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Layout & Distribution: Valéria Kozakova

Evaluating the Effectiveness of Risk Management

An analyst's view

William Hawkins

Agenda

1. Who am I? Why am I here?
2. Evolution of risk management
3. What interests an investor

1. Who am I? Why am I here?

Who am I? Why am I here?

- I am a “sell side” analyst for a stockbroker
- The financial investor is my client
- He believes that the stock market is efficient in the long run but inefficient in the short run
- He has a portfolio strategy to beat specified performance criteria
- He wants to find insurance stocks that are most suitable for his criteria
- He wants me to have the detailed knowledge to find the right opportunities
- He also wants me to be on top of all financially relevant events as they happen
- Division of labour. Specialisation

And why should you care?

- I affect your cost of capital
- I am the most frequent/interested end user of your financial reports
- Dialogue adds value for all parties



The things that interest me

- Valuation
 - ♦ Absolute
 - ♦ Relative
- Momentum
 - ♦ Earnings
 - ♦ Shareholders' funds
 - ♦ Required return
 - ♦ Dividends (cash flow)

PE


Price/Book (EV)

Dividend Yield

RoE/Required Return


Sum of Parts

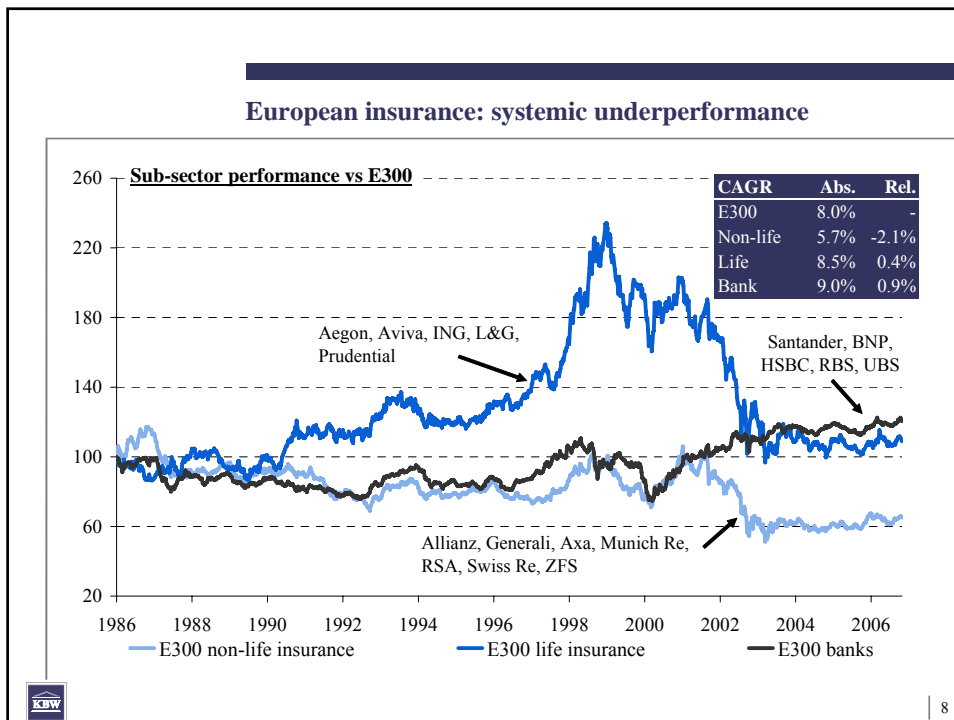
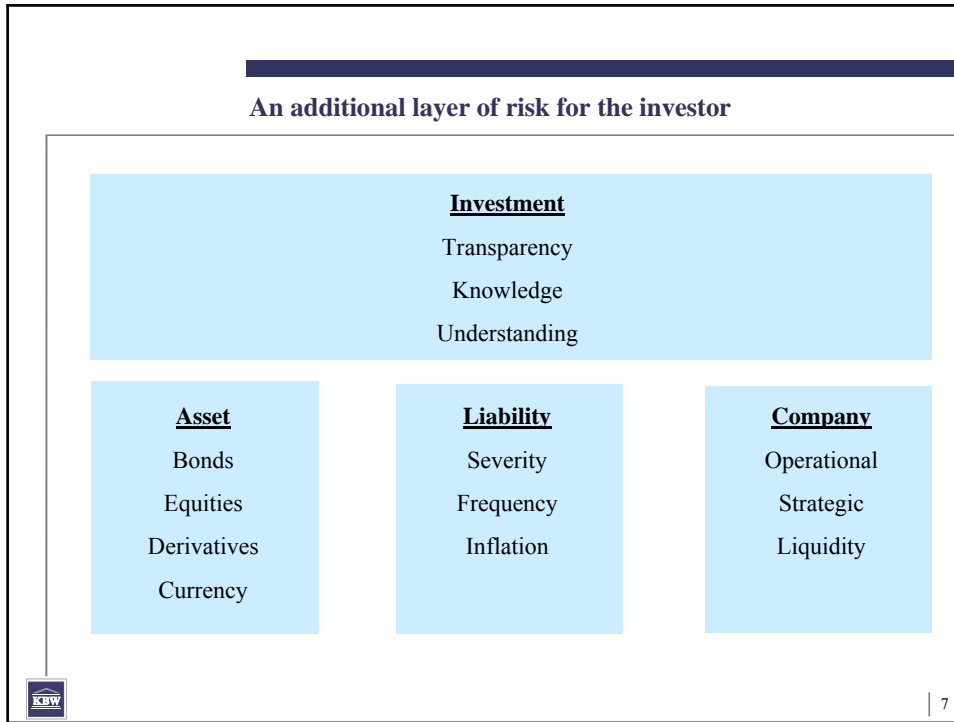
- What are the upside/downside risks to investors'/consensus expectations?
- What are the fundamental, technical, strategic and tactical *drivers*?


