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A Novel Approach to Valuing an Insurance Company's Economic Surplus

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A Novel Approach to Valuing an Insurance Company's Economic Surplus

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Abstract

The computation of the market value of economic surplus is a critical step in the valuation of a company; a line of business; or a product line for the purpose of merger/acquisition, financial reporting or internal management. The market value of economic surplus of an insurance company is generally defined as the market value of the assets supporting the liabilities less the market value of liabilities (MVL). MVL is typically computed directly, without regard to the underlying supporting assets, resulting in an unstable surplus. This paper provides a novel approach to the valuation of the market value of economic surplus (MVS). The resulting MVS is stable and reasonably immune to "market noise," and it can be used for better management of the business. A useful by-product of the proposed method is that MVL can be computed indirectly by subtracting MVS from the market value of assets. This indirect method avoids the many complications associated with direct computation, which typically involves discounting liability cash flows.