# Value & Capital Management: A New Era

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# Agenda

1. **What defines the "New Era"?**
2. Implications for value & risk management?

# The old paradigm: Focus on earnings and growth, less on capital, none on internal metrics.

| **Which three measures are most used for strategic planning and decision making?** |
| --- |
| 1. Earnings and earnings growth |
| 2. Revenues and revenue growth |
| 3. Cost or cost/income ratios |
| 4. Return on book capital |
| 5. Return on economic capital or economic profit |
| 6. Market share |
| 7. Other |
| 8. Market or shareholder value, Embedded Value, Intrinsic Value |

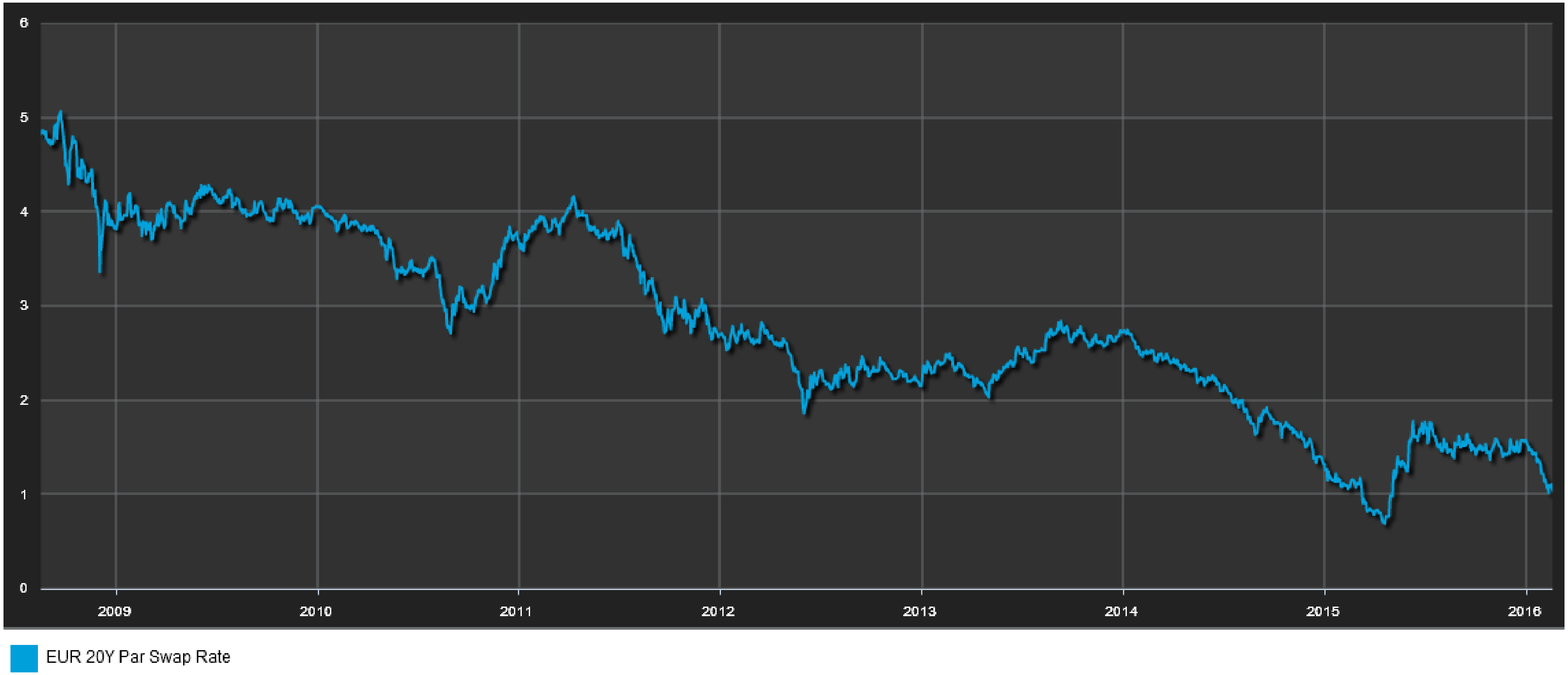
$$V = Ex\frac{P}{E} \quad \Leftrightarrow \quad \Delta V = \Delta Ex\frac{P}{E}$$

