

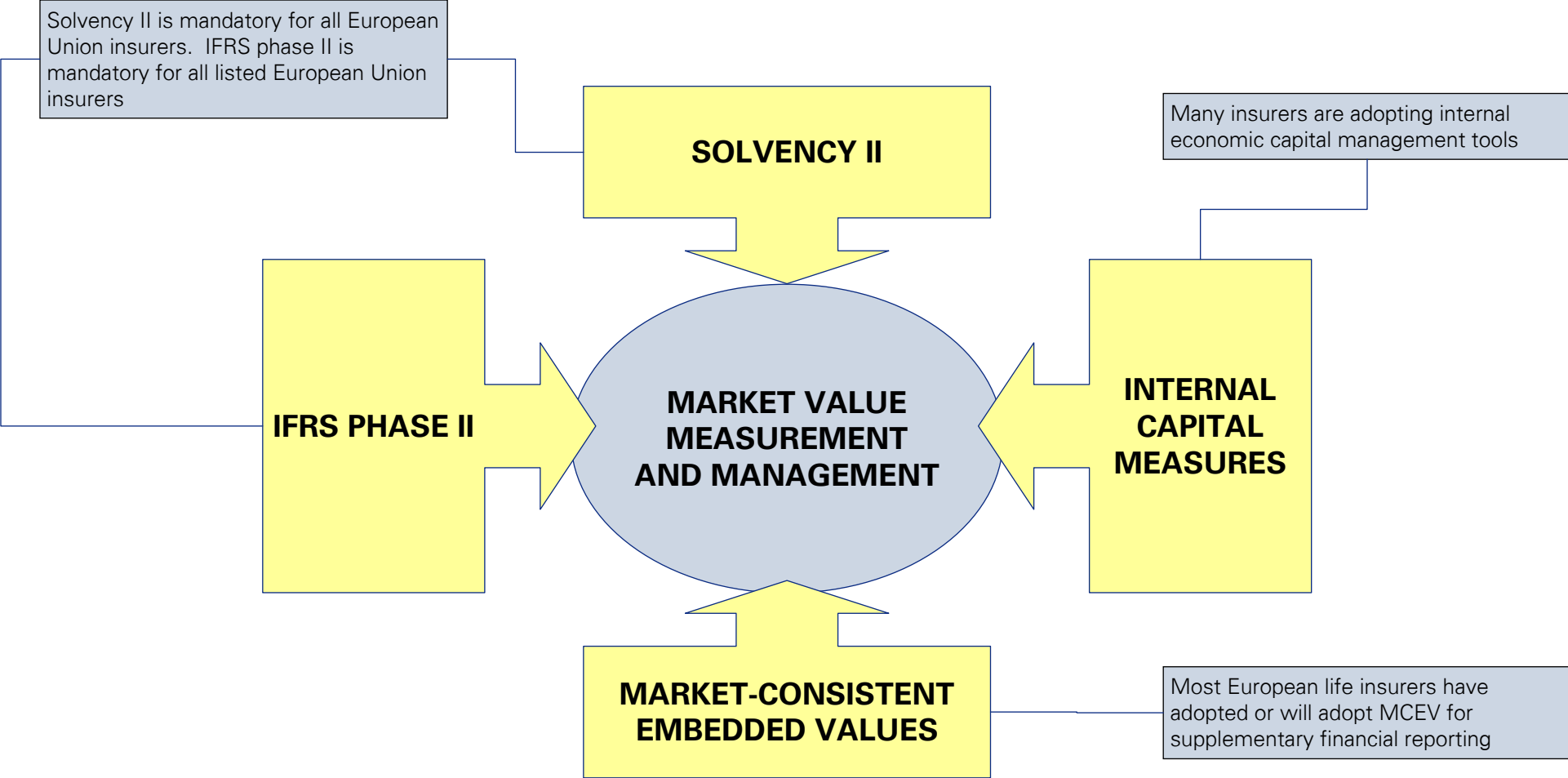
Solvency II as a basis for advanced performance management

Hype or fundamental change ?

