

## Swiss Re's *sigma* study finds cost of capital is key to assessing an insurer's profitability and its ability to create economic value

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**Zurich, 31 August 2005 – The cost of capital plays a key role in defining the profitability of insurers, according to Swiss Re's latest *sigma* report. The study found that underwriting profitability is an important driver of investor confidence, together with profitable top line growth and scale of operations.**

When investors provide capital to companies, they expect a return on that investment. This is the cost of capital to a company of using investor capital. It is calculated by comparing the expected return on other investments with a similar risk profile.

Cost of capital is crucial in measuring the extent to which an insurer is creating economic value.

The new *sigma* study, "Insurers' cost of capital and economic value creation," assesses an insurer's cost of capital by separately examining its insurance and financial market risk exposure.

### **Revised estimates for US insurers' cost of capital**

In the 1980s, the US non-life industry cost of capital was in the range of 15%. Today, cost of capital estimates for the US non-life industry range between 7–8%. Significantly lower risk-free interest rates, equity risk premium and percentage of equity invested assets led to the decline.

These results were obtained by applying two cost of capital estimation methods, the Capital Asset Pricing Model (CAPM) and the Market Consistent Pricing Model (MCPM), for which comparative illustrations are presented in the report.

### **Insights on factors determining value creation in insurance**

The *sigma* study offers insights as to how the cost of capital relates to shareholder value in insurance companies in theory and practice. It analyses the historical statutory accounts and market capitalisation data of 27 US Property & Casualty insurance companies. Given the small sample size, the results should be taken as indicative only, but the main three outcomes are of interest:

- Companies with the highest economic price/book ratios achieved a combination of high underwriting profit margins, premium growth and scale of operations.

The results indicate investors will assign a higher value to companies that can simultaneously achieve profitability and growth, but are unwilling to pay for growth at the expense of profitability. Furthermore, empirical analysis suggests investors may favour investing in larger companies which may be better positioned to secure long-term profitability and achieve the economies of scale vital in the industry.

- Investment strategy differences were found to have a neutral effect on the price/book ratio. It is difficult for insurers to earn excess returns through investment strategies that simply involve taking on more market risk. There remain, however, strong liquidity and tax arguments for insurers to invest in corporate bonds and shares.
- Higher investment income produced solely by taking more financial market risk may help insurers meet ROE targets, but is unlikely to increase their price/book ratio.

Insurers' focus should remain on profitable underwriting and growth, as increasing investment risk cannot compensate for poor underwriting.

## Notes for editors

### Swiss Re

Swiss Re is one of the world's leading reinsurers and the world's largest life and health reinsurer. The company operates through more than 70 offices in over 30 countries. Swiss Re has been in the reinsurance business since its foundation in Zurich, Switzerland, in 1863. Swiss Re offers a wide variety of products to manage capital and risk. Traditional reinsurance products, including a broad range of property and casualty as well as life and health covers and related services, are complemented by insurance-based corporate finance solutions and supplementary services for comprehensive risk management. Swiss Re is rated "AA" by Standard & Poor's, "Aa2" by Moody's and "A+" by A.M. Best.

#### How to obtain a copy of this sigma study:

The English, German, French, Italian and Spanish versions of the sigma study "Insurers' cost of capital and economic value creation: principles and practical implications" are available electronically on Swiss Re's website:

[www.swissre.com/sigma](http://www.swissre.com/sigma)

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