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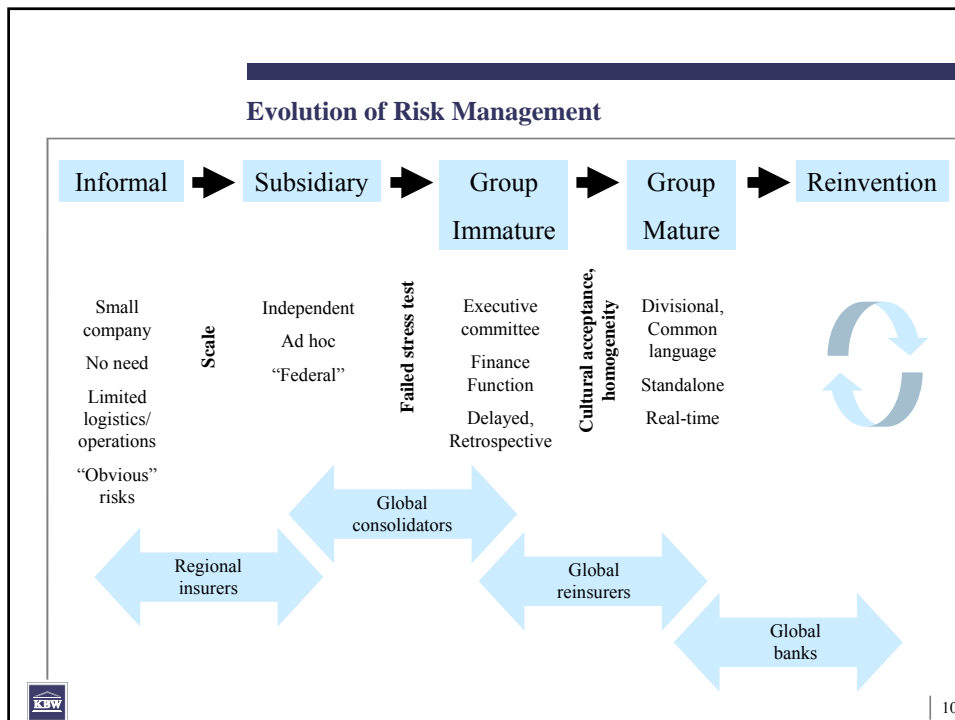
The information at my disposal

