

Capital Management Strategies

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Agenda

Today's Discussion

- Overview of capital and sources of capital
- Reinsurance as a source of capital
- Capital management for new products
- Conclusions

Capital Management - Introduction

Lessons Learned from the Global Financial Crisis

- Capital has a cost
 - *Optimise capital efficiency*
- Access to capital not always guaranteed
 - *Diversify sources of available capital*
- Guarantees / ALM have a real economic cost
 - *Ensure appropriate pricing, hedging and capital management in place for key risks*

Capital – Key Points

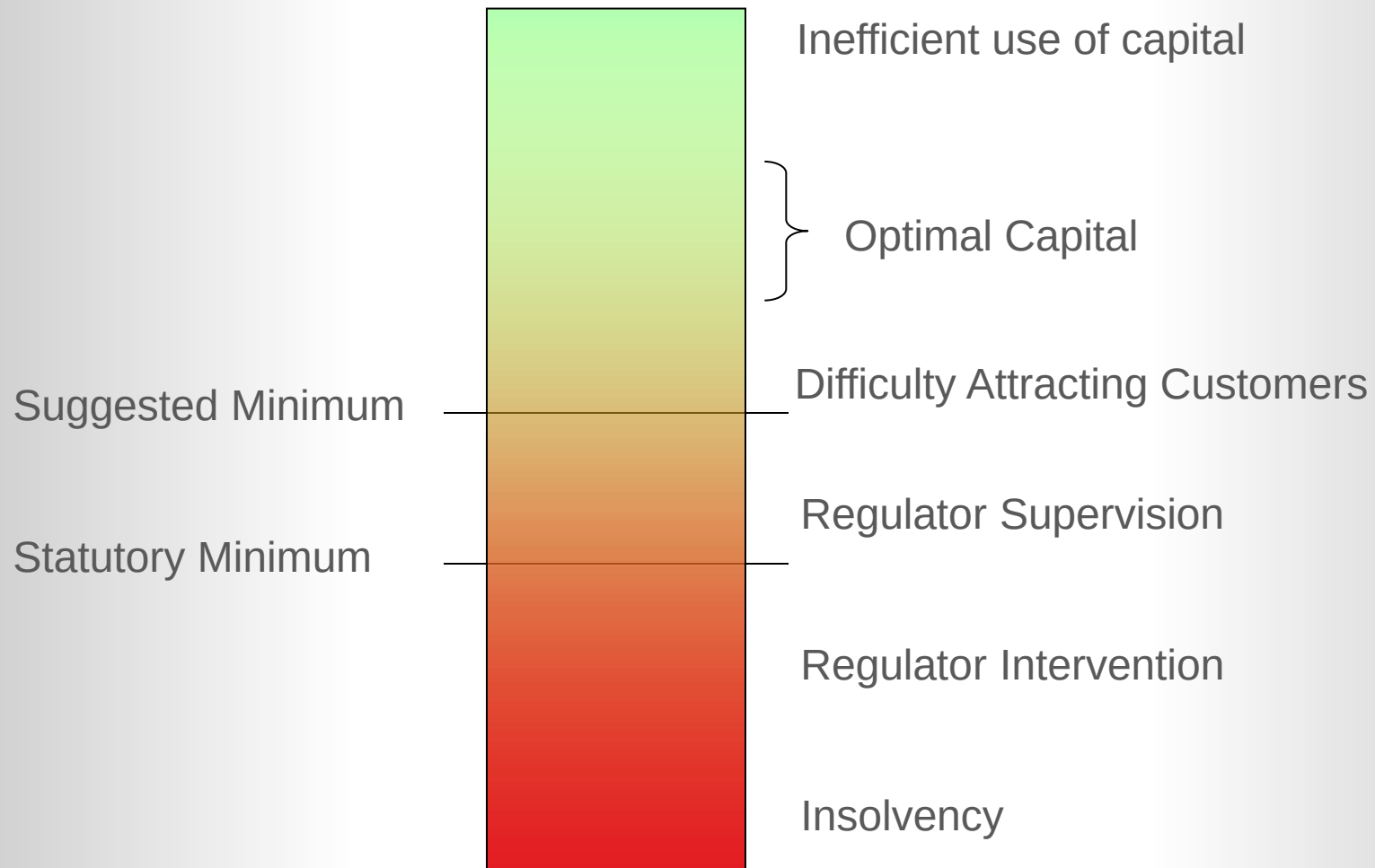
- Why is Capital important?
 - *It ensures long term survival of the insurer*
 - *It provides ammunition for future growth opportunities*
 - *It provides security / confidence to policyholders*

- Why is Capital Management important?
 - *Capital is a scarce resource and seeks the highest risk adjusted returns*
 - *Shareholders and analysts exert pressure to achieve these returns*
 - *Policyholders expect competitively priced products*

Capital – what capital?