# Looking forward, challenges to earnings growth and capital…


## Economic Environment

- Anemic growth
- Low rates
- Asset volatility

# Low interest rates – the “new normal”



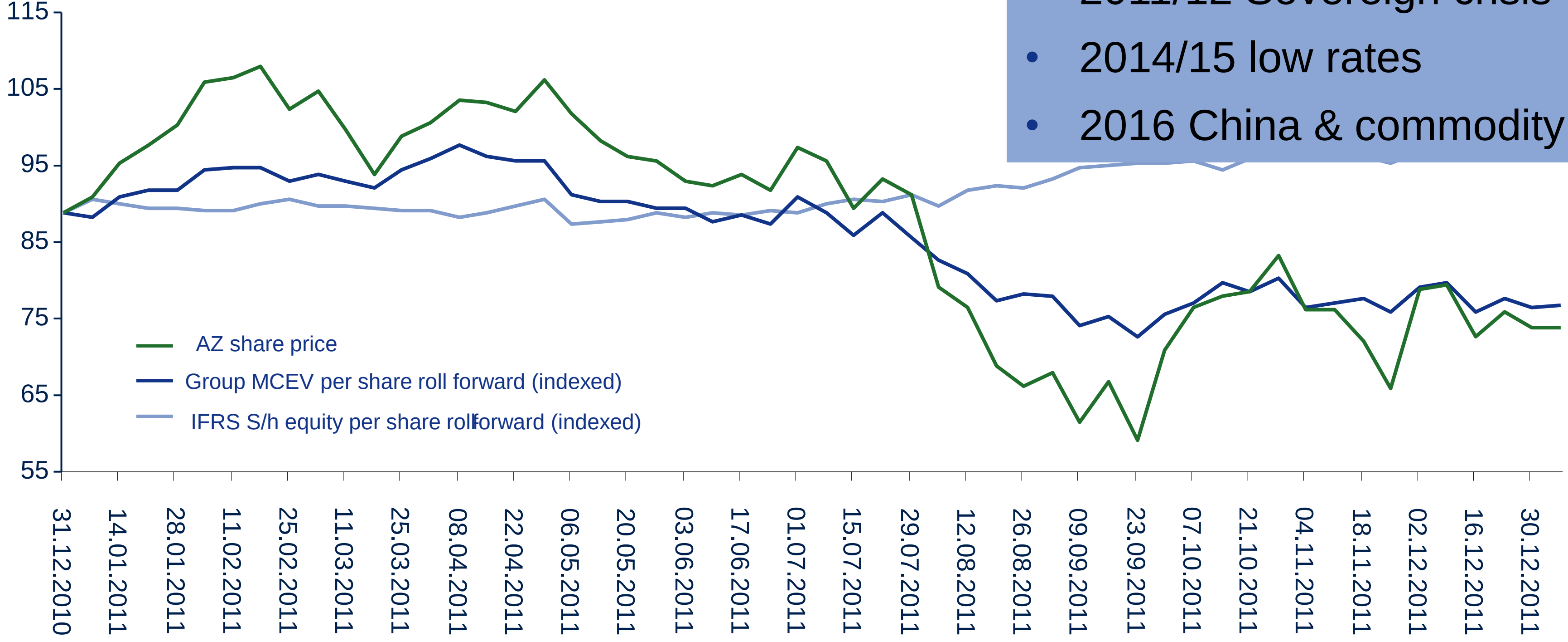

- Since 2008, lower interest rates due to global Quantitative Easing (QE), likely to continue as Draghi “pushes on string”
- Low rates adversely impact insurer earnings
  - Reinvestment rates below guarantees of traditional L/H legacy block
  - Lower investment yields impact PC operating profit

# What can happen in a volatile market environment?

Share price volatility from „black swans“

- 2008 Financial crisis
- 2011/12 Sovereign crisis
- 2014/15 low rates
- 2016 China & commodity

Allianz share price vs MCEV and IFRS roll-forward




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

# Looking forward, challenges to earnings growth and capital…



## Economic Environment

- Anemic growth
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## Regulatory Pressure

