OLIVER WYMAN

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Oliver Wyman report reveals how insurers can manage more effectively the trade-off between distributing cash and reinvesting to generate value

Across the insurance industry, senior management are finding themselves caught between the pressure to return cash more quickly to shareholders and the need to invest in value-creating activities that only pay back at some point in the future. A new report from Oliver Wyman describes how senior management can resolve this tension by taking a more systematic and fact-based approach to the necessary trade-offs, allowing them to communicate clearly to shareholders when cash will be returned and why.

The primary focus of shareholders has traditionally been creating long-term sustainable shareholder value. However, recently the calls from shareholders to refocus on cash generation have been loud. A recent Morgan Stanley investor survey[1] found that 80% of investors prefer insurers to use surplus cash to pay dividends or buy back shares rather than re-investing or retaining it. Insurers are clearly taking note. For example, Munich Re, Zurich Financial Services, AIG, Swiss Re and Old Mutual all announced share buybacks in 2007.

The perception problem

However, it is not necessarily in the best interests of the business or shareholders to boost dividend ratios or to buy back shares, as many parts of the industry have much room for profitable growth. It has become more vital than ever for insurers to make their case clearly to investors if they are to convince them that their interests will be best served by keeping cash in the business and growing long-term shareholder value.

But insurers need to do more than just talk a better game. The report also highlights a "lack of alignment among insurance executives", referring to the discrepancy between the perspectives and priorities of group-level senior executives, business unit leaders and the central finance function itself, all of whom operate with partial information about what the organisation can achieve. It is therefore often left to the CFO to provide the leadership and accurate financial analysis required to navigate this tension in a way that makes sense to all involved.

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[1] Morgan Stanley, *European Insurance, What the Market Thinks – An Investor Survey (Vol. 4)*, April 2008

Looking ahead – what insurers can do
Oliver Wyman presents a solution to this problem, which relies on insurers working systematically through three steps.

Step 1 – Determine where the cash is, and why it is there
An understanding and analysis of the sources and applications of cash, both now and in the future, should become part of the financial management information that the insurer generates. Oliver Wyman explains that its clients often begin by doing this as a “forensic exercise” before turning it into a standard business process. In terms of external disclosure of this information, the report notes that UK insurers Prudential and Friends Provident have both taken steps to enhance the disclosure of their cash position.

Step 2 – Understand how to unlock or accelerate the release of cash
Insurers should consider each pool of cash potential and identify the tools and actions which would need to be taken to unlock it. An obvious prioritisation tends to emerge, with some sources of cash being quickly and cheaply realisable, others being harder work or more expensive, and others being not worth the trouble or completely impossible to unlock. Oliver Wyman’s expertise on enhancing capital mobility can address these issues to a greater or lesser degree.

Step 3 – Make informed deployment versus payout decisions
Having got to this point, the CFO is able to add the possibility of accessing funds internally to his existing options such as new debt or equity issues. Where the analysis becomes particularly powerful is the ability to compare these sources of cash to the full range of uses of cash. These will include writing new business, warehousing insurance risk, taking on discretionary asset risk and, of course, returning the cash to shareholders. Each of these has both a cost and a benefit. This results in a particularly transparent and objective way of diverting resources to where they are most productive and of only retaining cash that can be more productively used inside the enterprise than by paying it out.

The Oliver Wyman report concludes that a balance must be struck between prompt return of cash and reinvesting for value. Increasing transparency is important but not enough on its own; insurers must also follow a more rigorous decision-making process, informed by the right tools and management information, in order to ensure that the right trade-offs are consistently made and that they can subsequently be more convincingly explained to shareholders.

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About Oliver Wyman
With more than 2,900 professionals in over 40 cities around the globe, Oliver Wyman is the leading management consulting firm that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development. The firm helps clients optimize their businesses, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities. Oliver Wyman is part of Marsh & McLennan Companies [NYSE: MMC]. For more information, visit www.oliverwyman.com.