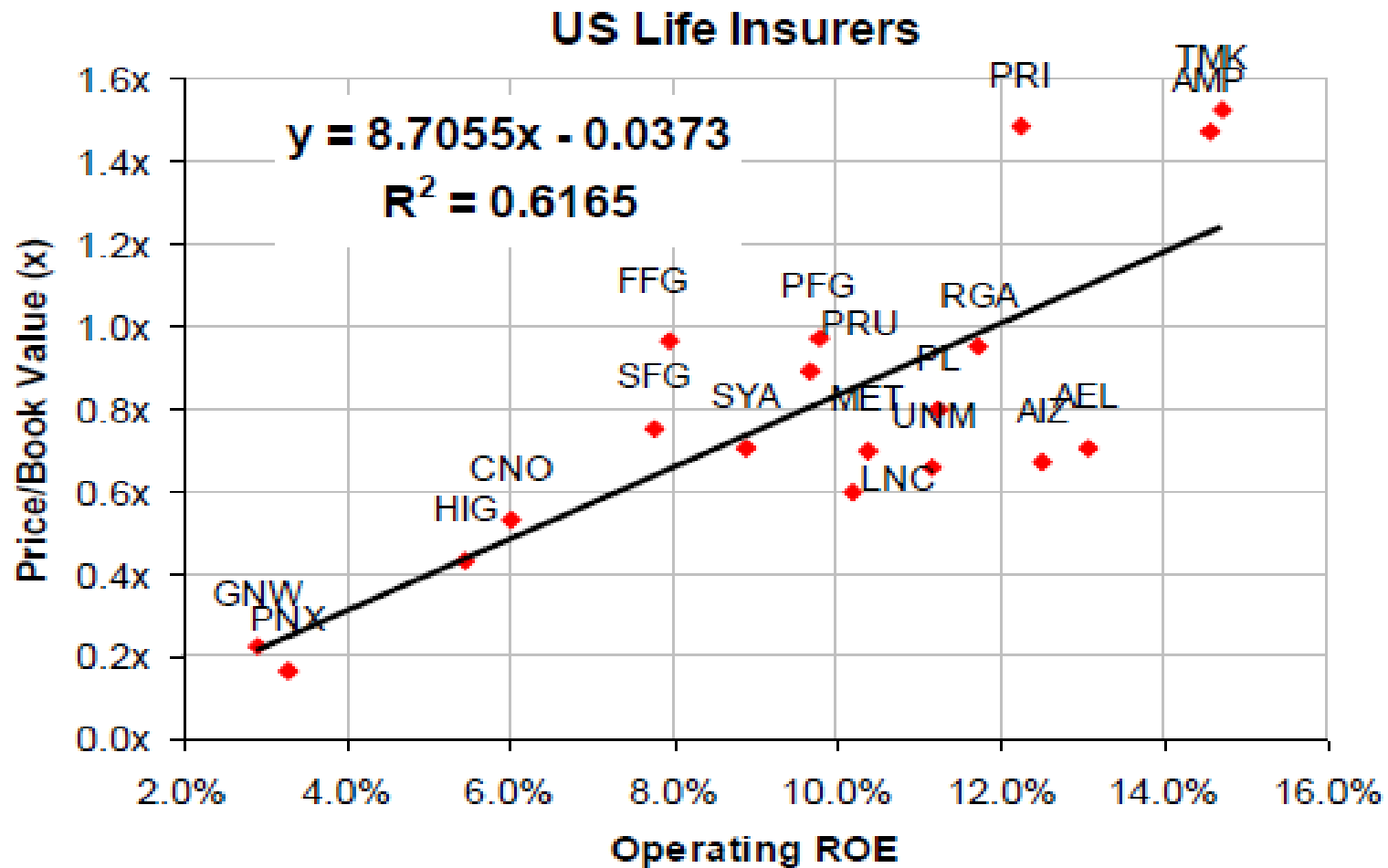
Capital Dimension	Regimes	Comment
Statutory	<ul style="list-style-type: none"> • Solvency I / II, U.S. stat., local solvency, etc. 	<ul style="list-style-type: none"> • Slow convergence led by S.II • Liquidity premium & discount rates
Economic	<ul style="list-style-type: none"> • Company specific RBC model • Used for decision making 	<ul style="list-style-type: none"> • Most detailed RBC model • May be used in statutory capital as internal model
Rating Agencies	<ul style="list-style-type: none"> • S&P, Moody's, AM Best, Fitch 	<ul style="list-style-type: none"> • The other RBC model...
Accounting	<ul style="list-style-type: none"> • IFRS phase 1 / phase 2, US GAAP, local GAAP 	<ul style="list-style-type: none"> • It's broken – where to go from here? EV, EEV, MCEV, ... • P&L is important though
Market	<ul style="list-style-type: none"> • Relative to local / global peers 	<ul style="list-style-type: none"> • Position in the cycle • Appraisal value

