they are payments for insurance or other services, or deposits on unit-linked policies, or a mixture of these (by way of an extreme comparison, this can be likened to banks showing all customer deposits as revenues).

In the case of unit-linked policies, it appears unarguable that revenue should be split between fees and deposits, and this split can generally be determined fairly readily. In the case of bundled or more complex products, it is much more difficult to separate premiums into their components. Given the transitional provisions contained in the draft accounting standard ED 73, it will be several years before the revenue and income-related ratios of life companies are comparable with those of other financial institutions.

Interestingly, past practice in the life industry has been to show bonus distributions as part of profits on the basis that this reflects the mutual nature of the life company. In the view of the writer, this treatment would not be correct from the perspective of shareholders in demutualised companies; it naturally follows that if policyholder entitlements are liabilities, then bonuses should be shown as expenses. This is also the approach adopted in the proposed accounting standard ED 73. (Some industry participants differentiate between the treatment of discretionary and non-discretionary bonuses.)
Actuarial assumptions
A Life Insurance Actuarial Standards Board has been established to set standards for the life company reports which are required to be lodged with the regulators. This is a similar role to that performed by the AASB for accounting standards.

Clearly the actuarial assumptions chosen can have a material effect on reported results and financial positions. ED 73 requires that key actuarial assumptions be disclosed; however, the financial implications of applying different actuarial assumptions are too complicated for many investors to grasp, rendering analysis of the investment merits of different life companies more difficult.

Further, the actuarial assumptions may need to be changed in the light of experience. The treatment of changes in assumptions is complex, particularly because of the long-term nature of life insurance business and the interdependence of some assumptions (eg, inflation and earning rates). Where actual experience differs from assumptions based on past and current performance, the effect should be recognised in the year it occurs. For most classes of business, changed assumptions concerning long-term future investment earnings should also be recognised immediately. Where assumptions other than those about investment earnings are changed, this will generally be recognised over the remaining life of the policy. In each case, the impact of changed assumptions should be fully disclosed.

Deferred acquisition costs
MOS treats deferred acquisition costs as a deduction from policy liabilities; that is, as a “negative liability” rather than as an asset. Given that in most industries acquisition costs are written off as they are incurred, the capitalisation of such costs can only be justified on the basis that the policies are long-term and will, in fact, be profitable.

The carrying forward of pure direct cost of policy acquisition (eg, direct commission, medical examination costs, etc) is relatively straightforward.

However, if deferred costs are defined to include general costs, perhaps even including an allocation of overheads, then the determination of costs becomes more subjective, and could vary significantly from year to year depending on the volume of business written.

MOS deals with this issue (at least in part) by prescribing the lower of the product-pricing assumptions or actual costs and permitting deferral only where those costs are expected to be recovered over the life of the policy. However, the recoverable-amount test implicit in this approach acts as a real constraint only when the policy is expected to generate a net loss. As a matter of technical detail, it is conceptually inconsistent to carry forward acquisition costs in a mark-to-market accounting model. The conceptually consistent approach would be to value the asset at its fair market value.

Acquisition accounting
A technical issue that arises in demutualisation is whether it provokes acquisition accounting as contemplated by AASB 1015 Accounting for the Acquisition of Assets. This issue arises in the context of needing to form a view about whether the value ascribed by directors to the shares in a new holding company is fair and reasonable, the recognition and amortisation of any goodwill arising, the fair value of assets acquired and the treatment of pre-acquisition profits and reserves and any impact these may have on the ability to pay dividends in future years.

Under AASB 1015 and ASC Practice Note 54, the issuance of shares in return for the members’ rights in relation to the mutual and control over the assets of the mutual represents an acquisition. Accordingly, the shares should be valued at fair value and, on consolidation, should be compared with the fair value of the identifiable net assets acquired. Any difference between these would represent goodwill or a discount on acquisition. A further consequence of this accounting requirement is that when the ultimate holding company receives dividends from pre-acquisition reserves, those dividends need to be deducted from the carrying amount of the investments and not taken to income; that is, they are not available for distribution to shareholders.

The substance of demutualisation is that the same ownership exists before and after, and there is no leakage of value from members to others. However, acquisition accounting takes the perspective of the reporting entity, rather than its members, and simply asks whether the entity has given up valuable consideration in return for the acquisition of assets. In the case of demutualisation, the ultimate holding company obtains control over the assets of the group in exchange for shares issued to the members. From the shareholders’ perspective, one asset has been exchanged for another of equal value. However, the question of comparative value is suspect when, as is generally the case, what is being given up is members’ rights that could never have been traded and would generally never be able to be accessed.

This difference of outlook has long been a matter of contention in relation to the accounting standard on acquisitions. In the original version of the standard, AAS 21 (in 1985), “intra-group company reconstructions, in which a
new holding company completely replaces an existing holding company were excluded from the standard. This exclusion was contentious at the time and subsequently was rejected by the then ASRB when it created AASB 1015 as an approved standard under the Corporations Law.