FINANCIAL SERVICES

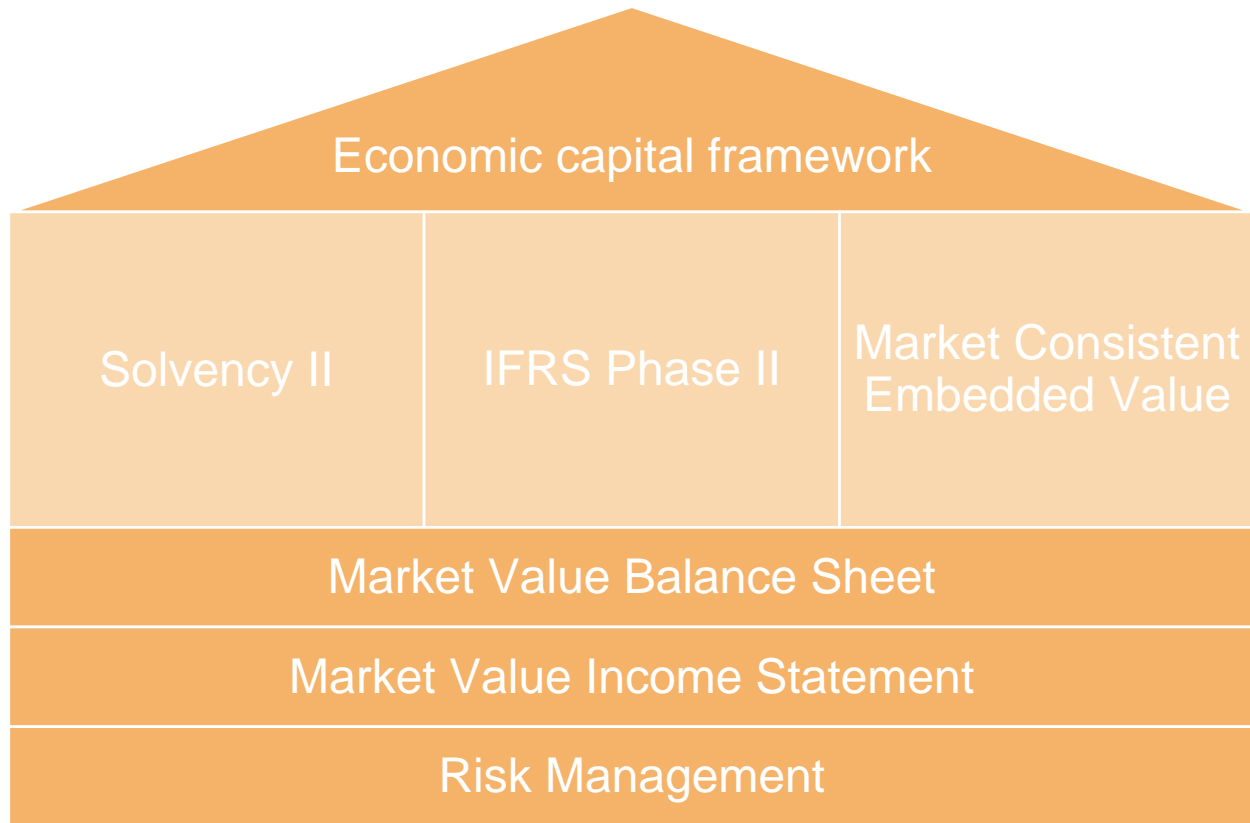
- The main challenge ahead
- The need for an integrated approach
- The impact is profound
- Some take away

There is a mountain to climb in terms of technical change...



INSURERS NEED TO CONSIDER NOW HOW THEY WILL RESPOND TO THESE REQUIREMENTS...

There are many different drivers....



...creating the need for an integrated approach

Objectives...

Business benefits

- Lower required capital due to usage of internal model
- Diversification benefits
- Increase performance by risk selection
- Competitive pricing
- Lower cost of capital by maintaining or improving rating
- Eventually, decrease workload for Finance, Actuary and Risk Management staff

