Session 2: Value Management under a Risk-Based Capital Regime

Moderator:

Mark W Griffin FSA,CERA

Presenters:

Thomas C Wilson

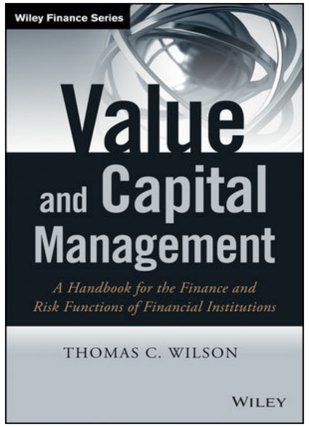
VALUE MANAGEMENT UNDER A RISK-BASED CAPITAL REGIME

Thomas C. Wilson
Chief Risk Officer, Allianz SE

SoA ERM Symposium
Florida, 19 April, 2018

TOM WILSON

2008 –	CRO, Allianz Group
2005 – 2008	CRO, ING Insurance
2002 – 2005	Global Head, Finance & Risk, Oliver Wyman
1998 – 2002	CFO, Swiss Re New Markets
1990 - 1998	Global Head, Risk Practice, McKinsey
1989	PhD Economics, Stanford
1984	BSc Business Administration, UC Berkeley



Value and Capital Management: A Handbook for the Finance and Risk Functions of Financial Institutions, 2015 Wiley Finance.

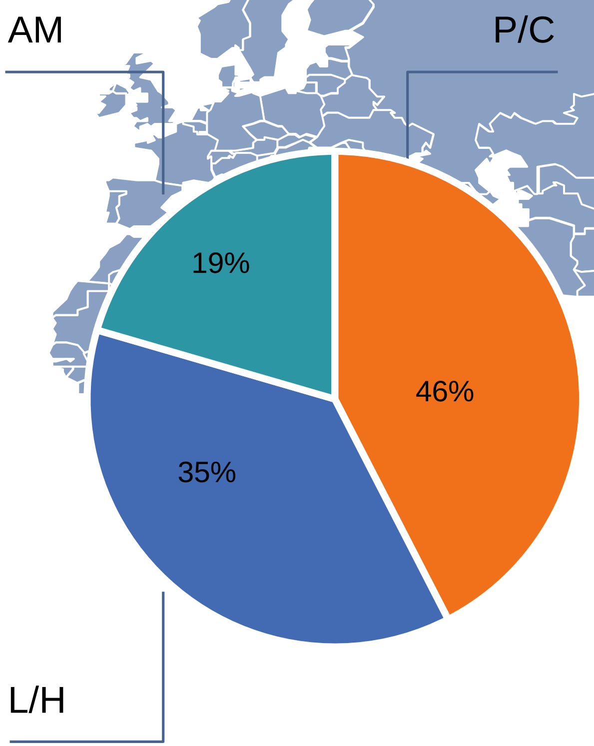
Also in Korean (2017), Chinese (2018, SUFE Press) and Japanese (forthcoming)

ALLIANZ

- One of world's **largest insurers** and **asset managers**
- **85+mn** insured customers
- EUR **125+bn** total revenues
- EUR **1,960bn** total AuM
- EUR **11.1bn** operating profit
- **229%** Solvency II capitalization
- EUR **83bn** market cap (Feb 2018)

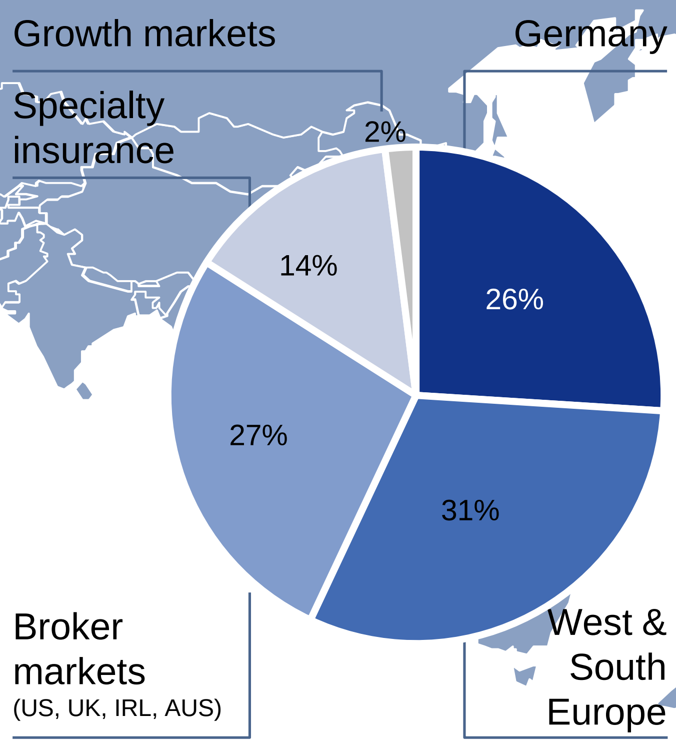
Segments

Operating profit in %
(excluding corporate segment)