- Capital & leverage
- Consumer protection
- Change in business model

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## Economic Environment

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## Paradigm Shifts

- Technology
- New competitors
- Demographics

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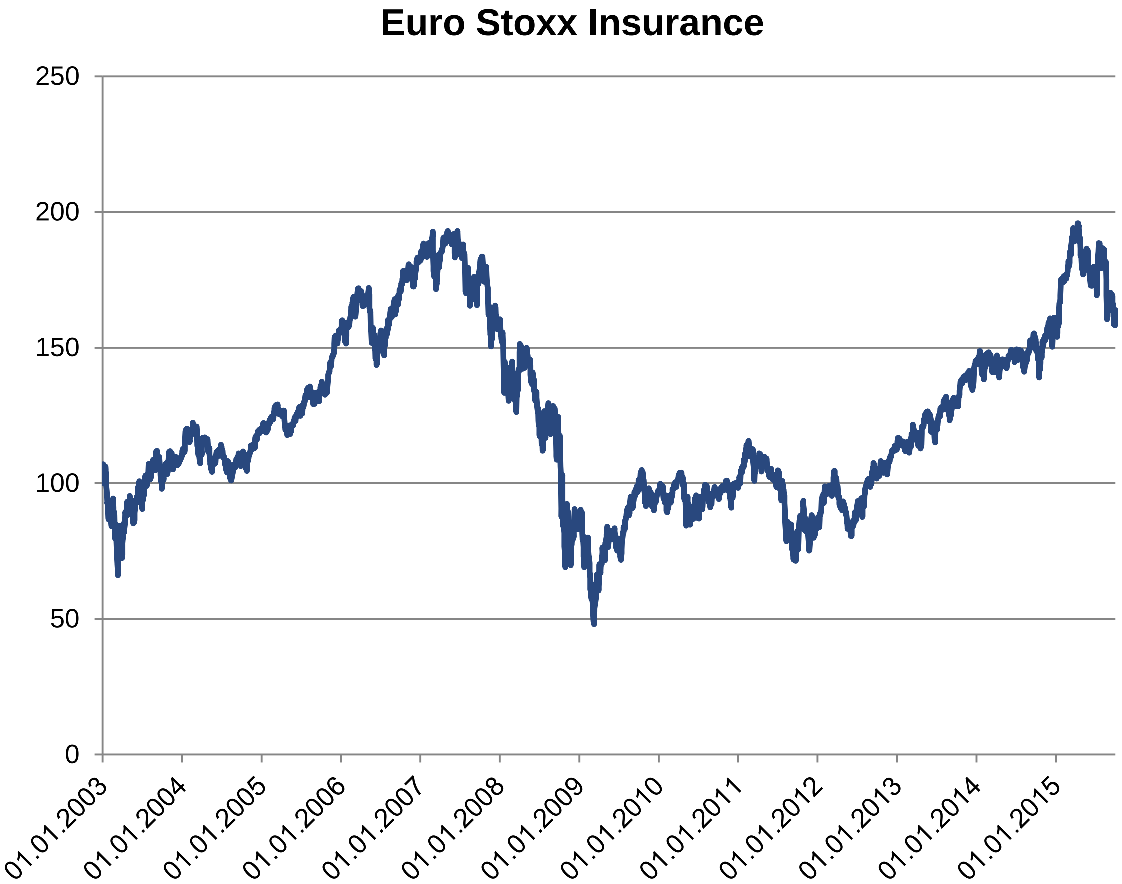
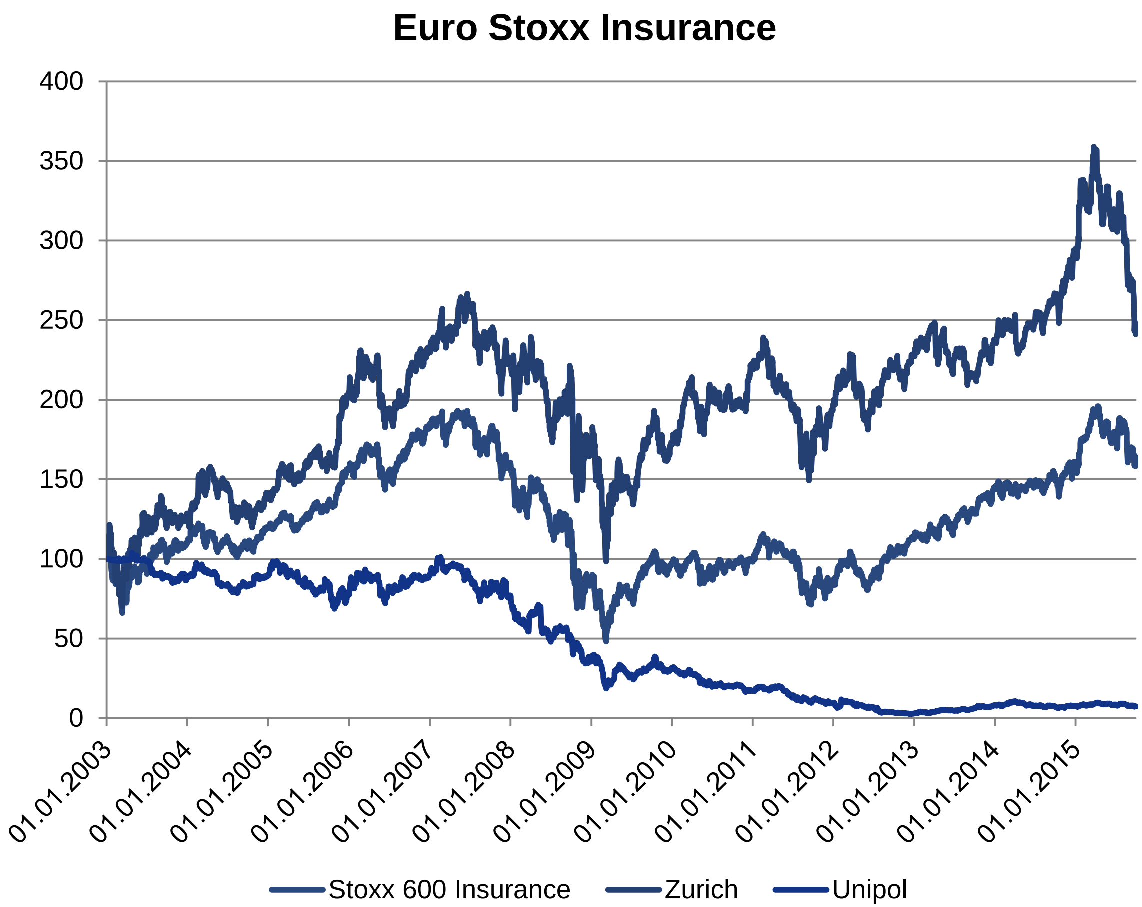
# A turbulent ride combined for insurers.