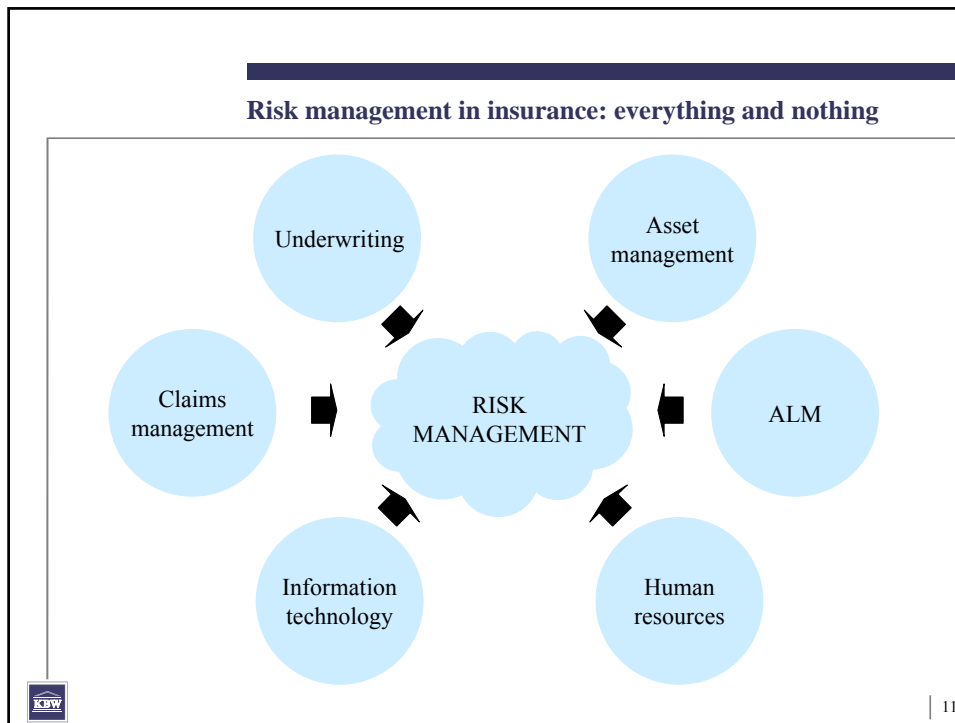
<u>Available</u>	<u>Unavailable</u>
<p style="text-align: center;">Company Data</p> <p style="text-align: center;"><i>Interim Reports</i></p> <p style="text-align: center;"><i>Presentations</i></p> <p style="text-align: center;"><i>Regulatory Filings</i></p> <p style="text-align: center;"><i>Embedded Value Reports</i></p> <p style="text-align: center; margin-top: 20px;">Personnel</p> <p style="text-align: center;"><i>IR</i></p> <p style="text-align: center;"><i>Senior management</i></p> <p style="text-align: center; margin-top: 20px;">Newsfeeds</p> <p style="text-align: center;"><i>Reuters, Bloomberg</i></p> <p style="text-align: center; margin-top: 20px;">Market data feeds</p> <p style="text-align: center;"><i>Datastream</i></p>	<p style="text-align: center;">Company Data</p> <p style="text-align: center;"><i>By-line/territory</i></p> <p style="text-align: center;"><i>Accident year/underwriting year</i></p> <p style="text-align: center;"><i>Reserve breakdown, triangles</i></p> <p style="text-align: center;"><i>Case, IBNR</i></p> <p style="text-align: center;"><i>Duration</i></p> <p style="text-align: center;"><i>Investment structure & matching</i></p> <p style="text-align: center; margin-top: 20px;">Personnel</p> <p style="text-align: center;"><i>Line management (rarely)</i></p> <p style="text-align: center;"><i>Underwriters/actuaries (rarely)</i></p> <p style="text-align: center; margin-top: 20px;">Consistent time series!!!</p>


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2. Evolution of risk management