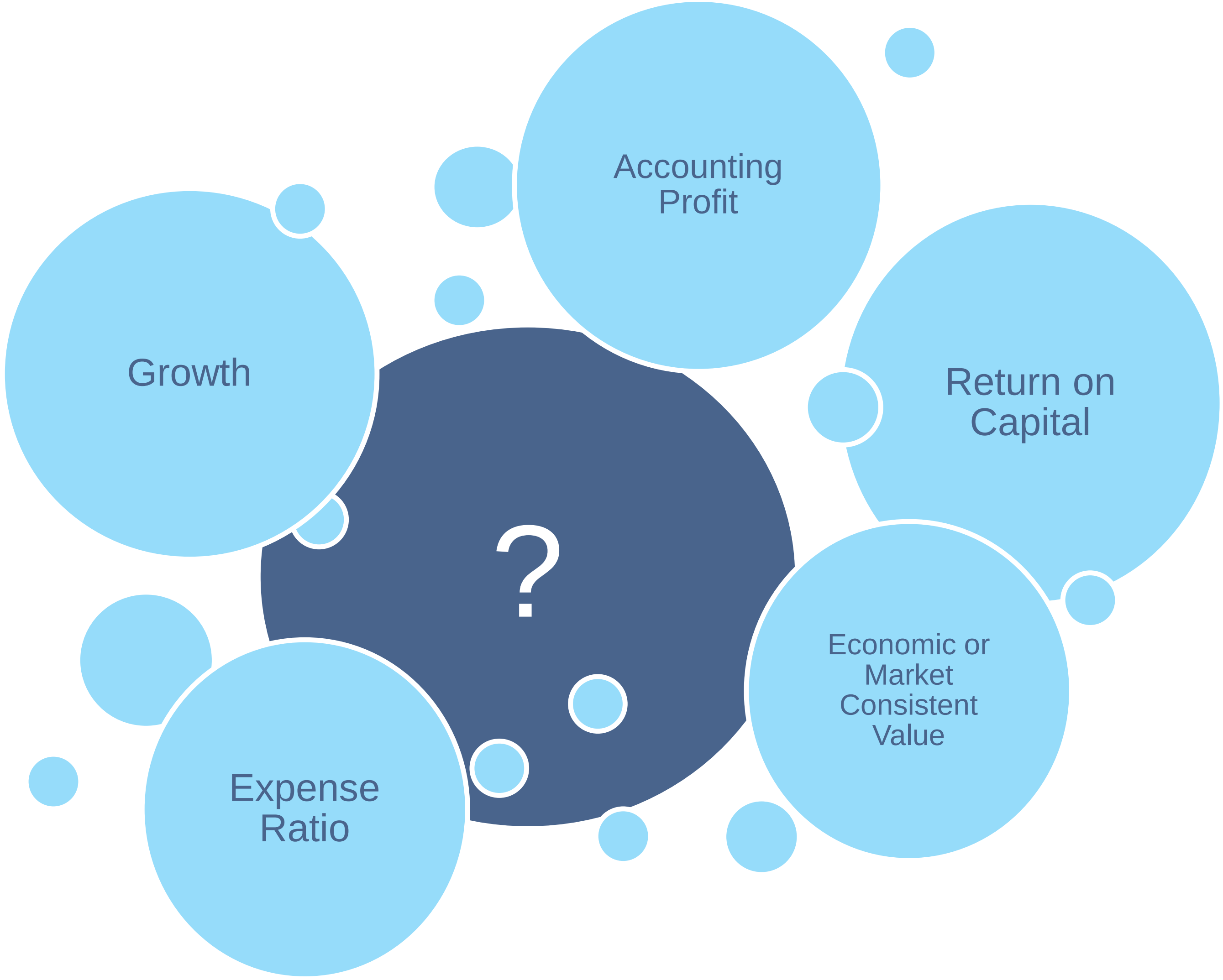
Regions

(2016) Operating profit in %

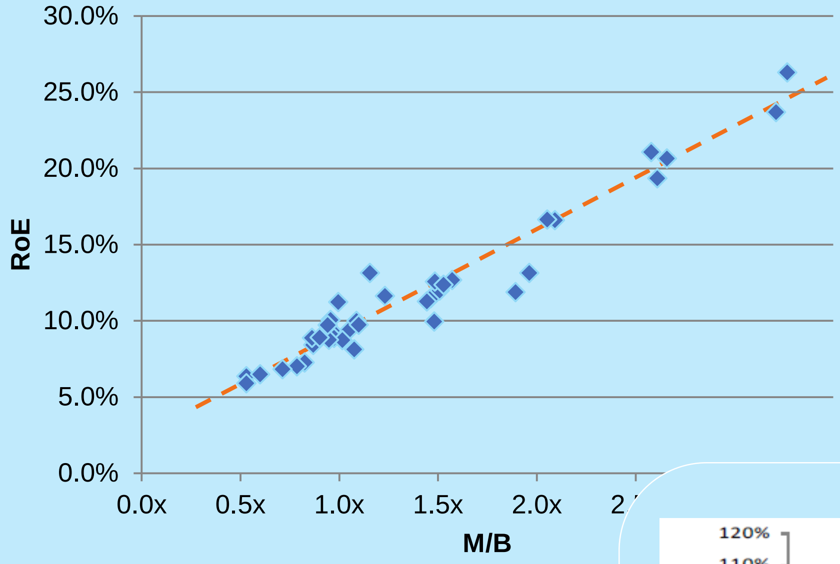


CONTENT

WHAT DRIVES SHAREHOLDER VALUE IN INSURANCE?

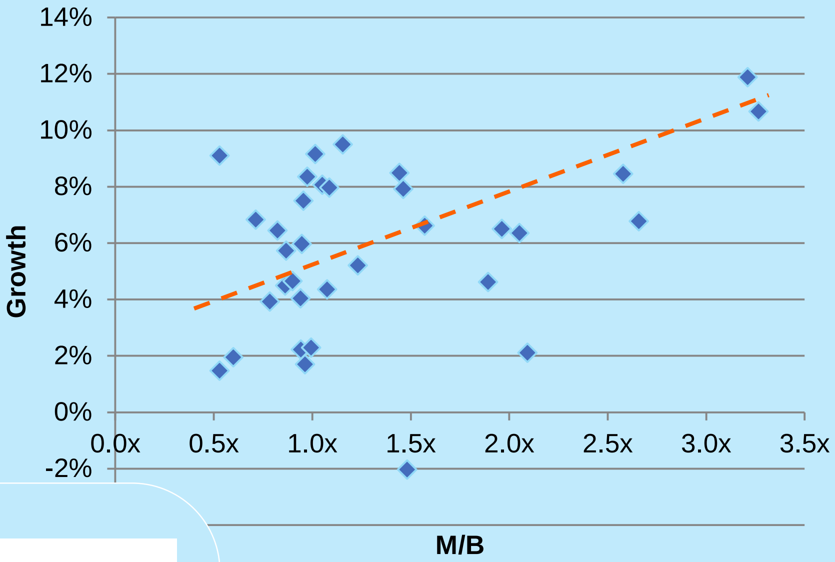


WHAT DRIVES SHARE VALUATIONS?



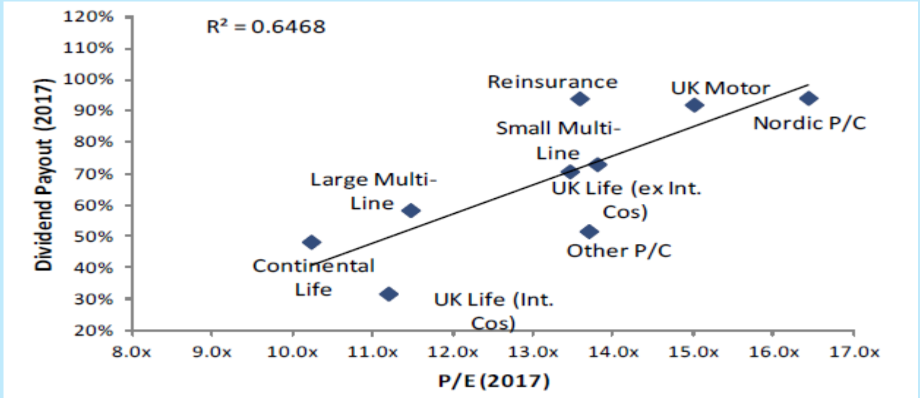
Operating profit, Capital i

Profitable Growth & Dividends



Growth

Aegon
Ageas
ASR
NN Group
AXA
SCOR
Allianz
Hannover Re
Munich Re
Generali
Mapfre
Poste Italiane
Gjensidige
Sampo
Storebrand
Swiss Life
Swiss Re
VIG
ZIG
Aviva
L&G
Phoenix
Prudential
Std Life Abdn
Direct Line
Hiscox
Lancashire
RSA
Saga