How Much Capital?



Source: Capital Costs of Insurance – some empirical analysis. Alex Thomson

Market Focus – Drivers of Value



Source: Company data, FactSet, Macquarie Capital (USA), August 2012

Sources of Capital

- Capital markets for equity, debt, hybrid debt
- Sell assets i.e. blocks of business
- Reinsurance
- Embedded Value Securitisation (essentially reinsurance through public markets)
- For subsidiaries, capital injection from parent

Benefit	Reinsurance	Debt	Hybrid Debt	Equity	Securitization
Risk Transfer:					
Covers losses above capital provided	Yes	No	No	No	No
Comfortable with insurance risks	Very	No	No	Somewhat	Somewhat
Targeted at specific risks	Can be	No	No	No	Can be
Access to expertise	Yes	No	No	No	Maybe
Financials:					
Reduces required RBC	Yes	No	No	No	No
Reduces required rating agency capital	Yes (for full-risk)	No	Maybe	No	Maybe
Treated as Tier 1 Capital	Yes	No	Maybe	Yes	Maybe
Dilutive	No	No	No	Yes	No
Financial leverage impact	Decrease	Increase	Increase	Decrease	Depends
Increases total capital	Yes	Yes	Yes	Yes	Yes
May cause a need to realize losses	Yes	No	No	No	No
Increases solvency ratio	Yes	No	Somewhat	Somewhat	Depends
Structure:					
Special-purpose entity needed	No	No	No	No	Yes
Credit enhancement / recourse needed	Maybe	No	No	No	Maybe
Liquidity	Depends	Yes	Yes	Yes	Depends
Tax efficiency	Partial to full	Partial to full	Partial to full	None	Full
Introduces counterparty risk	Yes	No	No	No	No
Cash or "cashless"	Yes	No	No	No	Yes
Value and Costs:					
Flexibility	Yes	Some	Some	No	No
Maximum tenor	Long	Short-Medium	Short-Medium	Long	Medium
Maximum size	Medium to large	Very large	Very large	Very large	Very large
Minimum size	Small to medium	Large	Large	Large	Medium to large
Market status	Open	Open	Open	Open	Opening
Rapid implementation	Often	No	No	No	No
Confidentiality	Yes (except Sch S)	Only if private	No	No	No
Restrictions on management actions	Maybe	Maybe	Maybe	No	Maybe
Administration and systems changes	Maybe	No	No	No	Maybe
Low transaction costs	Yes	No	No	No	No
Overall cost	Low-Medium	Low	Medium	High	Low-Medium
Amount of legal documentation	Low	Medium	Medium	Medium	High

Reinsurance as a source of capital

Converting economic value into capital

On most companies' balance sheets there are:

- *Assets* that have a *lower statutory value* than economic value:
 - Negative reserves
 - VIF, etc.
- *Liabilities* that command a *higher statutory value* than economic value:
 - Conservative prescribed mortality & lapse valuation assumptions
 - Uneconomic discount rates, etc.
 - Exception: negative spread blocks

“Selling” these assets and liabilities allows companies to:

- Realize the difference between economic and statutory value
- Convert an inadmissible asset into an admissible asset
- Accelerate earnings

Why are capital motivated reinsurance attractive?