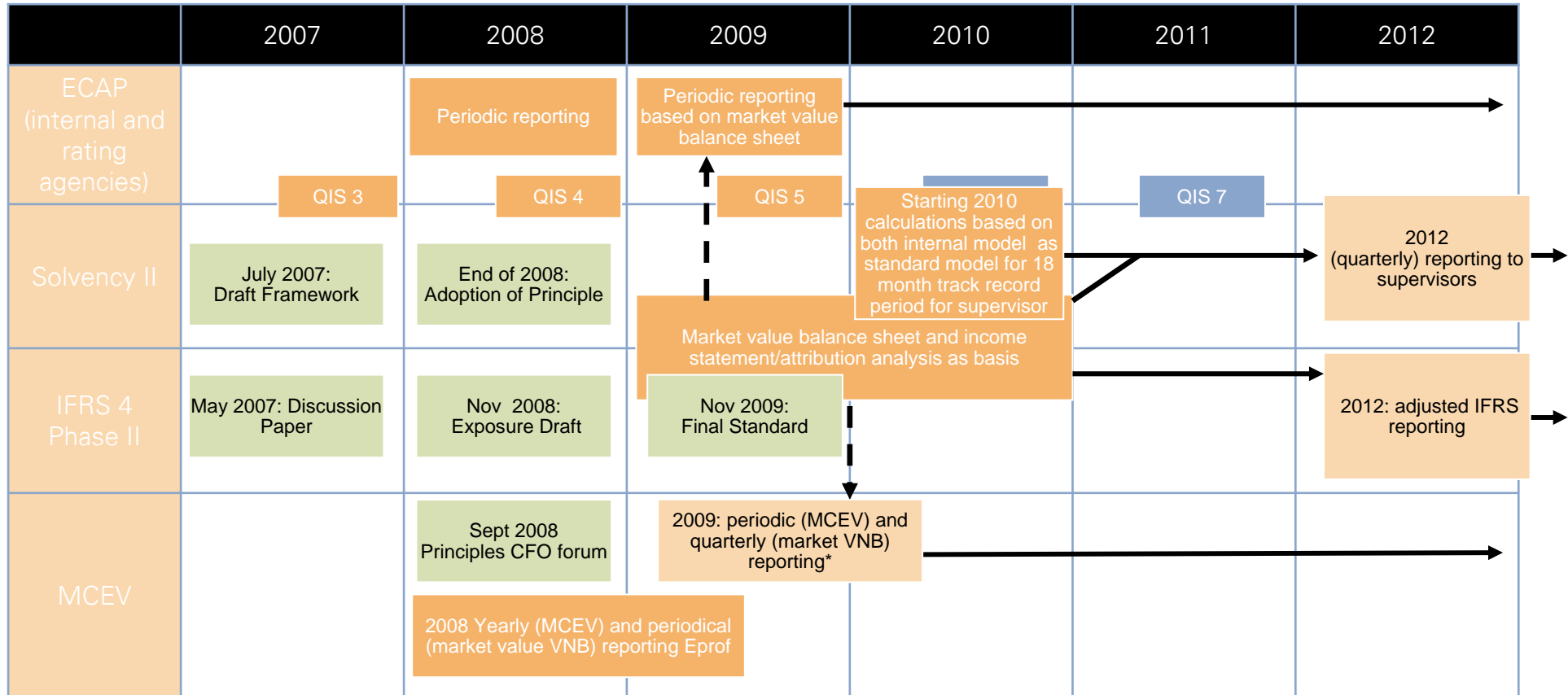
Volume

Compliance

- Compliance MCEV, Solvency II en IFRS 4 Phase II
- Harmonisation financial reporting, solvency management en business strategy
- Embedding in performance management
- Understanding and reconciling results
- Audit trail assumptions, methodologies, data, systems. validation, consolidation, etc.

... balancing business benefits and compliance

Timelines from a compliance perspective



■ Principles/Guidelines

■ Internal reporting

■ 1st external publication date (book year)

* For companies publishing EEV; For CRO members optional starting 2008

The impact is profound ...

- Corporate Governance
- Risk and capital management
- Performance management
- IT systems, data and processes
- Modelling
- Product development and pricing
- Reporting
- Auditability

...it affects every aspect of the business

Corporate Governance

- Need for more central control
- Open up the silo's !
- Changing role of the CFO
- Rising star of the CRO
- Business needs to embrace MVM
- Management incentives to be redesigned
- Great challenge for the Audit Committee !

Risk and Capital Management

- Capital will need to become mobile
- Innovations necessary to manage capital
- Who owns diversification benefits?
- Transparency drives consistency
- Clear risk objectives crucial
- Operational risk is underestimated
- Reputation has no geographical borders
- Do we really understand our risk appetite and exposure?

Performance Management

- Value based management is core !
- Planning and control cycle to be redesigned
- Current reporting process needs complete overhaul
- Whole set of new KPI's to be learned
- Attribution analysis hugely complex
- Culture shock around the corner
- Will we really understand the numbers?

Modelling

- Are we using consistent models?
- How do models change over time and at what impact?
- Are models properly validated? By whom?
- Are we consistent in applying model risk?
- How do we evaluate un-modelled portfolio's?
- how do we apply the diversification credit?
- Do we really understand our models?

IT systems and Data

- It is all about future cash flows, hence about
 - Data availability
 - Data accessibility
 - Data integrity
 - Uniform taxonomy and consistency

- Legacy systems are a real issue

Reporting

- Will be value based management reporting
- Are internal and external reporting aligned?
- The analysis of change of a single portfolio is already difficult ...
- Maintaining reconciliation between various reporting bases is crucial
- MCEV reporting now takes a few months: we now want to fit it in our 10/15 day closing process ...
- Does the concept of materiality change as a result of this all?
- The actuaries understand the balance sheet ...
- ...do we really understand the profit and loss account?

Auditability

- Does audit risk change?
- The black box needs to be opened
- Actuarial competency will significantly drive the audit
- Audit trail of (changing) assumptions needs to be robust
- The essence of the financial statements is much more forwarding looking ...
- Is the future “true and fair”?
- ...can the auditor audit the future?

Product development and pricing

- Existing profitable product may prove to be loss making
- Existing options and guarantees may be too consumer friendly
- Current businesses may have to be exited
- Alternative re-insurance may be sought
- Products will be redesigned and repriced
- Explicit pricing of risk components
- Do we really understand the risks and rewards of our products?

Some take away's...

