Value & Capital Management: A new era

Thomas C. Wilson
CRO Allianz SE

Institute of Actuaries
London, 20 January, 2017
Agenda

1. A New Era

2. Implications for insurers
Which measures are most used for strategic 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

OWC, 2003, The Evolving Role of the CFO and CRO
Looking forward, challenges to earnings growth and capital …

Economic Environment
- Anemic growth
- Low rates
- Market volatility

10 yr Euro Swap rates, 2006-2016
What can happen in a volatile market environment?

Allianz share price vs MCEV and IFRS roll-forward

Roll-forward based on 2010 disclosed IFRS and MCEV sensitivities without quarterly rebalancing.
More than just one company, one year

Comparison, adjusted MCEV Roll-Forward vs. ∆TNAV and ∆Share Price

<table>
<thead>
<tr>
<th>Company</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
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<tbody>
<tr>
<td>Allianz</td>
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Looking forward, challenges to earnings growth and capital…

Economic Environment
- Anemic growth
- Low rates
- Asset volatility

Regulatory Pressure
- Risk-based capital
- Risk management
- Consumers
Solvency II, a substantially more volatile regime

Periods of extreme financial market volatility …

… impact Solvency II ratios significantly
(example of traditional Life products, comparison of change in surplus as a % of assets)

*) Barclays Capital Euro Aggregate Corporate average credit spread
Source: Morgan Stanley, Oliver Wyman
Looking forward, challenges to earnings growth and capital...

Economic Environment
- Anemic growth
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Regulatory Pressure
- Risk-based capital
- Risk management
- Consumers

Paradigm Shifts
- Consumers
- Business system
- Shareholders
Shareholder activism, focus on capital

“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) … capital is spent. We are supportive of investment in new business … (at) 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*

“A focus on cash and dividends has driven the sector to an 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*
Agenda

1. A New Era

2. Implications for insurers
A turbulent ride for banks and insurers

Eurostoxx Insurance Index, 2003-2015
Still, some prosper more than others

Raising two questions:
• What drives trend with market?
• What drives relative outperformance?
Drivers of relative share value are trivial…

…but what drives M/B?
There is a theory…

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

…that generally works

Source: KBW Insurance Overview, 2014
The New Era requires an holistic view…

**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
## A clear capital budget

<table>
<thead>
<tr>
<th>Sources of Capital</th>
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<tbody>
<tr>
<td>External capital / financial leverage</td>
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<tr>
<td>Capital generated from earnings</td>
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<tr>
<td>Capital freed from existing business</td>
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- Allocate capital between financing-, strategic-, and growth initiatives consistent with corporate strategy;
- Never invest if long-run returns below cost of capital;
- Invest as much as possible if long-run returns greater than cost of capital;
- Maintain resilient capital structure, respecting regulatory constraints, consistent with risk appetite;
- Return any excess capital to shareholders.

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Clearly communicated financial targets emphasizing growth, returns and capital...

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<thead>
<tr>
<th></th>
<th>2015</th>
<th>2018</th>
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<tbody>
<tr>
<td>3-year EPS CAGR</td>
<td>8.0%</td>
<td>5%</td>
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<tr>
<td>RoE Allianz Group</td>
<td>12.5%</td>
<td>13%</td>
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<tr>
<td>P/C CR</td>
<td>94.6%</td>
<td>94%</td>
</tr>
<tr>
<td>L/H OEs with RoE ≥10%</td>
<td>65%</td>
<td>100%</td>
</tr>
<tr>
<td>L/H NBM</td>
<td>2.1%</td>
<td>3.0%</td>
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<table>
<thead>
<tr>
<th>Businesses with NPS above market</th>
<th>2015</th>
<th>2018</th>
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<tr>
<td>RoE Allianz Group</td>
<td>50%</td>
<td>75%</td>
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<tr>
<td>SII interest rate sensitivity</td>
<td>14%-p</td>
<td>&lt; 11%-p</td>
</tr>
<tr>
<td>Potential to free up €3 bn in capital</td>
<td>&lt;11%-p</td>
<td>&lt; 10%</td>
</tr>
<tr>
<td>IMIX</td>
<td>68%</td>
<td>72%</td>
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<tr>
<td>Share of new digital retail products (P/C)</td>
<td>&lt; 10%</td>
<td>~100%</td>
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...and capital management strategy...

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 %)

- **Internal growth**: 20% (20% in 2013)
- **External growth**: 20% (20% in 2013)
- **Shift of investment to real assets**: 20% (10% in 2013, +25%)
- **Regular payout**: 40% (50% in 2014)

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

Minimum ratio after all stresses

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<tr>
<td>2008 Financial Crisis</td>
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<td>2011/12 Sovereign Debt Crisis</td>
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<tr>
<td>2014/15 Low rate scenario, no UFR</td>
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<tr>
<td>2001 Equity crash</td>
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Historic Scenarios – Illustrative

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<td>1:10 year modelled event</td>
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Parametric Stresses – Illustrative

Starting Solvency Ratio

Figure 14: Allianz – recent solvency trend and potential outcome under further stresses

Figure 20: Zurich – recent solvency trend and potential outcome under further stresses

Source: Deutsche Bank estimates, company data
Biography, Thomas C. Wilson

2008 – Chief Risk Officer, Allianz Group  
(Chief Risk Officer, Dresdner Bank)

2005-08 Chief Risk Officer, ING Insurance

2002-05 Global Head, Finance & Risk Practice,  
Oliver Wyman & Company

1998-02 CFO Swiss Re New Markets

1990-98 Global Head, Risk Management Practice,  
McKinsey & Company

1989 PhD Economics, Stanford University

1984 BSc Business Administration,  
University of California at Berkeley

Author, Value and Capital Management – A Handbook for the Finance and  
Risk Functions of Financial Institutions, 2015, Wiley Finance Series