- Generally the **cheapest source of capital**:
 - Form of **secured lending** (e.g. secured with future profits)
 - Can be highly subordinated (e.g. tail risk transfer only)
 - Can be delivered as B/S asset (no cost of funding) or cash
 - Can generate **Tier 1 capital**
 - Repayment is contingent, hence **not leverage**
- Readily available from reinsurers
- Private & flexible
- Do not require extensive road shows or shareholder approval
- Execution does not depend on market sentiment of the day
- Market is open whilst e.g. securitization market still only open for cat bonds (short tenor, unwrapped)

Solvency ratio and B/S impact

$$\text{Solvency Ratio} = \text{Available Capital} / \text{Required Capital}$$

Financing solutions can:

- | | | |
|---|--|----|
| a) Provide capital only | reinsurance ¹ , contingent loan | or |
| b) Reduce required capital only | reinsurance ² , hedging | or |
| c) Provide capital <u>and</u>
reduce capital requirement | reinsurance¹ | |

1: with upfront commission

2: without upfront commission

by

- | | |
|------------------------------------|-------------------------------|
| ▪ Transferring/capping a liability | to reduce required capital |
| ▪ Creating an admissible asset | to increase available capital |
| ▪ Providing cash | to increase available capital |

Where does it work?

Distinguish “environmental” from “economic” issues

- Business making losses = economic
- High capital requirements = environmental
- Reinsurance can’t make “economic” problems go away
- Reinsurance can draw benefit from “environmental” issues to help offset “economic” problems – the two are, however, independent

Good candidates of “environmental” issues:

- Ignore lapsation
- Assume 100% lapsation
- Ignore back-end loads
- Ignore risk mitigants
- Ignore excessive future profits
- Ignore absence of risk
- etc.

Case Study 1: US AXXX Financing

- Equity = Assets – Liabilities
- Increase Assets or Lower Liabilities to boost ROE
- Release redundant reserves via Financial Reinsurance
 - E.g. AXXX or XXX in US
 - Favorable to equity analysts

Protective Life is entering into a 20 year transaction....to finance up to \$945mn of its AXXX reserves... The deal could free up \$245mn of capital immediately and increase to \$1bn by 2027.....Our sense is PL could deploy excess capital freed up from the transaction for acquisitions that could be quickly accretive to earnings.

– Barclays, Equity Research, 16 October 2012

Case Study 2: Taiping Financial Reinsurance

Taiping Life has entered into a financial reinsurance contract....whereby the admitted assets (applied in calculation of statutory solvency) would be increased gradually..... It is estimated that the statutory solvency in the second quarter of 2013 would be increased by approximately RMB 4 billion.

– **China Taiping Insurance Holding Company**, 2012
Interim Results Presentation

....Taiping Life entered into a reinsurance arrangement to cede part of its mortality and accident and health risks which will free up around Rmb4 bn of capital.....Solvency concern is removed.... Capital raising and group restructuring is not imminent.... However, the capital raising could be postponed by reinsurance agreement for another 1-2 years. We see this as an important catalyst and maintain our OUTPERFORM

– **Credit Suisse**, 10 September 2012

Case Study 3: AFLAC Japan Surplus Relief

...on the surplus relief transaction... Aflac Japan recognized approximately ¥20 billion in ceding commission in March of this year for new policy issues from April 2011 through March 2012, for three of our products... We estimate this transaction benefited our solvency margin ratio at March 31, 2012 by approximately 20 points.

– **Aflac**, Financial Analysts Briefing, 16 May 2012

Greater Capital Return Visibility... Today AFLAC hosted its investor day. We came away more positive on the stock... we feel that the company has multiple tools at its disposal to improve the solvency margin ratio, including another surplus relief transaction (1Q12 transaction resulted in 20pts of relief)...

– **Credit Suisse**, 17 May 2012

Managing Capital Volatility

Capital Volatility - Causes

- ALM Mismatch
 - Lack of long dated assets
 - Currency mismatch
 - Non-economic prescribed valuation rates
- Statutory Reserving Bases
 - Net Premium Valuations
 - Arbitrary discount rates
- Volatile Markets
 - Interest Rates
 - Equities
 - Credit Spreads
- Decrements
 - Experience worse than expected