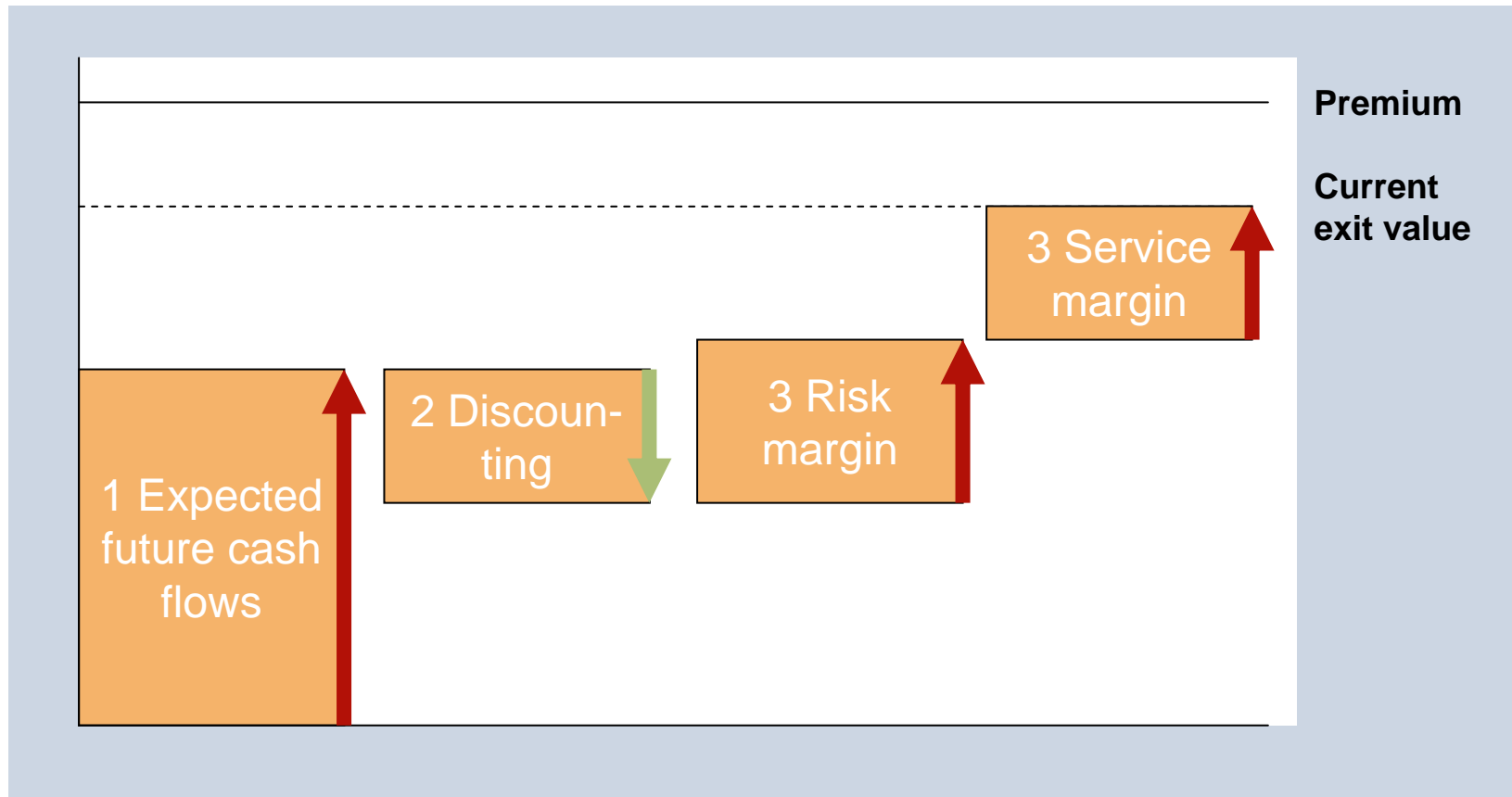
- The future: balancing capital efficiency and capital adequacy
- The driver to make it work: value based management
- Create consistency: align various initiatives
- IT systems and data play an even greater role than before
- It is a Huge effort, but 2012 is around the corner

Together we can make it work !!

Annexes



Three building blocks of the market value liability look very straightforward...

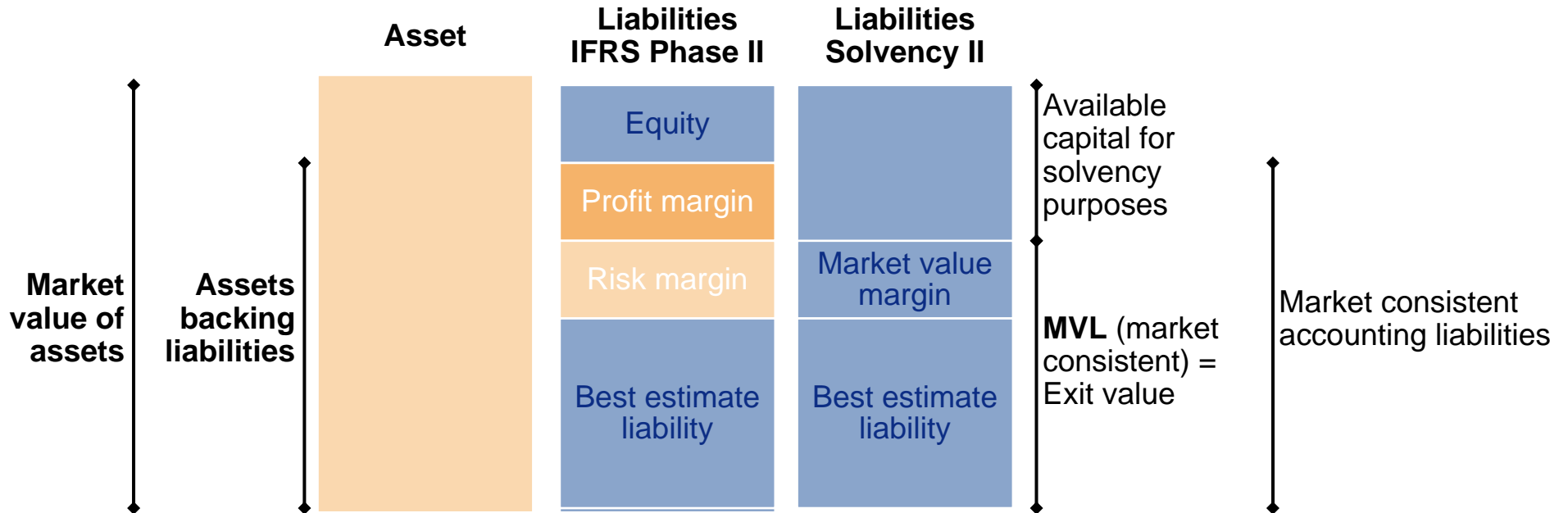


...but in fact trigger very complex issues

What are some of the issues?