- Risk management questionnaire**
- Spoke with Aegon, Allianz, Aviva, Axa, Fortis, Generali, Munich Re, Swiss Re**
- “Does your risk management effort give you a competitive advantage?”
 - 100% Yes!!
 - “Where has the drive for risk management come from?”
 - Mostly internal, secondly rating agencies. One explicit reference to investors
 - “How old is your current risk management framework?”
 - Mostly 3 years. Oldest 8
 - “Do you have a CRO?”
 - Only one clear “no”
 - “Where does your CRO sit in your management structure?”
 - Mostly under the CFO; one under the COO; one independently on the executive board
 - “How many dedicated risk management employees do you have?”
 - Generally 2-300. Some with very few. Some with 400 (excl banking)
 - “How do you measure the value added by risk management?”
 - Avoiding surprises, achievement of projects, implementation of processes, setting and monitoring financial targets?
- KBW
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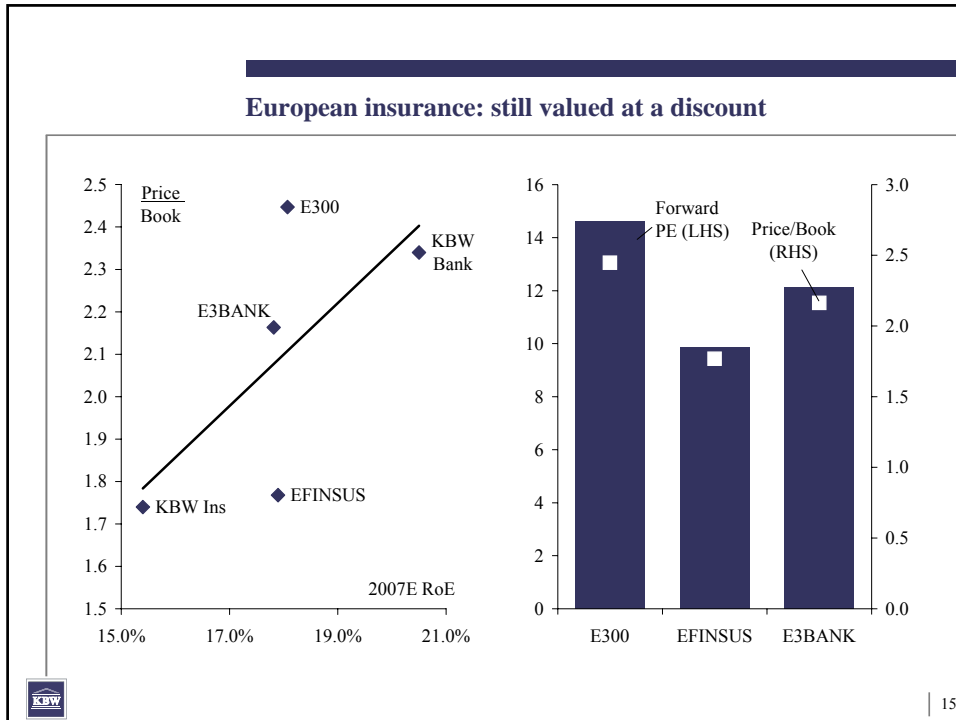
Questionnaire: investment conclusions

- You can't all have a competitive advantage!
- Most risk management frameworks are new and untested
- A sub-division of Finance
 - (a) to add credibility
 - (b) to complement capital management
- Well-resourced but generally still "head office"
- Still very difficult to measure performance, and hence accountability

- **The pressure from investors is indirect**



3. What interests an investor



Reinsurance facts. Since 2001 ...

- Average return on equity: 6%
- “Exceptional losses”: \$50-60bn (1/2 WTC & Katrina)
- Capital raised: \$60bn
- Capital repatriated: \$15bn

=> Would you invest in a sector that earns 6%, loses 30% of its capital from “learning experiences” and raises four times as much capital as it distributes?

Risk & Capital management: the same coin ...