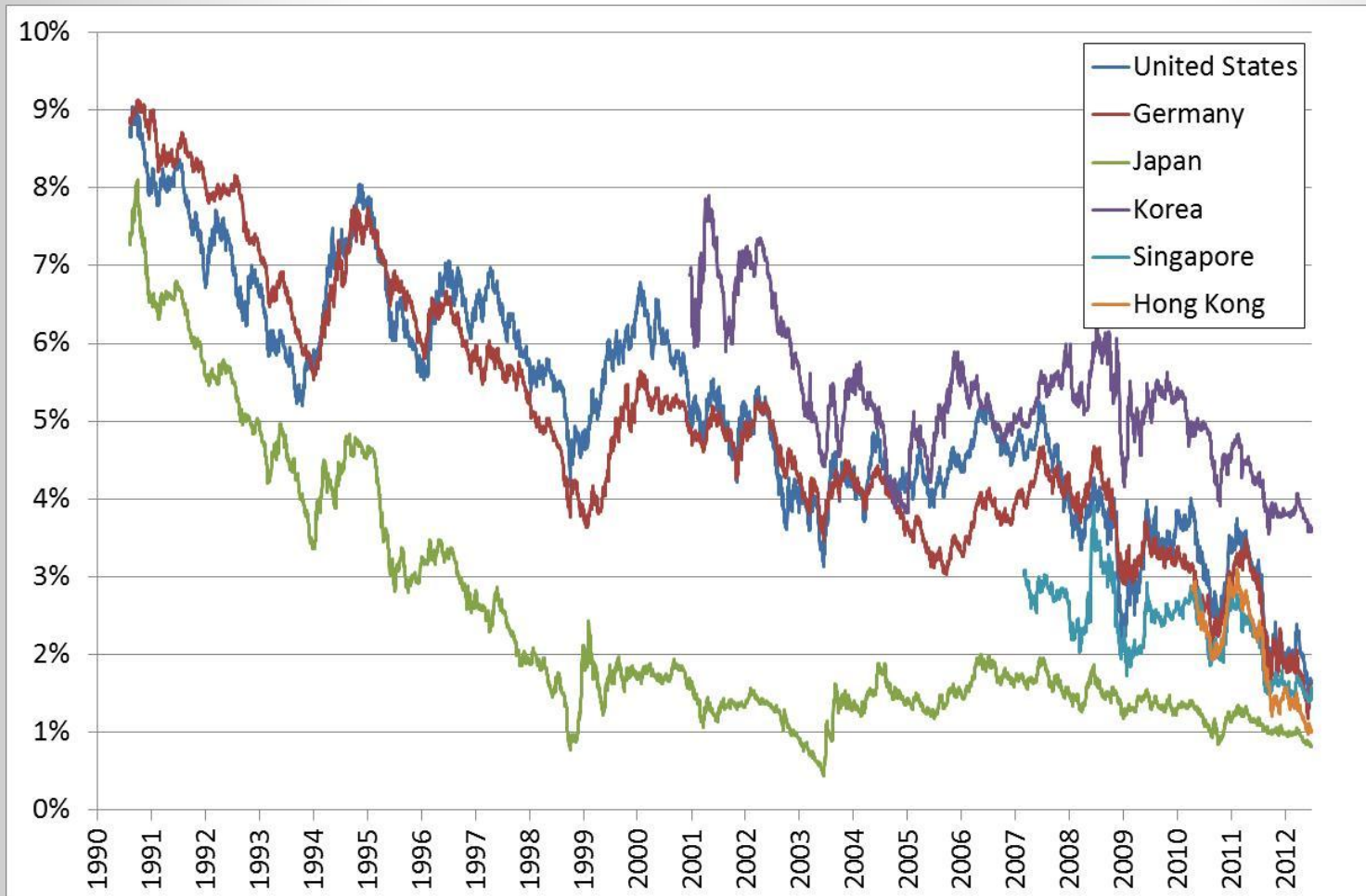
Volatility – VIX

What Volatility?



Interest Rates – USD 10 Government Bond yields

At historical lows in most markets



Managing Capital Volatility

“Just in Time” Capital

- Provide Line of Credit / Capital Facility to meet future capital needs
 - Flexible and efficient source of “just in time” capital
- Reinsurer analyses, prices and reinsures a small quota share of a larger block
- Quota share can then be increased in future to raise additional levels of capital
 - Can be done quickly and quietly, with minimal effort
- Provides certainty of financing size and cost in advance of need

“Just in time” Capital

Provides Line of Credit / Capital Facility that can be used for:

- Solvency Margin management
- M&A financing
- Finance New Product Launch / Market Entry
- Finance other business initiatives