## Eurostoxx Insurance Index, 2003-2015



# Still, some prosper more than others in spite of the headwinds.

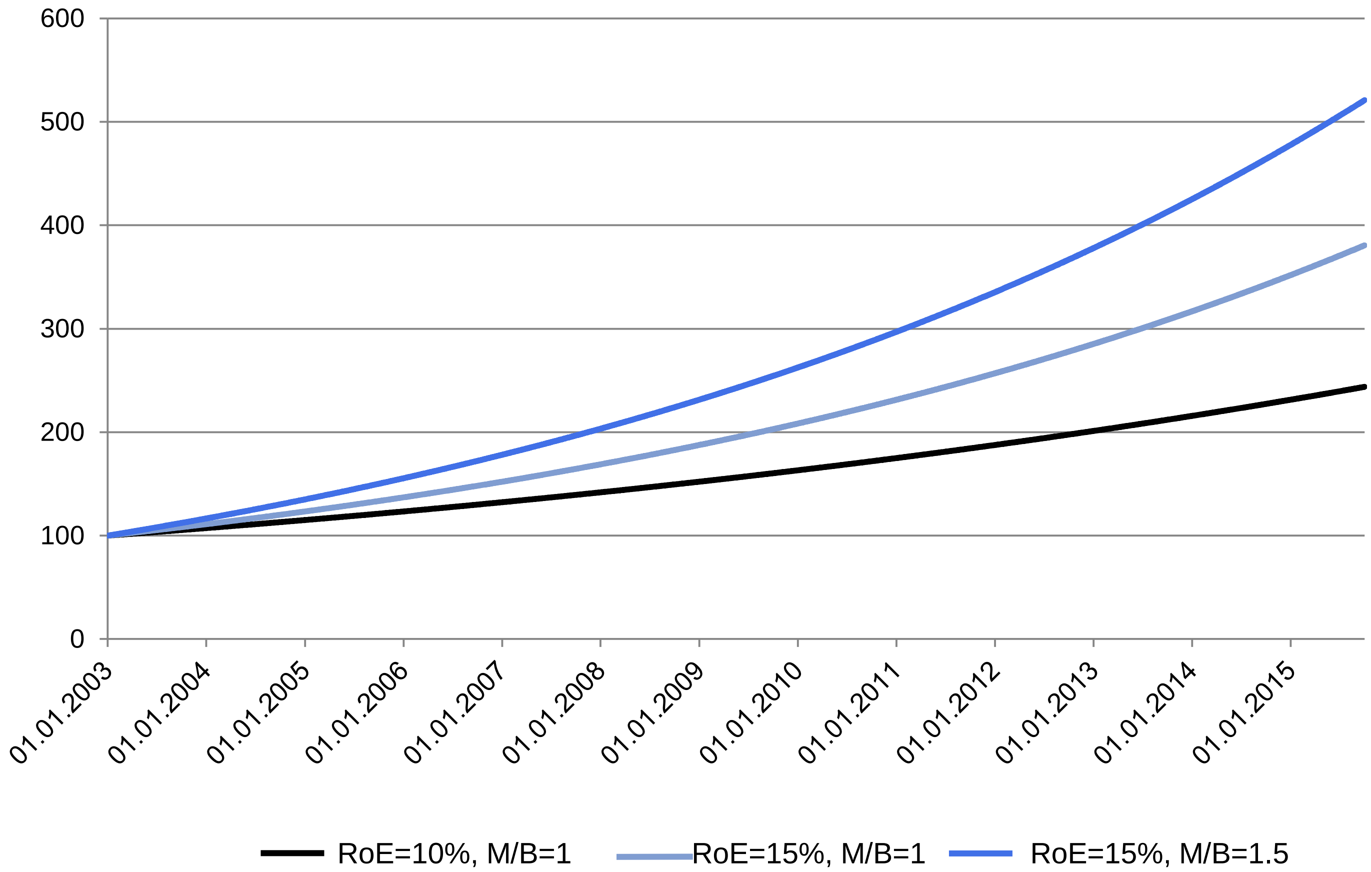



Raising two questions:

- What drives trend with market?
- What drives relative outperformance?

*Wilson, T., 2015, Value and Capital Management: A Handbook for Finance & Risk Professionals, John Wiley & Sons, Forthcoming*

# Drivers of relative share value are trivial…




# …but what drives M/B?

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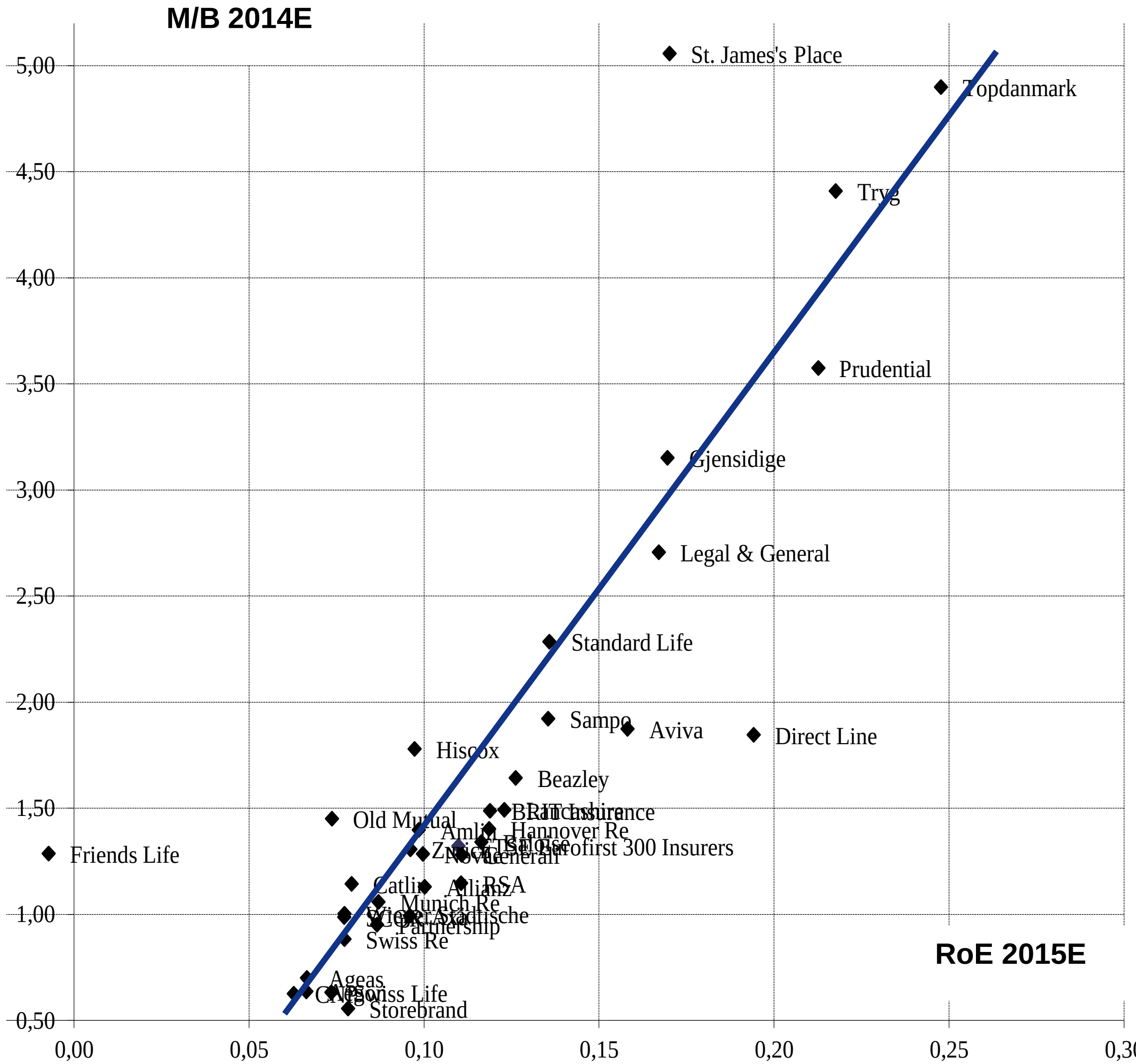
# There is a theory…