Dividends in lieu of growth

* BofA Merrill Lynch European Insurance Valuation Sheet, Feb 2018, Allianz analysis

RoE = Return on Equity, M/B = Market to Book valuation multiple, P/E = Price to earnings valuation muptiple

THE „THEORY“ AND THE PRACTICE

Excess Returns to Shareholders

$$\frac{M}{B} = \left(1 + \frac{RoE - CoC}{CoC - g}\right)$$

Present Value of a Perpetuity

RoE = Return on Equity
CoC = Cost of Capital
g = Growth

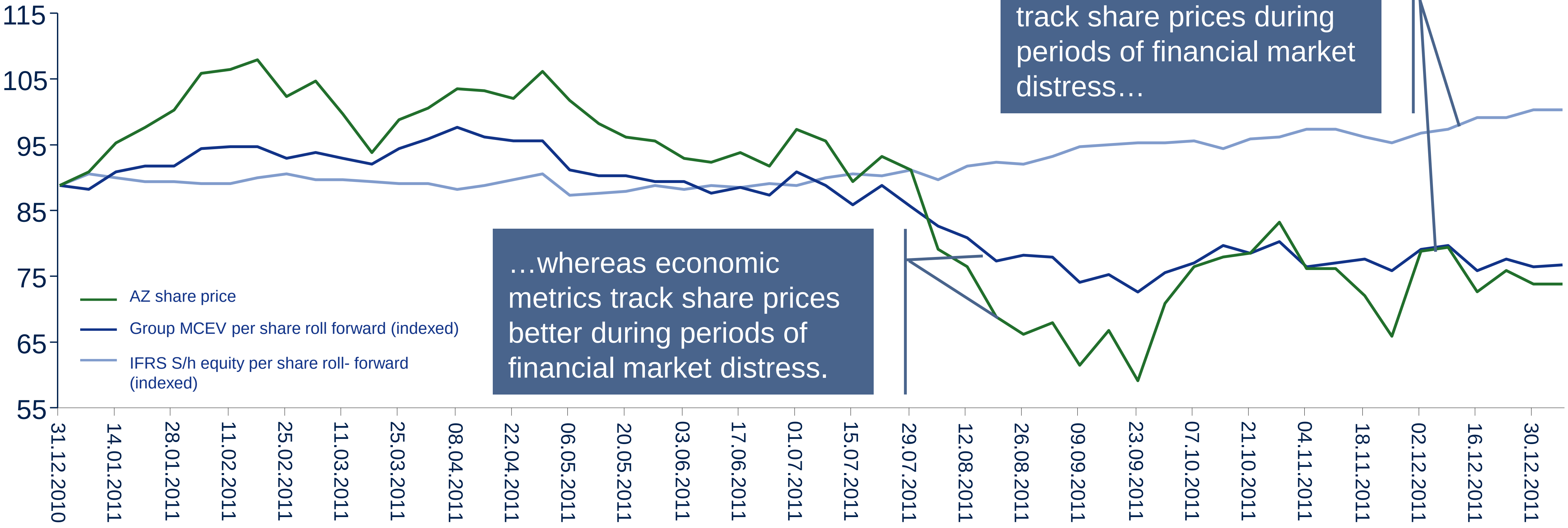
	Life	P&C
M/B 2008e	**1,08**	**1,46**
RoE 2019e	10,82	12,35
Normalized EPS growth 2019e	3,9%	4,9%
Implied M/B	**1,13**	**1,46**

Life		P&C	
Aegon	Swiss Life	Allianz	Swiss Re
Ageas	VIG	Hannover Re	Zurich
ASR	Aviva	Munich Re	Direct Line
NN Group	L&G	Mapfre	Hiscox
AXA	Phoenix	Gjensidige	Lancashire
Generali	Prudential	Sampo	RSA
Poste Italiane	Std Life Abdn	Storebrand	Saga

* BofA Merrill Lynch European Insurance Valuation Sheet, Feb 2018, Allianz analysis