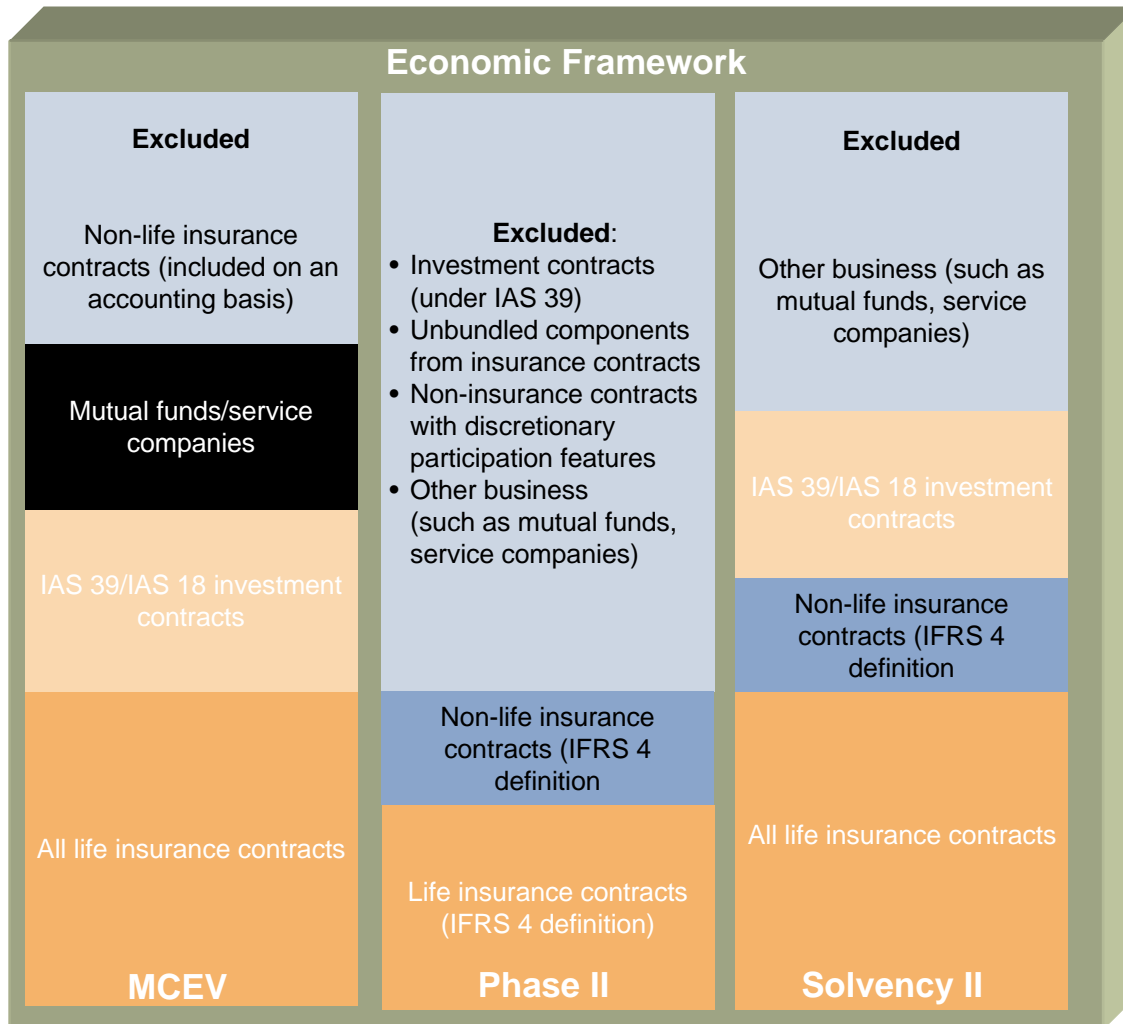
	Expected cash flows	Discounting	Risk margin
Definition	Explicit, unbiased market consistent probability weighted current contractual estimates of future cash flows.	Current market discount rates that adjust the future cash flows for the time value of money.	Explicit unbiased estimate of the margin that is required for bearing risk and providing other services.
Issues	What is market consistent for costs, mortality, morbidity?	Which discount rate should we use? - government bonds? - swap rate?	Should the risk margin be calibrated to the premium i.e. no day1 profits?
	What about post contract premiums? What is a renewal?	Should we include our own credit rating?	Is the margin a shock absorber or a compensation for risk?
	Can we use entity specific experience?	Can we apply our asset base related discount rate?	Is the risk margin part of equity or provisions?
	Do we include discretionary participation cash flows?	Should the discount rate be risk adjusted?	What is the calculation base percentile or cost of capital?
	Are savings elements considered cash flows?		

Traditionally accountants and actuaries have different views...