Risk

Financial market

Underwriting

Asset/Liability

Operational

Strategic

Capital

Profit potential

Capital intensity

Capital availability

Cost of capital

Mix of capital

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Internal processes vs external results

Integrated risk management in the Munich Re Group:
Protecting and optimising the return on shareholder capital

PROTECT + **OPTIMISE**

Effective risk governance:
Supervisory board, board of management and board risk steering committee

Insurance diversification:
Munich Re has state-of-the-art tools and processes to safeguard controlled insurance risk taking

Underwriting Control is exercised through

Limits	Scope	Accumulation control
Through listed underwriting limits set by Board of Management	Through COCs and IS teams	Single risks
Management level 1	Divisional	Events
Management level 2	Optional	Cross balance sheet
Senior underwriter		
Underwriter		
UW assistant		

Risk management - More conservative allocation of risk capital
Breakdown of Group required risk capital as at 1 January 2006

in € bn	1 January 2006	1 January 2005	Δ in %
Reinsurance segment			
Property/casualty	7.9	9.9	26
Life and health	0.7	2.2	107
Marital	0.1	0.6	-85
Other	0.8	0.8	0
Simple sum	9.5	13.5	30
Segment distribution shift	-2.1	-4.2	50
Total reinsurance segment	18.2	11.1	64
Primary insurance segment			
Property/casualty	0.9	0.8	17
Life and health	0.2	0.4	-50
Marital	0.1	0.2	-50
Other	0.2	0.2	0
Simple sum	1.4	1.6	-13
Segment distribution shift	0.2	0.2	0
Total primary insurance segment	2.8	3.4	-18
Munich Re Group total	21.0	14.4	46

Active capital management - Alignment of internal steering and external target communication
Calculation of RoRaC

Target net income	RoRaC	RBC	1/11/06	Additional available equity
Consolidated (IFRS) net income	Measure for the efficient use of capital involved in the value creating process	Risk-based capital (RBC) beginning of year derived from comparable companies	1+1-Year LGR rate in Munich Re's tax rate of 40%	Additional available equity beginning of year + Economic equity - margin for future risks - RBC
€2.6bn	15%	€17bn	3.0% & 80%	€4.6bn


RoRaC = $\frac{\text{Net income} - \text{Risk free interest rate} \times (1 - \text{tax rate})}{\text{Risk-based capital}}$

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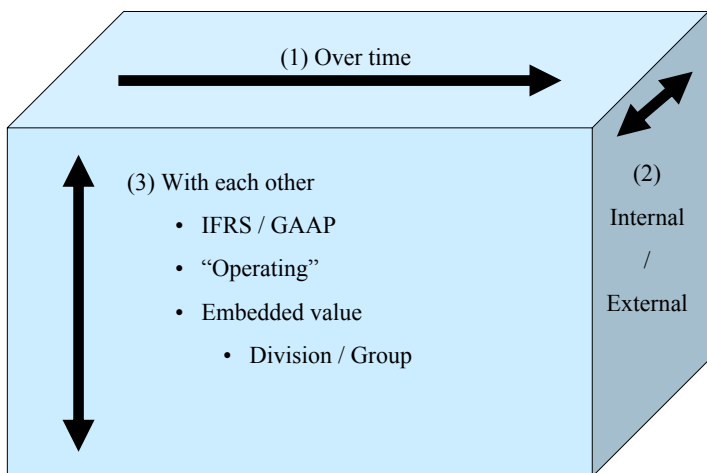
Making external results meaningful


- Risk/capital disclosure must be consistent with other publicly disclosed data for it to be useful
- Timeliness is valuable
- A reasonable mind needs to be able to consider how the numbers will change in the future
- “Earnings” have been excessively maligned
- Company management must have its own view of value