VALUATIONS TRACK ECONOMICS DURING CRISIS

Allianz share price vs MCEV- and IFRS equity roll-forward*, 2011

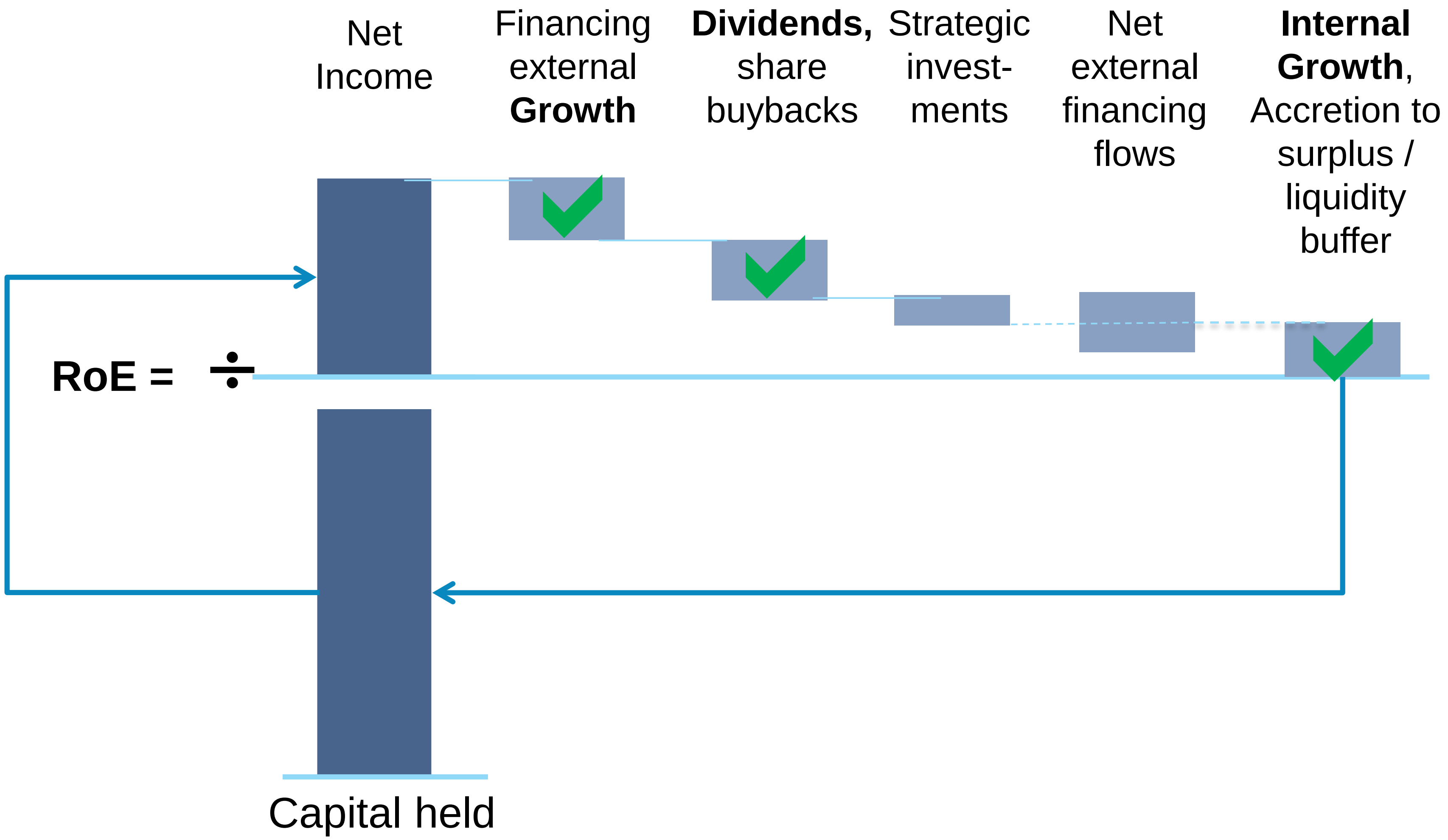


Accounting metrics do not track share prices during periods of financial market distress…

…whereas economic metrics track share prices better during periods of financial market distress.

* Roll-forward based on 2010 disclosed IFRS and MCEV sensitivities without quarterly rebalancing.

THE MECHANICS OF VALUE AND CAPITAL MGMT



Managing value requires a sustainable cycle of profitable growth and returns to shareholders, supported by capital management

SHAREHOLDERS AGREE…

"Earnings analysis is of limited use … We prefer composites that i) generate strong cash flow after 'maintenance capex' … , ii) have high growth capex that supports future earnings and iii) … surplus cash generation, driving financial flexibility and the ability to redeploy capital for growth."
Morgan Stanley 2012

"(Investors need to understand)… how the capital is spent …We are supportive of investment in new business … (if it generates) IRRs above the company's cost of capital and with reasonable payback periods . . . (but) business at or sub 9% IRRs which takes 9 years to break even ... is not a viable source of value for shareholders."
Barclays 2011

"(In lieu of profitable growth opportunities)…dividends have been the key attraction for investors in the European insurance sector. A focus on cash and dividends has driven the sector to an unprecedented fourth consecutive year of outperformance of the European equity market…
Regulatory capital is the fuel for dividends …(and) Given the importance of dividends we think it is crucial to understand how capital will be generated going forward."
Morgan Stanley 2016

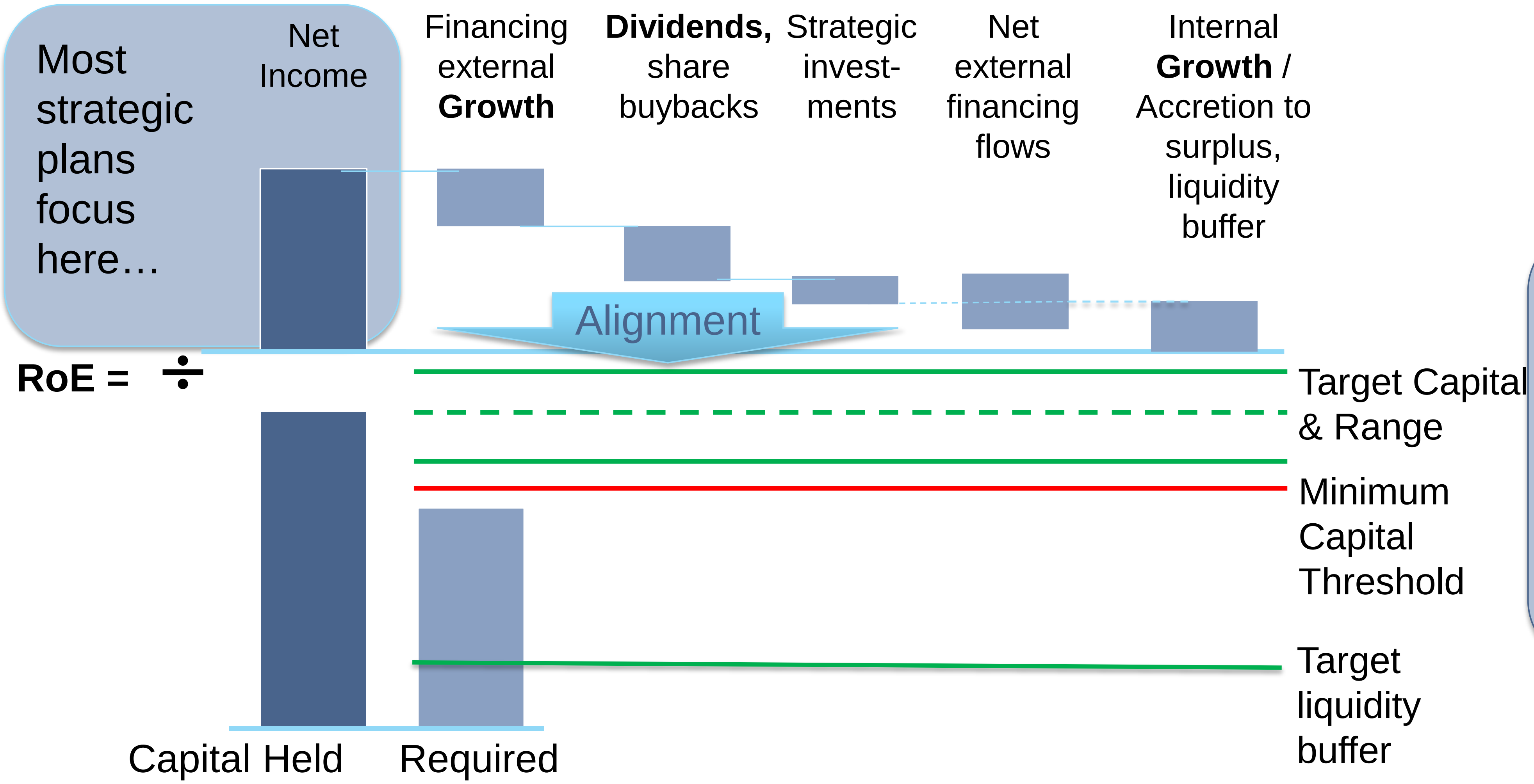
…capital management *is* value management!

CONTENT

HOW TO MANAGE CAPITAL AND VALUE?