...and so have CFO's and CRO's

Where are the differences, but more importantly

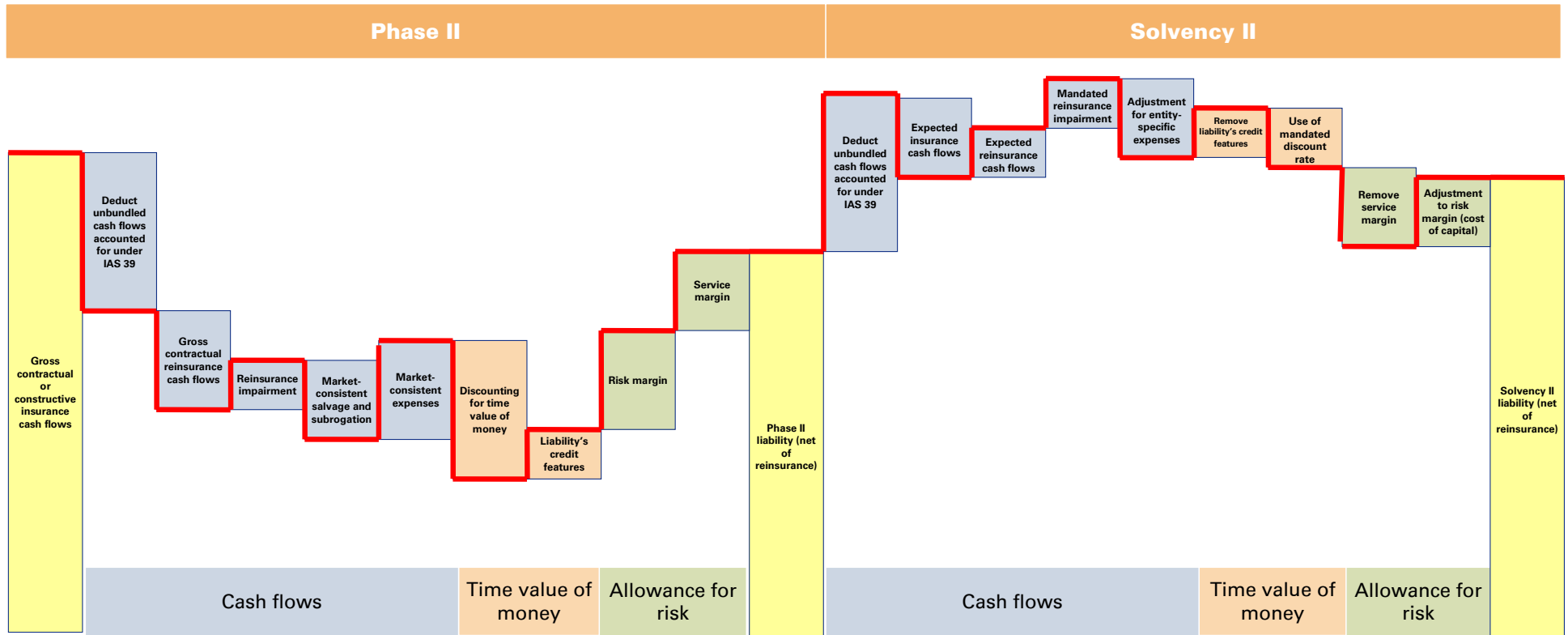


Different populations of contracts

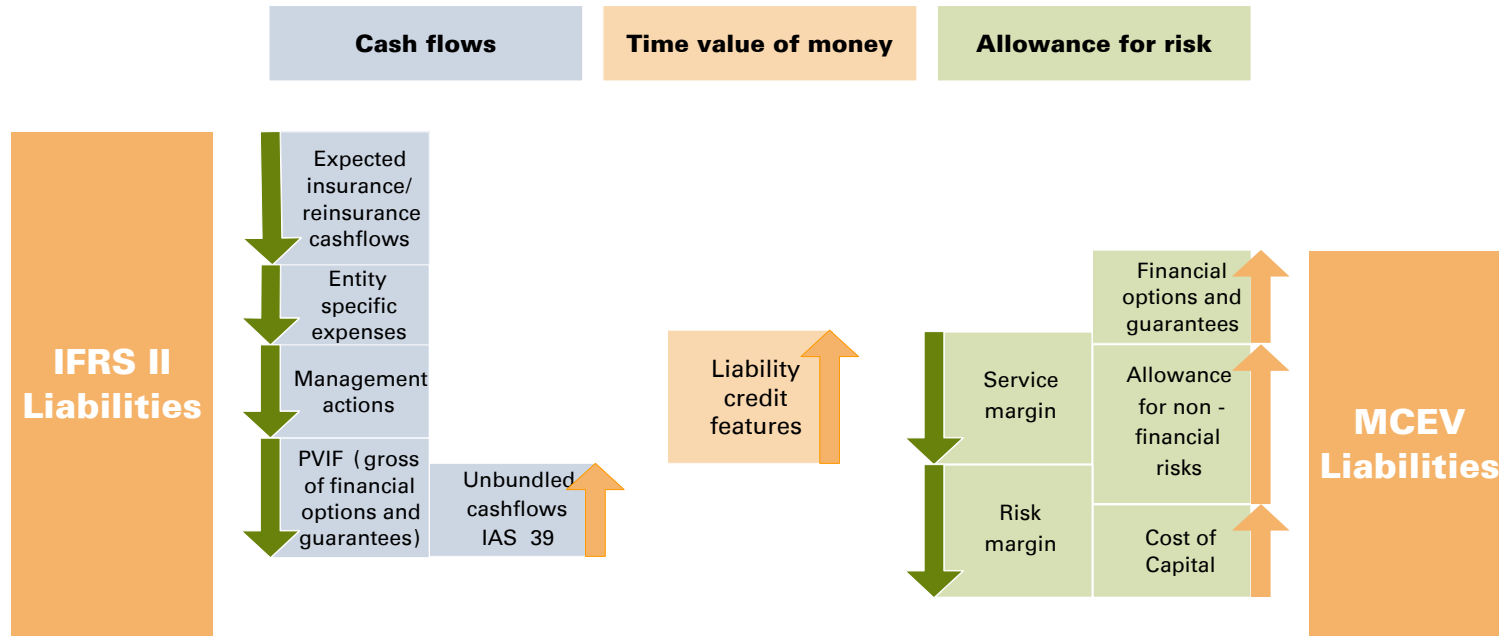
- MCEV comprises all life business (and could potentially include mutual funds and service companies)
- Phase II comprises only insurance contracts, as defined (and contracts with discretionary participating features)
- Solvency II comprises all 'regulatory' insurance business (which will include investment contracts)
- The Economic Framework comprises all business