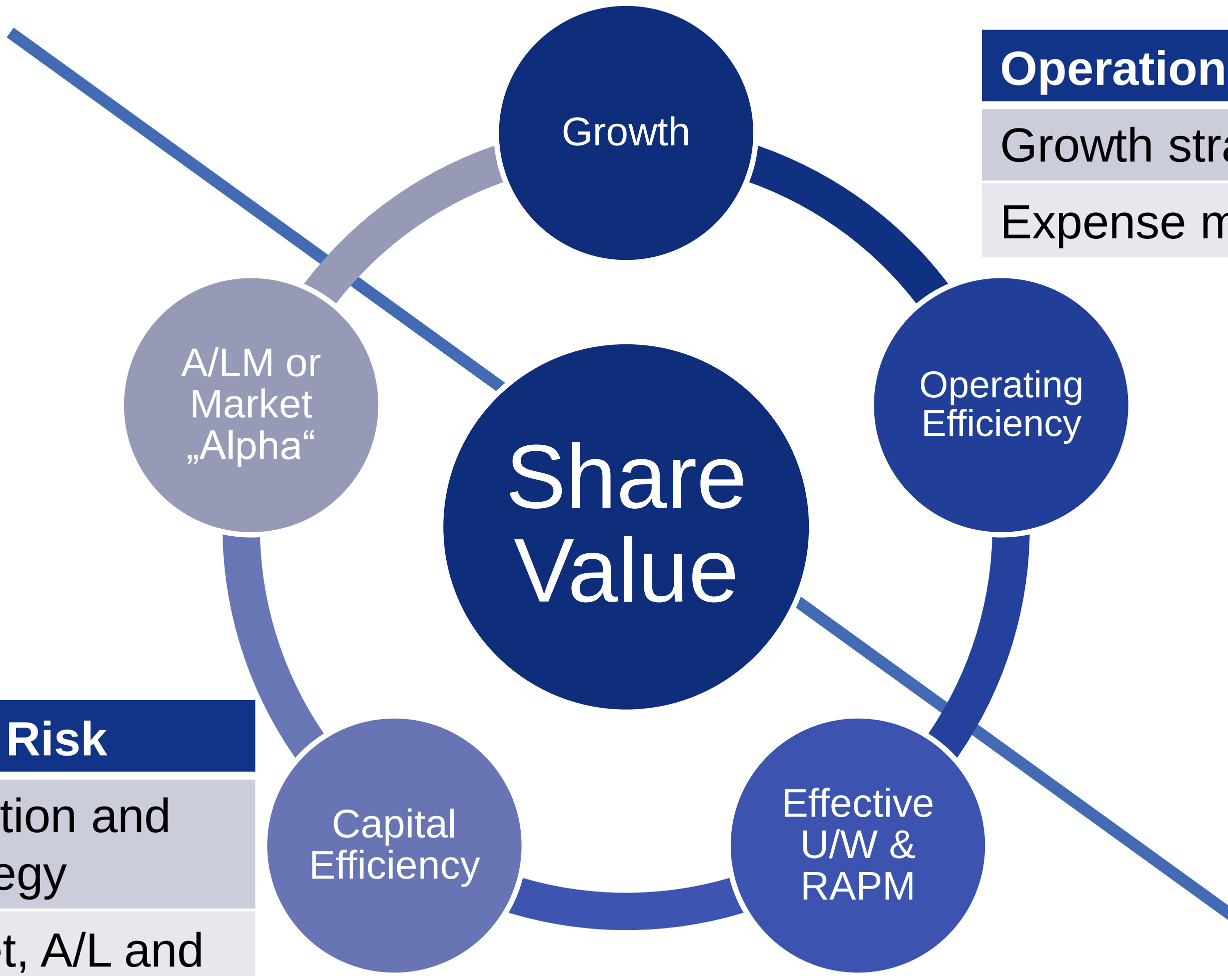
$$\frac{M}{B} = 1 + \frac{(RoE - CoC)}{CoC - g}$$

# …that generally works




Source: KBW Insurance Overview, 2014

# Capital management offers an underultilized lever to increase value




| **Operational drivers** |
| --- |
| Growth strategies |
| Expense management |

| **Finance and Risk** |
| --- |
| Capital allocation and portfolio strategy |
| Balance sheet, A/L and liquidity management |
| Risk management & u/w |

# Recognized by shareholders

"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."