The ASC became concerned about inconsistencies in practice and in September 1994 issued Practice Note 54 which states (paragraph 5) that "because there is no similar exemption in AASB 1015 from the coverage of the Standard, AASB 1015 applies if assets are acquired in a restructuring or reconstruction".

Therefore, the accounting treatment for a demutualisation should be no different from any other acquisition (with all this implies in terms of freezing pre-acquisition reserves and the amortisation of any goodwill).

The impact of acquisition accounting on demutualisation produces some unusual results. In particular, it is necessary to appreciate the implications of whether the holding company is a life company or a non-life company. AASB 1015 requires that the holding company book the net assets acquired at fair value. If fair value is equal to appraisal value, then AASB 1013, AASB 1015 and the proposed accounting standard on life insurance cause the following accounting results:

- All pre-acquisition reserves are frozen and are no longer available for distribution to shareholders (other than in a winding up).
- Dividends received out of pre-acquisition reserves have to be applied to reduce the value of the holding company's investment in subsidiaries.
- On consolidation, the excess of appraisal value (which includes the present value of the shareholders' interest in profits from existing and future business) over embedded value (which includes the present value of the shareholders' interest in profits from existing business) will appear as goodwill on acquisition.
- The extent to which subsequent movements in the value of what in substance is internally generated goodwill will depend on the ownership structure of the group. This is because the proposed life accounting standard does not specifically override the goodwill standard's prohibition on recognising internally generated goodwill.
- In a life company the excess of embedded value over net assets acquired is an identifiable intangible asset (and clearly a "wasting asset"), the value of which (if recognised) should be amortised against profits over the life of the acquired policies.
- In any event, as the commercial reality is that losses arising on future business will generally be financed out of the excess of embedded value over net assets acquired, the logical way to treat badwill arising is to write it off against this excess. This treatment would also be logically consistent with compliance with the impairment tests of AASB 1010 and s.294(4) of the present Corporations Law.

Post-demutualisation surplus
A clarification in the final accounting standard on life insurance accounting of the appropriate initial and annual treatment of the excess of appraisal value over embedded value, and embedded value over net assets, will be welcome. However, even if this occurs, then in the years following demutualisation the amount actually available for cash distributions to shareholders will be the amount of the surplus less:
- Retentions required to support reasonable future bonus expectations of policyholders;
- Amounts necessary to meet Life Act capital adequacy and solvency requirements;
- Amounts retained to enhance financial strength;
- The minimum 80% of the profit on participating business which, if it is to be distributed, must be allocated to policyholders; and
- Profits arising out of the recognised increases in the goodwill component of appraisal value. (Under the Life Act, these amounts could be distributed, subject to capital adequacy and solvency provisions. However, conventional accounting does not
permit such goodwill increments to be recognised as profit, let alone distributed to equity holders.)

Although there is some overlap in these items, it remains clear that there are real constraints on the ability of life companies to distribute to shareholders, in the form of cash dividends, the profits they recognise.

These constraints will have the greatest impact on life companies with a strategy of increasing their participating policy business. Conversely, companies whose participating policy business declines should generate significant free cash as less is required for future bonus expectations. The extent to which this cash can actually be distributed to shareholders will, however, be constrained by compliance with AASB 1015.

That is, cash released from pre-acquisition (pre-demutualisation) reserves is not available for distribution. This is because pre-acquisition reserves are effectively frozen and any cash generated is reflectively a repayment of capital (and deducted from the holding company’s cost of investment in subsidiaries). When the proposed changes to the Corporations Law arising out of the simplification programs are enacted, this constraint may no longer be relevant.

In assessing the real impact of these constraints on the value of life company shares (through their effect on dividend payout ratios) it needs to be borne in mind that:

- not all public companies have high dividend payout ratios; and
- as time passes significant profits will be released and be available for distribution (particularly in life companies with declining participating policy business) by the unwinding of the present value discount.

**VALUATION ISSUES**

The valuation of a life insurance company or its shares is a complex task requiring detailed actuarial information which is generally not publicly available. There is no easy short cut. The task is further complicated by the fact that a number of key accounting practices in the life insurance industry are significantly different from those in other industries.

The following broad guidelines may assist potential investors, although the investment merits of each company must be assessed on the facts of each case.

**Future cashflows**

Consistent with general valuation theory, the real value of a life insurance company is the present value of the future cashflows it is expected to generate. As noted, detailed future cashflow information may not be publicly available, and its disclosure is unlikely to be mandatory in the foreseeable future. This problem is not unique to the life industry; it occurs also in mining and extractive industries, although here the products sold (eg, gold, base metals, etc) are generally more homogenous than is the case in the life industry.

**Discount rate used**

Investors familiar with the capital asset pricing model (CAPM) should note that the discount rates applied by actuaries in recent life company valuations fall in the range of 12% to 14% (after tax). The good news is that, given the underlying "investment" nature of the industry and the long-term nature of many policies, an average successful life insurance business should generate returns at least equivalent to those implied by the CAPM for a diversified investor – that is, the bond rate currently around 8% plus beta of one times the lower end of the risk margin range (say 5% to 6%) equals 13% to 14% discount rate.