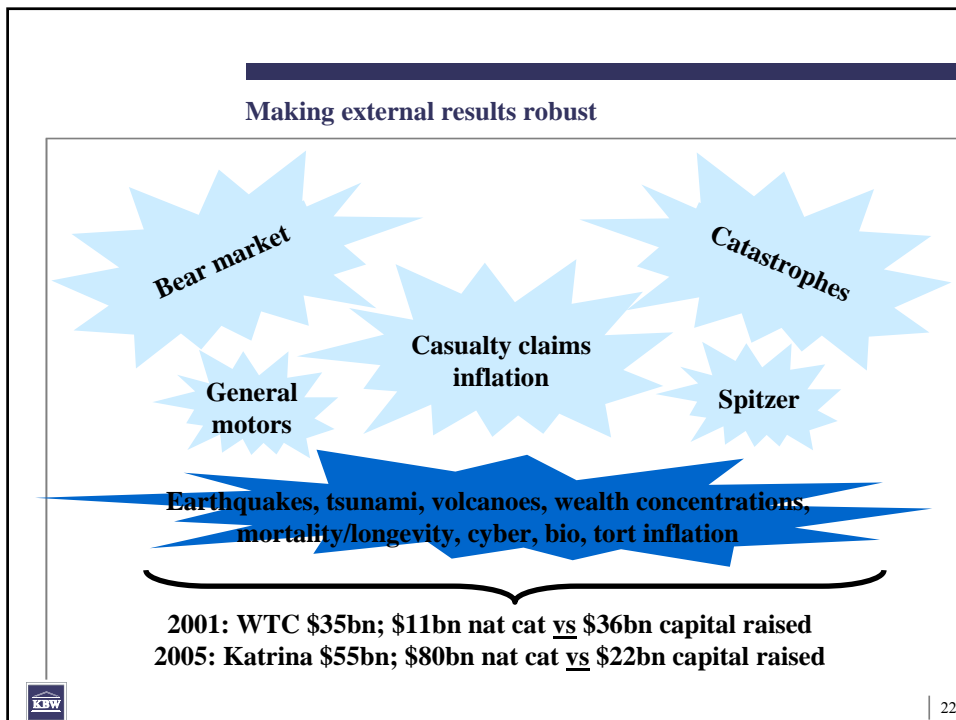
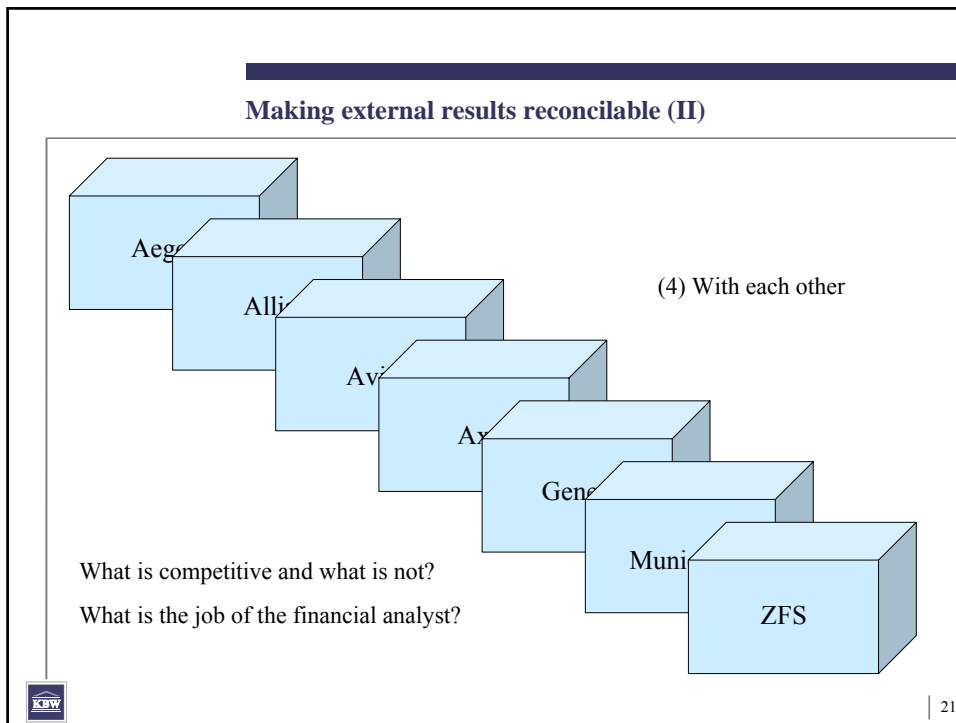
Business	Asset M.	Other
Credit		Bank
Market		P&C
Reserve		Life
Premium		Life
Risk segment ✗		Business unit ✓


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Making external results reconcilable (I)




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Investment conclusion

- Investors are more focused on capital management than risk management
- This is because they are focused on results, not process. Process is still important
- **Successful risk management means that the diversification credit is not neutralised by operational risk**
- A risk/capital model changes the question from “What can I do with all this capital I’ve got?” to “What would be the capital cost of writing this business and is it attractive?”
- A forward-looking tool with clear “yes/no” outputs
- Show evidence of active capital management!!!



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Reg AC

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