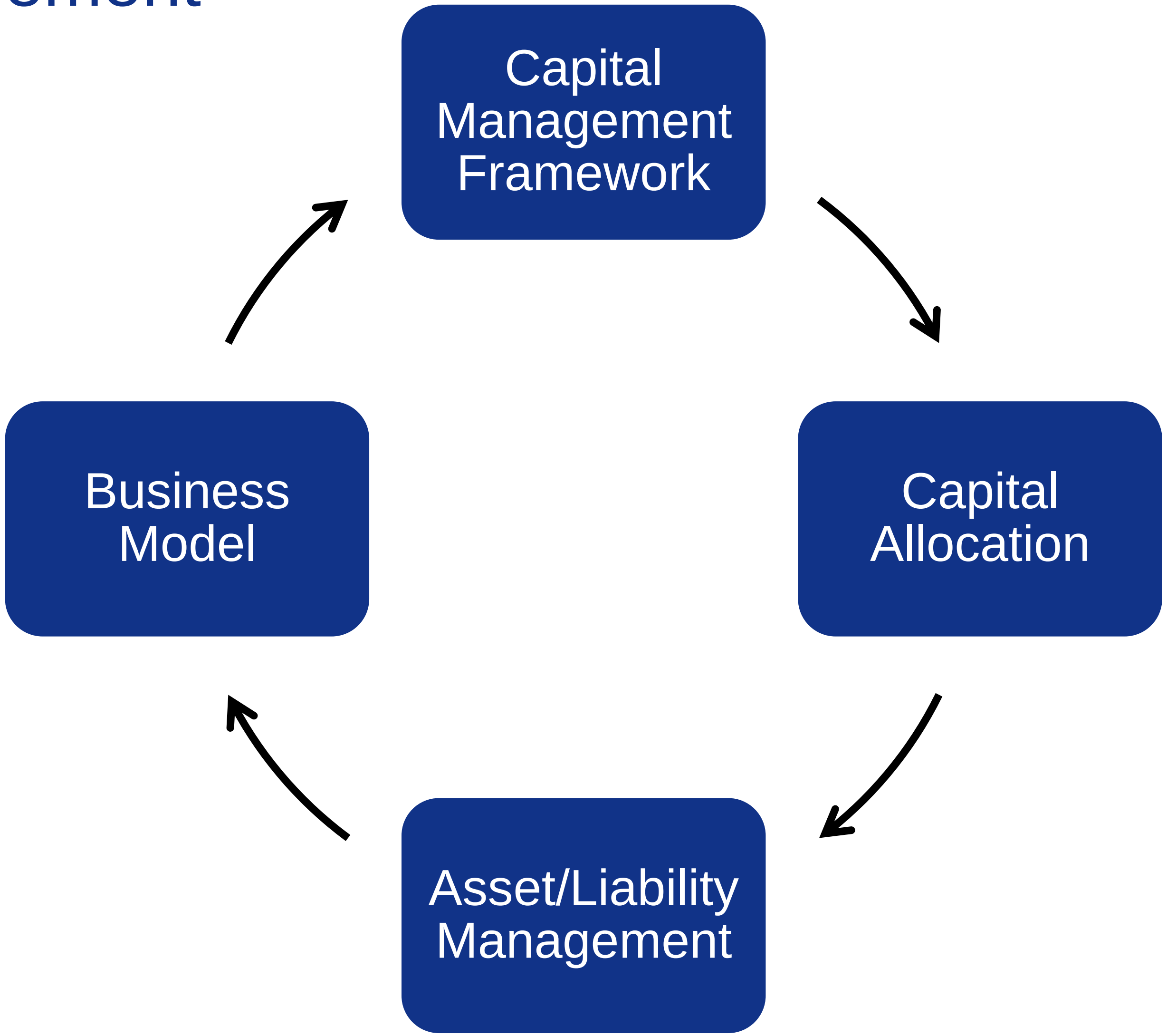
*Barclays 2011*

"(In lieu of growth)…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*

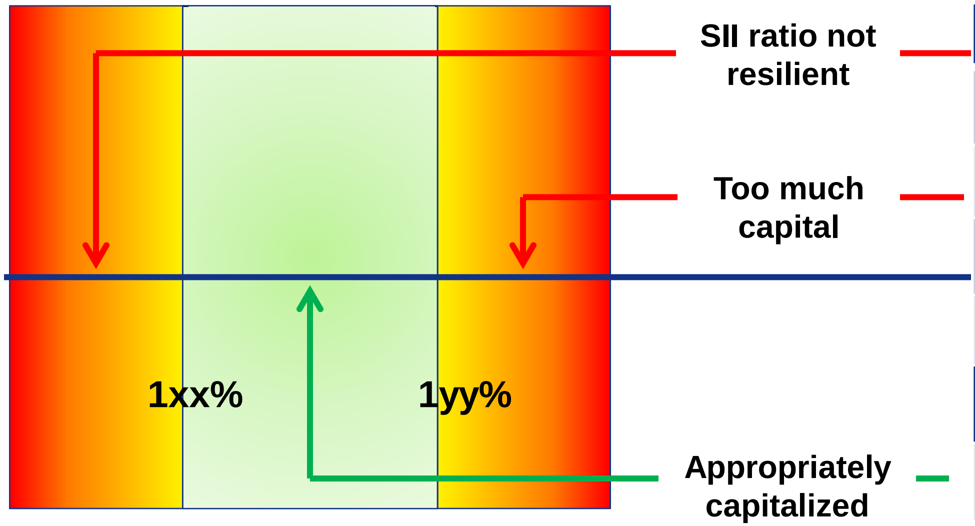
# Implications for insurers‘ risk and capital management



# Solvency capital framework

- What target level after stress?
- What stresses?

## Minimum ratio after all stresses




| Historic Scenarios – *Illustrative* |
|---|
| 2008 Financial Crisis |
| 2011/12 Sovereign Debt Crisis |
| 2014/15 Low rate scenario, no UFR |
| Etc. |
| **Parametric Stresses – *Illustrative*** |
| 1:x year modelled event |

→ **Starting Solvency Ratio**

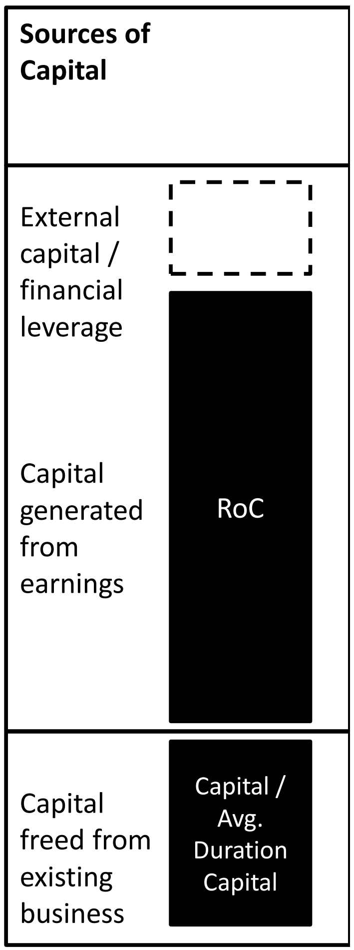
**Chart 6: Solvency II stress test**

| | Last published | Current | Yields life -25bps | Equities -20% | Credit +50bps | Deflation Stress | Deflation Scenario | Optimal range |
|---|---|---|---|---|---|---|---|---|
| AEGON | 160% | 156% | -1% | -4% | -1% | -6% | 150% | 140-170% |
| Allianz | 200% | 186% | -6% | -5% | -4% | -15% | 171% | 180-220% |
| Aviva | 172% | 166% | -2% | -6% | -4% | -12% | 154% | 160-175% |
| AXA | 212% | 205% | -4% | -5% | -1% | -9% | 196% | 170-230% |
| Generali | 196% | 176% | -9% | -9% | -4% | -23% | 153% | na |
| Prudential | 190% | 168% | -6% | -1% | -4% | -11% | 157% | na |
| Zurich | 123% | 109% | -1% | -3% | -6% | -10% | 98% | 100-120% |
| Legal and General | 219% | 193% | -5% | -3% | -6% | -14% | 179% | 175-225% |