...where are the commonalities

Therefore maintaining reconciliation is essential (I)



Therefore maintaining reconciliation is essential (II)



Definitions:

IFRS liabilities	= Best estimate liability (using non-entity specific assumptions) + Risk margin + Service margin
MCEV	= Free surplus + Required capital - Cost of capital - Allowance for non-financial risks + PVIF (net of financial options and guarantees)
Free surplus + Required capital	= Market value of assets attributed to covered business - Liabilities (excluding required capital), therefore:
MCEV	= Market value of assets attributed to covered business - MCEV liabilities, with:
MCEV liabilities	= Liabilities (excluding required capital) + Cost of capital + Allowance for non-financial risks - PVIF (net of financial options and guarantees)

Changed demands of stakeholders lead to considerations of insurance management ...

Stakeholders demands

- Risk orientation
- Transparency
- Higher returns

Environmental changes



Insurance managers considerations

- How can I achieve higher returns without taking higher risk?
- How to reduce capital needs while increasing capital adequacy?
- How can I align growth, acquisition and disposal strategies and the best possible performance?
- How to align business planning with risk management and capital process?
- How to structure reinsurance or hedge strategy effectively?
- What kind of tools do we need to take risk adjusted returns into account in making strategic decisions?

... which result in the integration of performance and risk management to be one of the current focus areas in the insurance industry

Different performance management practices

Focus is either on growth or on profitability

Different measurement methods

- Insufficient performance orientation
- Insufficient risk orientation
- Poor supply of information

Trends

Increased reliance of leading insurance companies on sophisticated internal models in order to base management decisions on risk adjusted return measures

A world wide tendency for regulators to encourage better alignment of capital requirements

New focus of rating agencies and regulators on enterprise risk measurement and embedded internal models into business processes

Impact on insurance companies

Insurers will see fundamental changes in the way that their capital adequacy is assessed

Insurance companies managing their business based on integrated view on performance and risk will gain competitive advantages

There will be impact upon the heart of business processes, including calculation of risk-based capital numbers based on stochastic modeling

Many Top Managers have taken the message already ...

...main focus is on sustainable performance... one should not confuse short term profit with long term business success ...

Dr. Perlet CFO Allianz Group, February 2008

What we did was put all of our businesses in a common framework so we could compare the risk adjusted returns ... on an apple to apple basis

Steven Bensinger, GFO AIG Group, 2007

Our focus will be on product innovation ... and ... higher customer service ... without sacrificing ... financial strength ...

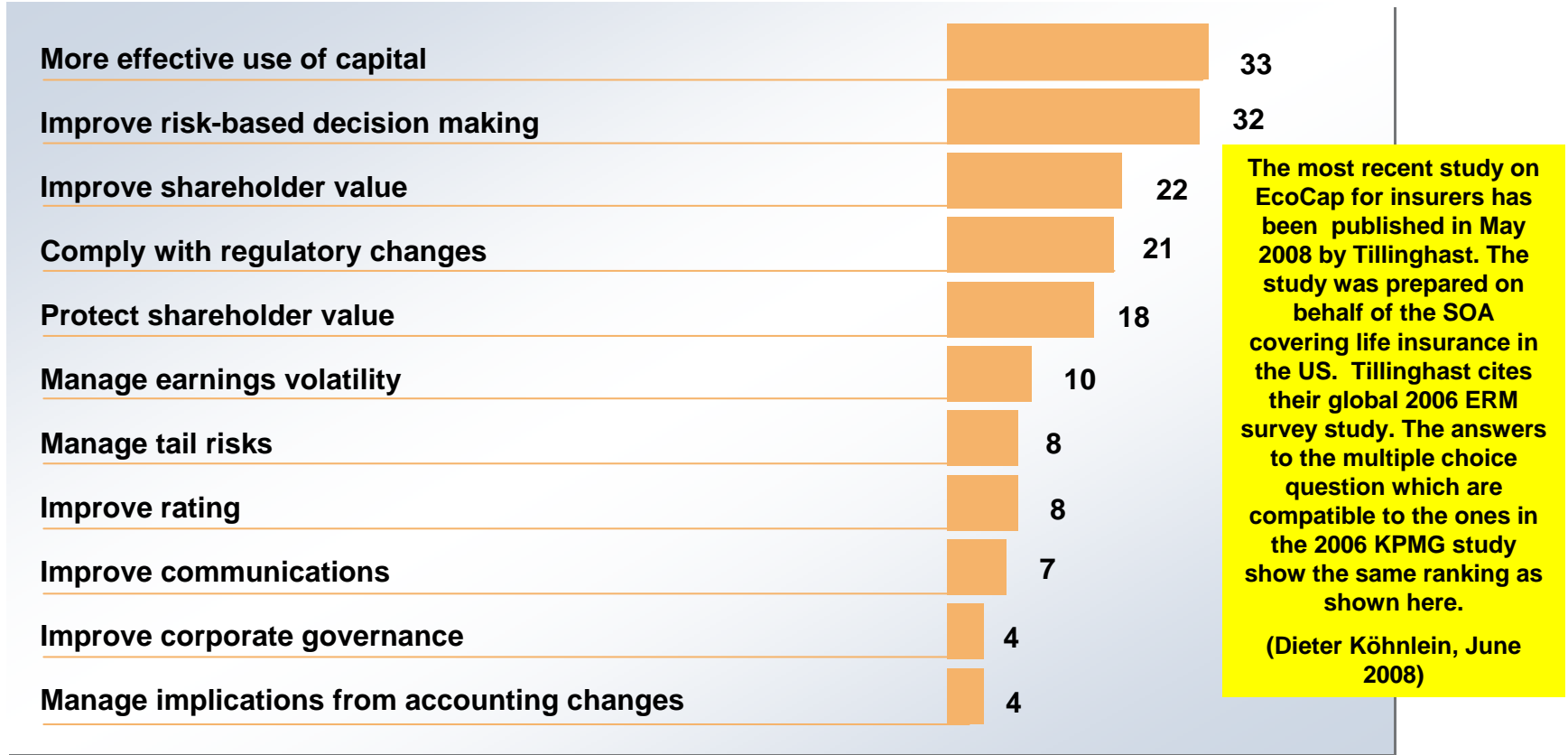
G. Persinotto, Co-CEO Generali Group, September 2007