However, some of the unusual tax characteristics of life companies and the absence of reliable cashflow data mean that little comfort can be taken from the use of what appears to be a reasonable discount rate in isolation from detailed information about the nature, timing and real risk of the underlying cashflows.

**Net asset backing**

Net asset backing is of greater relevance in assessing value in the life industry because of the mark-to-market accounting of assets and liabilities in companies’ annual financial reports. However, since a significant part of these net assets are effectively "locked up" by the capital adequacy and solvency requirements of the Life Act, and significant redundancy, lease commitment and other costs and losses may be incurred in a run-down situation, the stated asset backing is unlikely to be readily accessible in practice.

Asset backing may therefore be of limited relevance to value other than as a broad predictive guide to future cashflows and profitability.

**Embedded value**

Embedded value is calculated actuarially and includes the following components:

- **Net worth**, representing the shareholders’ interest in the market value of the assets in excess of policyholder and other liabilities; and
- **Value of inforce business**, representing the discounted present value of the shareholders’ interest in the estimated future profits arising from existing business at the valuation date.

**Appraisal value**

Appraisal value represents the sum of the embedded value plus the value of new business not yet written. That is, it

**Appraisal value reflects the value of the life company including a normal premium for control (although a special purchaser could offer more) and is similar in concept to its full takeover value.**
includes the discounted value of the shareholders' interest in the estimated future profits from business written after the valuation date, with due allowance for new business losses.

For investors more familiar with valuation criteria applied in other industries, the concept of appraisal value may be likened to the valuation of the whole of a company, including the value of its goodwill. The concept of appraisal value therefore reflects the value of the life company including a normal premium for control (although a special purchaser could offer more) and is similar in concept to its full takeover value.

In some life companies appraisal value may be equal to, or even be less than, embedded value. This could reflect situations where new business is being written at a loss, perhaps because the cost of obtaining new business is so high that it is not adding to, or is even reducing, the value of the company as a whole. Although it might seem sensible in such situations to stop writing new business, the cost of dismantling large distribution and agency networks and associated overhead structures could be prohibitively high. The least costly way of minimising losses may be to rationalise the networks and increase their productivity.

**Multiple of MOS earnings**

The use of earnings multiples is widespread in investment analysis. Unfortunately, most Australian life companies have only reported MOS earnings for 1994 and subsequent years. Because the number of listed life companies in the Australian market is small and the effect of fluctuating equity market conditions on reported results is significant (although effectively partly smoothed by MOS), it may be some time before sufficient comparable companies are listed to readily enable the use of capitalised earnings methodology. Further, earnings multiple comparisons between life companies and other financial earnings are complicated by the unique features of MOS earnings calculations and fundamental differences in accounting such as present value, mark-to-market and accounting for goodwill.

Care must be taken in applying price-earnings multipliers to MOS earnings. Although MOS earnings are calculated in present value terms, the use of price-earnings ratios in other valuation situations is really a surrogate method for discounted present value analysis. Thus the application of a multiplier to MOS earnings is conceptually akin to (but not identical to) applying a multiplier to earnings which are already (in surrogate terms at least) a multiplier.

**Historical and projected capital needs**

Some guide to the prospects of life companies may be obtained by examining their historical and projected capital needs. However, account should be taken of whether:

- management and/or management philosophy has changed materially;
- significant capital injection may already have occurred; or
- cash required to finance new business strain and/or distribution network rationalisation costs may be needed for longer periods or in greater amounts than presently projected.

**CONCLUSION**

Demutualisation presents investors with an opportunity to acquire a direct equity in some of Australia’s largest institutions.

However, the life industry, and life insurance accounting in particular, has a number of unique characteristics that have to be taken into account by investors. The life industry’s use of present-value concepts and mark-to-market accounting in its financial reports and profit determination is to be applauded. Other life industry accounting and reporting practices create difficulties in comparing life companies with other investments; in some cases (while understandable in the context of the industry), accounting practices common in the industry are arguably wrong (eg, definition of revenue, treatment of bonuses as profits).

Further, the involved mathematics of actuarial calculations, the difficulty in assessing the financial implications of differing actuarial assumptions, and the inconsistency of some of the concepts inherent in MOS (profit smoothing, profit anticipation and the treatment of deferred acquisition costs) with profit-recognition criteria applied in other industries, make investment analysis particularly difficult.

If the stockmarket value of successful life company shares is properly to reflect the underlying value of their businesses, and if life companies requiring capital from the equity markets do not want to overpay for that capital because of the market’s perception, or lack of understanding, of the true risks involved, then three basic conditions need to be met:

- life company financial reports must become more comparable with other investments (but they should not step back from present-value or mark-to-market accounting in doing so);
- high standards of disclosure should apply; and
- the KISS principle should be applied whenever possible.

Perhaps more than in most equity investments, the selection and backing of good management will be the key to investment success. Investors should take care in differentiating between sound investment opportunities in some of Australia’s leading institutions and the inevitable industry “black holes”.

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