Source: Jefferies estimates, company data

# Capital allocation: Capital budget

## From sources to uses



# Capital budget – Illustrative

Group financial results 3Q 2014

Allianz

## New dividend policy[1] going forward

**1** 50% pay-out

- Regular pay-out ratio of 50% (up from 40%)

➡ Healthy balance between dividend yield and investments in profitable growth

**2** Dividend continuity

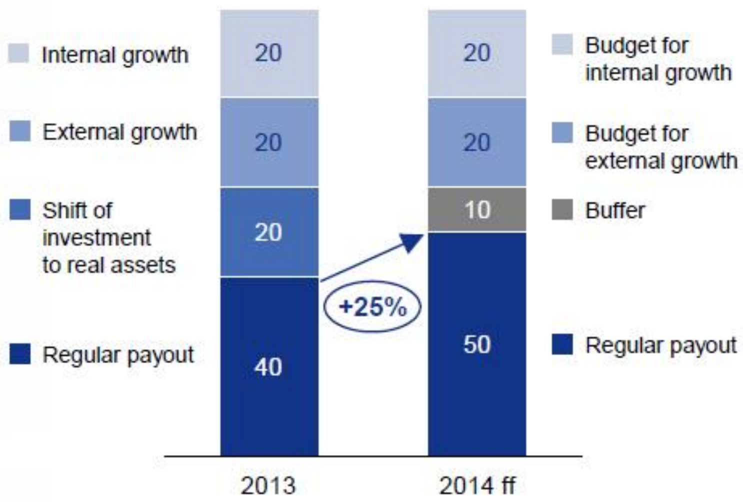
- Dividend no less than previous year's level

➡ Predictable income for investors

**3** Discipline

- Payout of unused external growth budget every 3 years
- Entire dividend policy subject to sustainable Solvency II ratio > 160%

### Allocation of net income[2] 2014ff (in %)




Evaluation of unused budget for external growth every 3 years, starting end of 2016

1) This dividend policy represents the management's current intention and may be revised in the future. Also, the decision regarding dividend payments in any given year is subject to specific dividend proposals by the management and supervisory boards, each of which may elect to deviate from this dividend policy if appropriate under the then prevailing circumstances, as well as to the approval of the annual general meeting