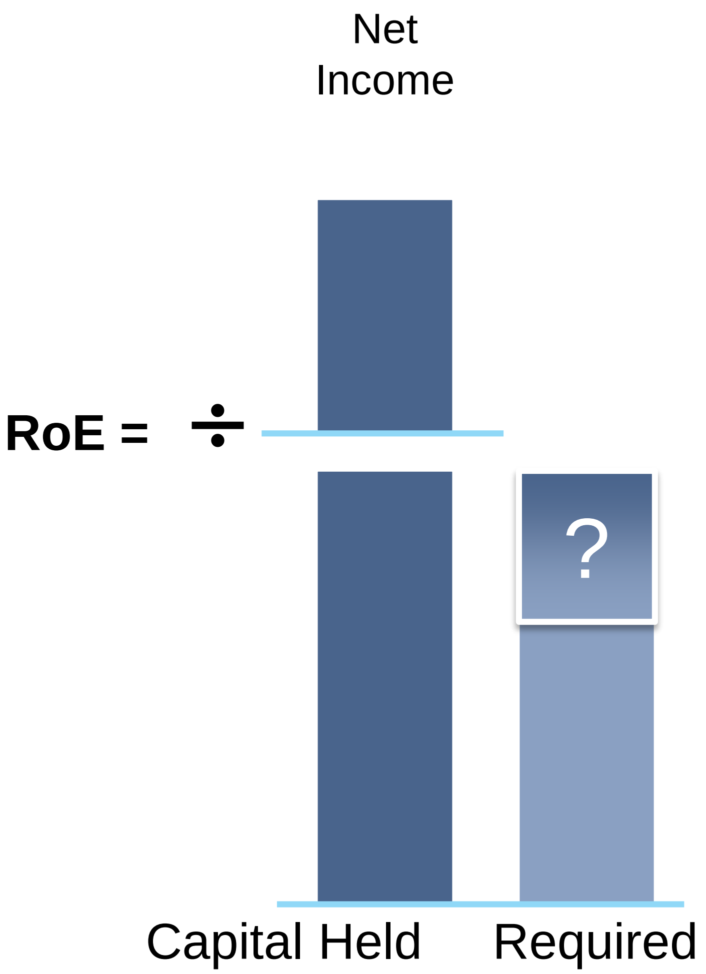
- Setting risk appetite – Capital, liquidity and risk
- Allocating capital – aligning risk and business strategy
- Managing capital – The role of ORSA

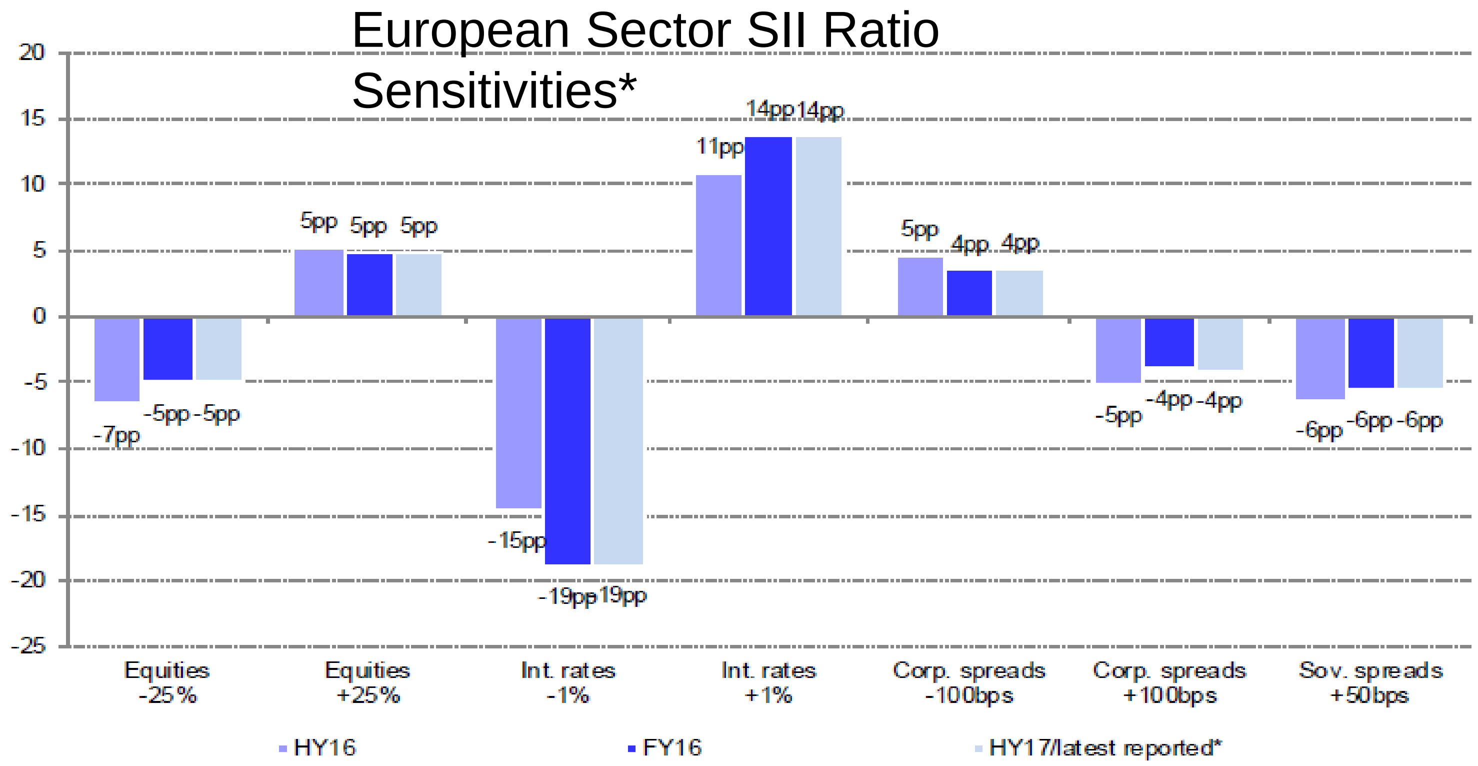
CAPITAL AND LIQUIDITY THRESHOLDS



… often missing is the Capital Budget, a multi-year view aligning business-, capital- and & risk-strategy