Capital management for new products

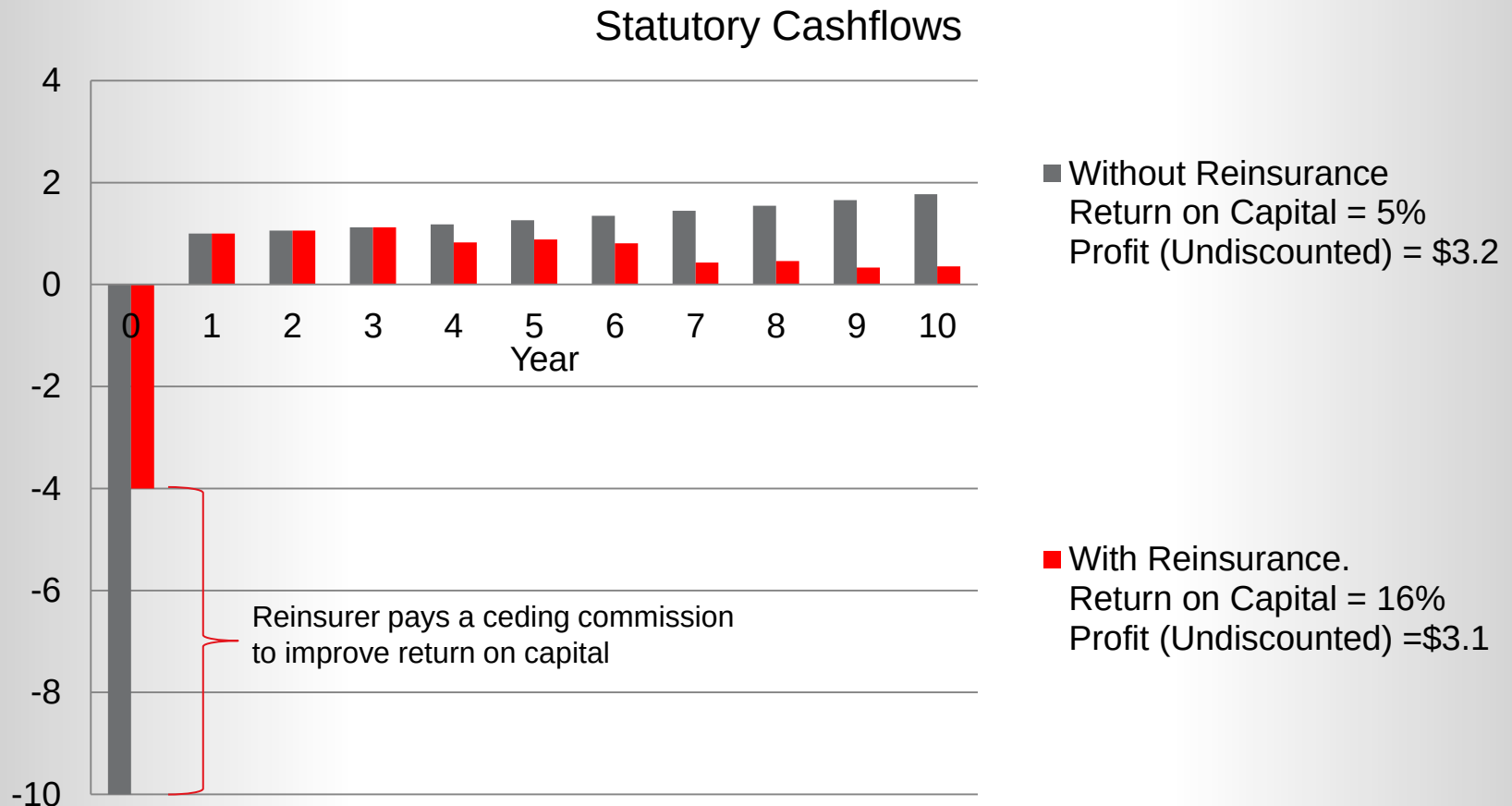
New Product Pricing

Capital Management Strategies

- Change the product design
- Utilize reinsurance to improve ROE allowing for greater returns and/or more competitive pricing:
 - Finance new business strain
 - Reduce redundant capital
 - Recognize some credit spreads

New Product Pricing

Capital Management – Illustration



Conclusions

- Significant changes are coming:
 - Capital market volatility
 - Accelerating regulatory change
 - Growth
 - M&A's

- We have seen over the last 12 months significant increase in transaction volume in Asia and increased acceptance and relevance of financial reinsurance as a capital management tool



Thank you for your attention.