2) Net income attributable to shareholders

40

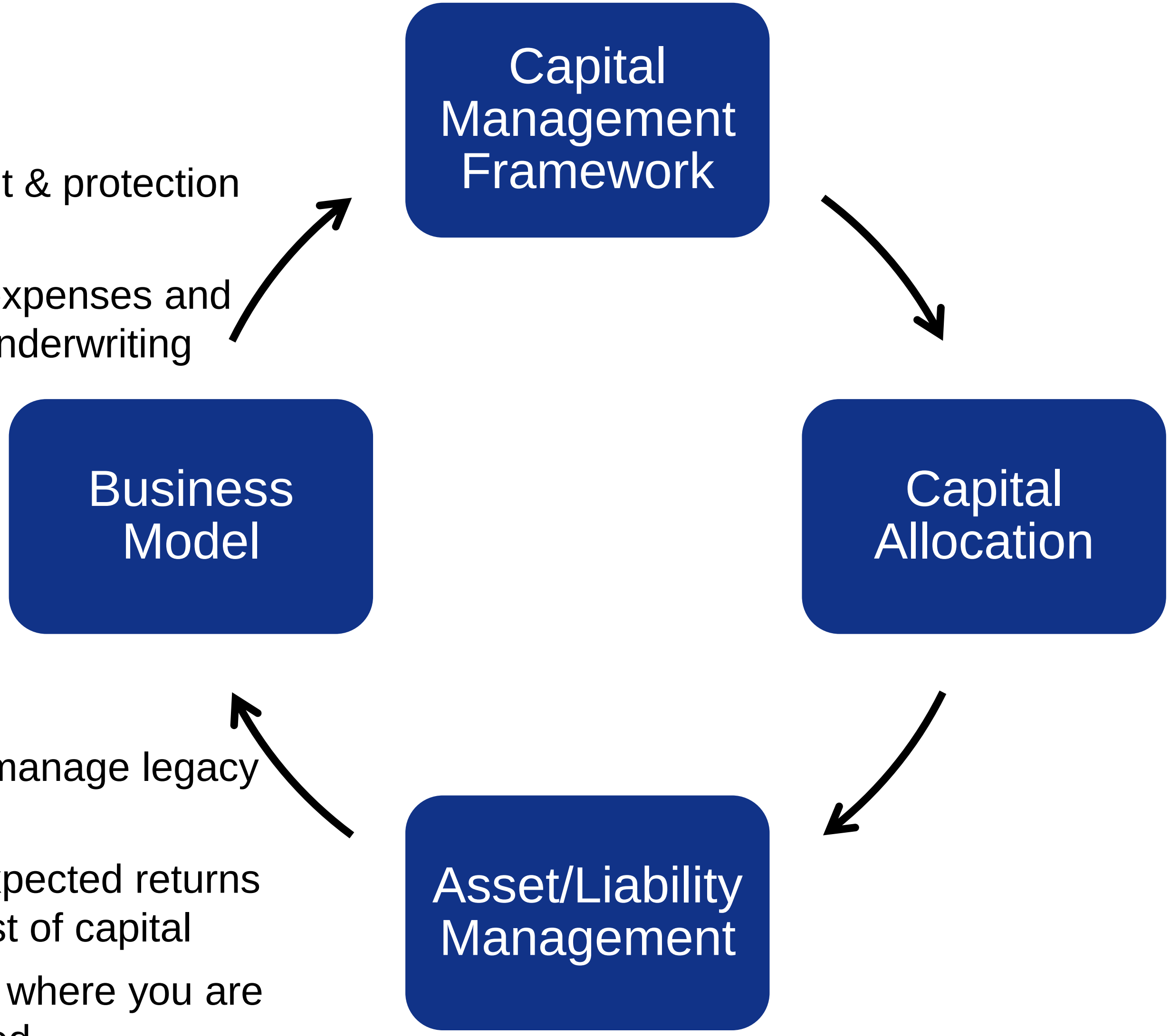
# Capital budget – Illustrative

## Earnings, capital allocation, and cash management discipline for stronger value creation by 2018

| | | |
|---|---|---|
| Growth | Increase earnings | 5% EPS CAGR |
| Capital | Improve … | |
| | … capital productivity | 13% RoE |
| | … capital intensity | Sensitivity reduction of Solvency II ratio, potential to free up EUR ~3bn |
| | … capital fungibility | At least EUR 4bn upstream opportunities |
| Cash | Enhance liquidity | Remittance ratio >80% |

# Implications for insurers‘ risk and capital management

- Capital light & protection products
- Focus on expenses and technical underwriting




- Prudently manage legacy business
- Balance expected returns against cost of capital
- Invest only where you are remunerated

# Managing value: Three core skills

## Better Information – What gets measured, gets managed

- How to value risk-based, capital intensive businesses?
- How to link management actions, risk adjusted performance measures (RAPMs) and other, Key Performance Indicators to value?

## Better Insights – How to create value through operations

- What "rules of the game" (or generic strategies) create value in each business segment?
- What core skills are required in each segment?

## Better Decisions – How Finance & Risk create value

- Strategic planning and capital allocation
- Balance sheet, asset/liability and liquidity management
- Risk management and risk underwriting

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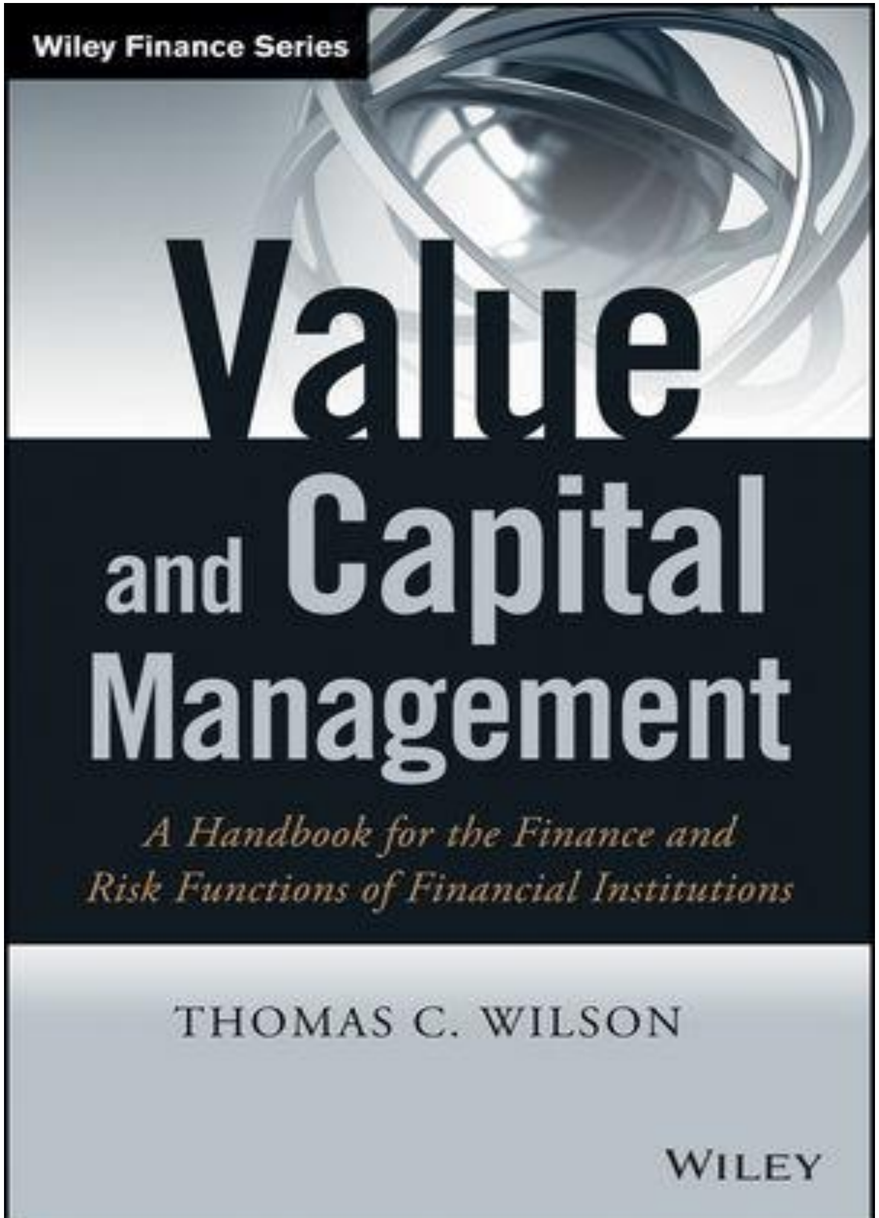
Wiley Finance Series
Value
and Capital
Management
A Handbook for the Finance and
Risk Functions of Financial Institutions
THOMAS C. WILSON
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# Questions