OPTIMAL CAPITAL BUFFER AND RISK-BASED REGIMES

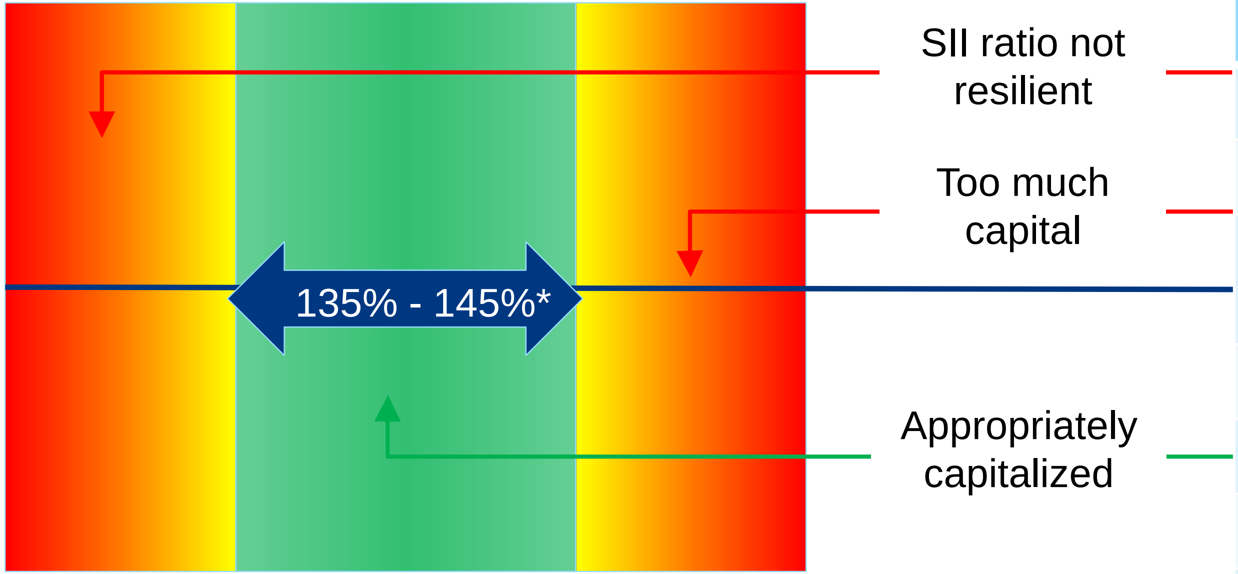




* Deutsche Bank, European Insurers – Solvency Matters, Feb 2017

ALLIANZ SOLVENCY MANAGEMENT RATIO

Minimum ratio after the worst stress



Base Case
Historic Stress Scenarios
S1: 2012 Sovereign Debt Crisis
S2: 2014-15 low rates and UFR at 3.2%
S3: 2008 Financial Crisis
S4: 1997-2000 Dot-com Bubble
Parametric Stress Scenario
S5 1:10 years modelled event

→ Target Solvency Ratio

Scenario-based process also for liquidity buffer (idiosyncratic, systemic scenarios)

* Up to 10%p for SII credit spread risk, deemed less relevant for liability driven investors

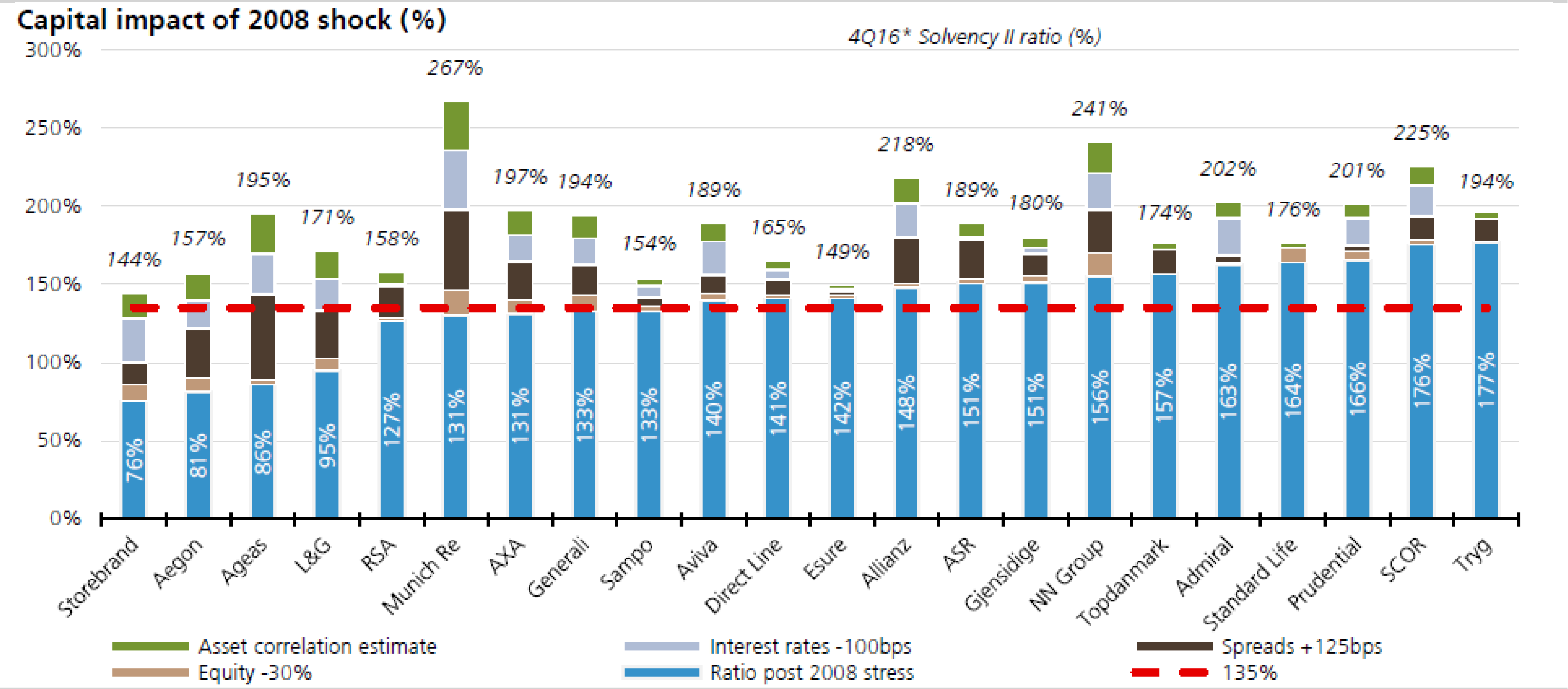
INDUSTRY ACCEPTANCE OF ALLIANZ APPROACH

Figure 5: Methodology

We highlight the following on our methodology:

- The basis of this methodology is centred on how Allianz calibrates its Solvency II target range. It calibrates its Solvency II target level as a Solvency II ratio that would enable it to absorb a 2008 shock, and remain above a 135%, a level where the company believes it would not need to raise capital. Allianz has disclosed an 80ppt hit from a 2008 scenario; a 'floor' of 135% therefore implies it targets a Solvency II ratio of 205%, in the middle of its 180-220% range;
- In calculating this 2008 scenario, we stress for movements observed in the 18 months from the date Lehman Brothers filed for bankruptcy (15 September 2008). This equates to 125bps widening in credit spreads, a 30% reduction in equity markets and a 100bps reduction in yields;
- Note that we have adjusted for positive spread sensitivities as we do not see these as a real world reflection of the risks. Please see adjacent footnotes;
- Backing out Allianz's disclosed 80ppt hit for a 2008 Solvency shock, implies an amplification of 1.3x to its disclosed sensitivities due to correlation between sensitivities. We apply this 1.3x factor to companies disclosed sensitivities (see Figure to the right). This is consistent with the average diversification credit (c30%) across the sector.

Figure 7: Illustrative capital positions after 2008 shock to 4Q16 capital positions

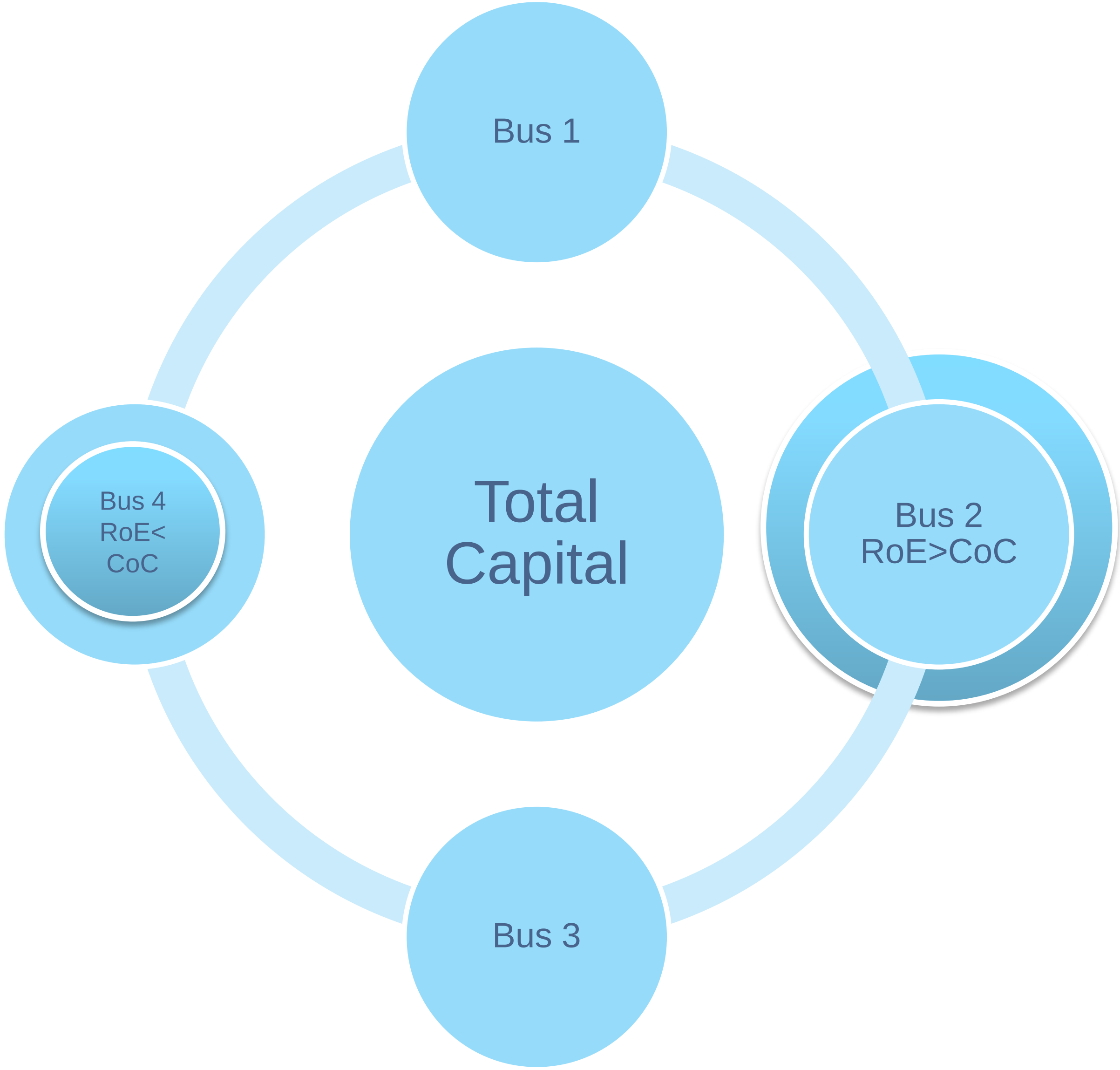


Source: UBS estimates. *4Q16 UK Life shown on a shareholder basis, except Standard Life.

ALLOCATING CAPITAL: SIMPLE RULES…

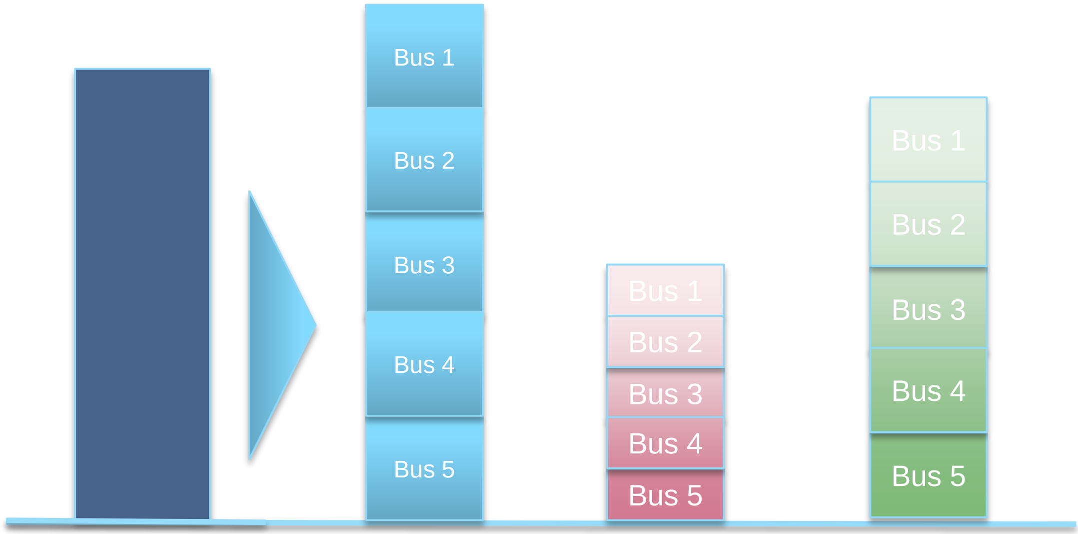
Simple Rules

- Don‘t invest if long-run returns below the cost of capital – fix or exit the business
- Invest as much as possible if long-run returns above the cost of capital, even raising capital if necessary - grow
- Maintain resilient capital sturcture, respecting regulatory constraints and risk appetite
- Return excess capital to shareholders



ALLOCATING CAPITAL: … COMPLEX PROBLEM

Complexity 1: Allocation to business



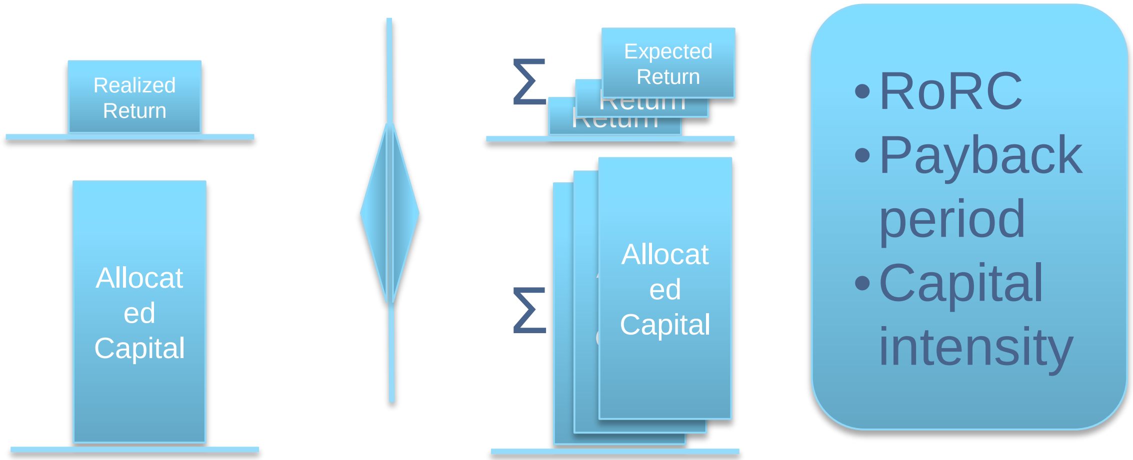
Group IFRS Equity – anchor point for communication?

IFRS
- Financial leverage
- Arbitrary, historical allocation

Required
- Less than actual
- No reflection of required buffer

Mgmt ratio
- Clear view on excess @ target return
- Reflects buffers required

Complexity 2: Backward, Forward View



Realized performance – reality vs promises

Present value expected performance – for steering change in business mix, strategies

MANAGING CAPITAL AND VALUE: ORSA

From

Risk & Capital Mgmt

ORSA Report

Section 1: Description of Enterprise Risk Management System

Section 2: Forward looking assessment of risk profile, capital and solvency position.

Approved by Board, submitted to Regulator

To

Risk & Capital Mgmt

Project solvency, analyze scenarios

Review against risk appetite

Use "toolkit" of contingent actions

Align risk, capital and business strategy

ORSA Report

AGENDA

01 **ROLE OF CAPITAL IN VALUE CREATION**
Insurance is a risk-based, long-term, capital intensive business. What role does capital play in value management?

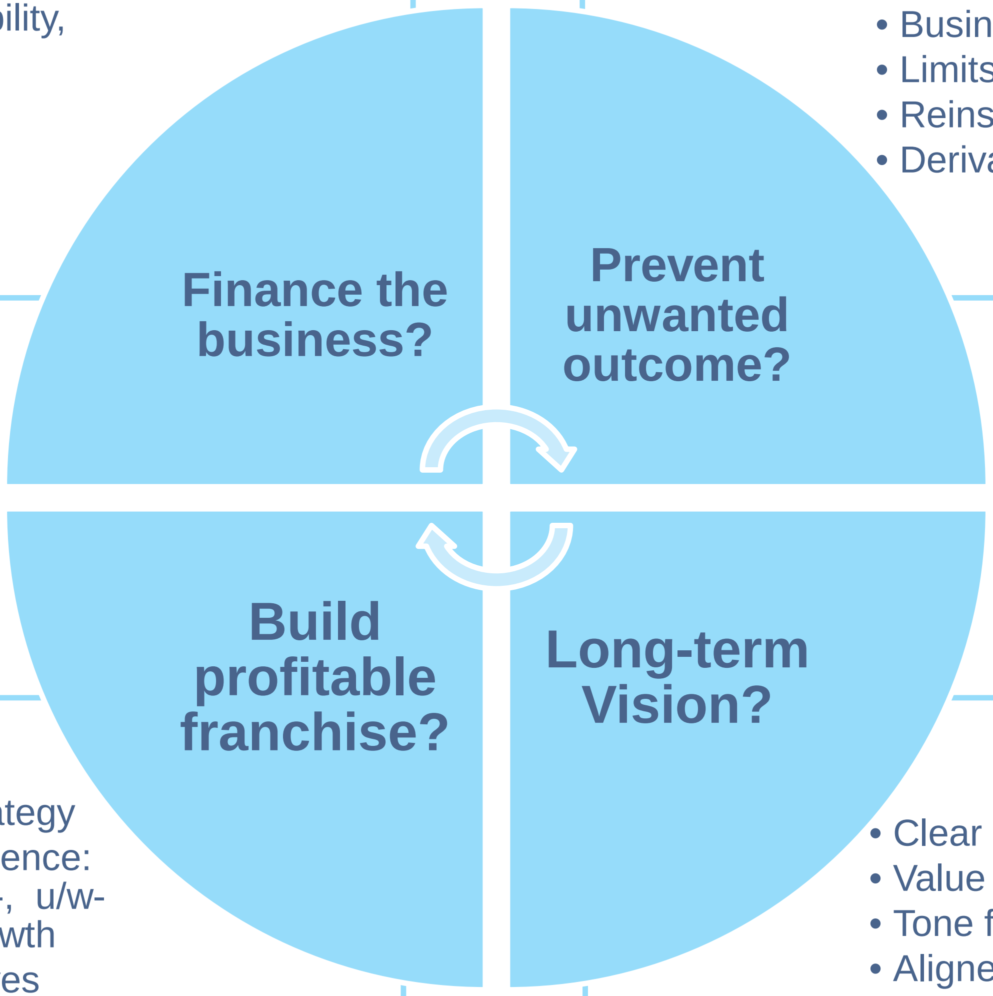
02 **MANAGING CAPITAL AND VALUE**
Managing value requires an alignment of risk appetite, capital and business planning combined with a dynamic ORSA process. What are some lessons learned under a risk-based regime?

03 **ROLE OF RISK AND ACTUARIAL**
Managing value and capital in insurance is complex with substantial implications for business strategies. How can risk and actuarial support the process?

MANAGING VALUE AND CAPITAL

- Optimize WACC, resilience / flexibility, fungibility
- Capital markets
- Reinsurance
- Business model

- Standards & policies
- Business model
- Limits
- Reinsurance
- Derivatives



- Operational strategy
- Technical excellence: customer value-, u/w-cost-mgmt, growth
- Aligned incentives

- Clear strategy
- Value management
- Tone from the top
- Aligned incentives
- External commitment

…IN A „TEAM SPORT“

Strategy Information Execution

CEO	Strategic vision, stakeholder promises	CRO	Aligning Risk and Business Strategy
Performance Steering, Capital Allocation	CFO	Innformation and independent advice	CA
CUO CIO Business Heads	Deliver sustainable economic outperformance	Treasury / Capital Mgmt	Financing & Liquidity

ROLE OF RISK AND ACTUARIAL

- Senior partner in the business – „tone at the top“
- Aligned objectives: Focus on long-term sustainable value creation
- Provide technical information, advice and an opinion
- Balance between IQ, EQ and leadership

Thank you very much for your attention!

Contact details:

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