There is an increasing sophistication in the business world around risk management matters, and the level of common understanding is rising ...

Andreas Grünbichler, GRO Zurich Financial Services, 2007

... performance considerations based on risk evaluation become an integral part of decision making

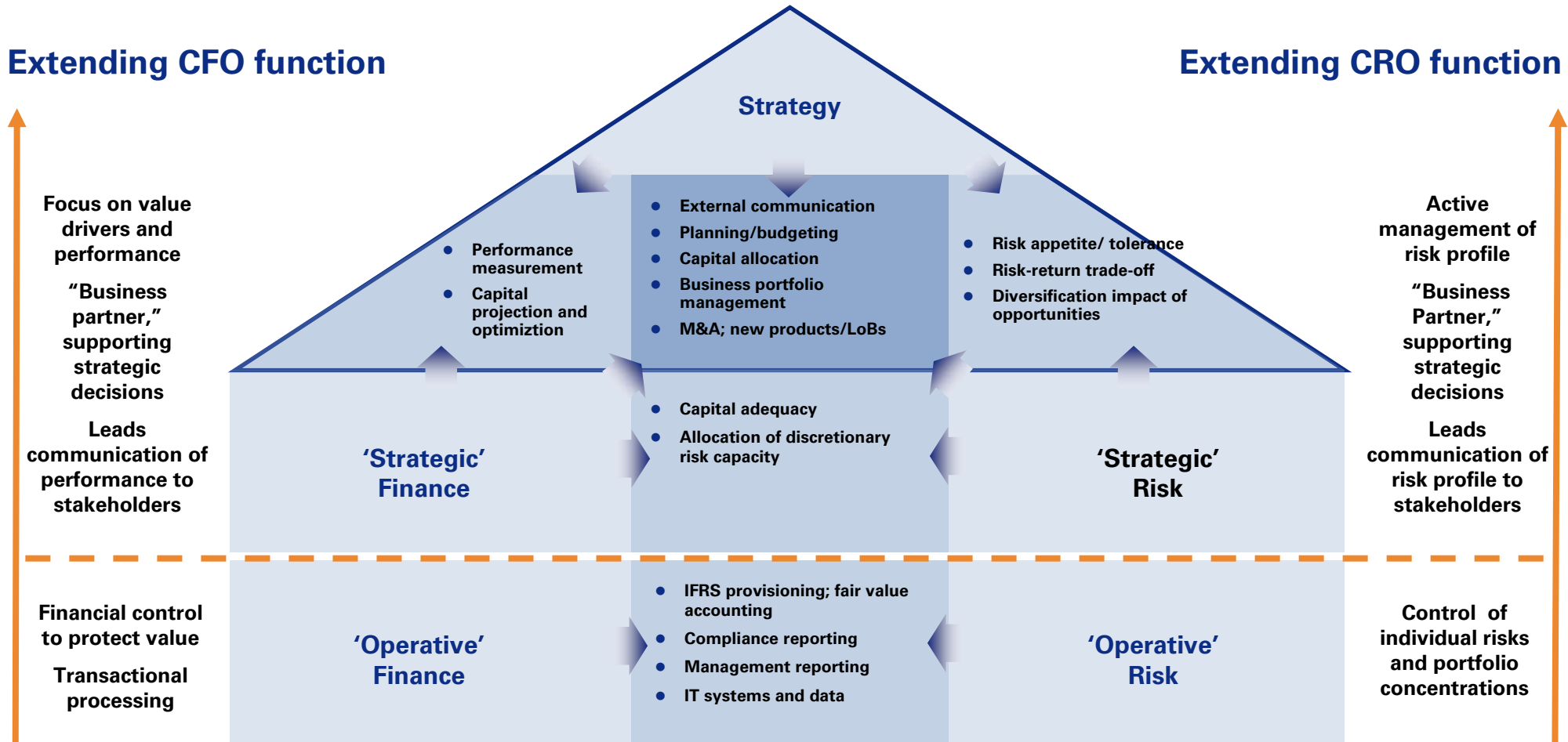
A recent KPMG survey has identified top objectives for improving risk and capital management . . .



* Not all percentages are equal to 100 since this is a multiple choice question
Source: KPMG International, 2006, reviewed 2008

. . . with top priorities being performance issues including improving risk-based decision making

Integrated management of performance and risk addresses key issues at the intersection of risk, finance and strategy



Integration of risk and performance management needs to be considered in many dimensions

In any dimension integration has to be conceptually designed and implemented



Let us now consider what integration means in each dimension and which kind of benefits it generates

Integrated management of performance and risk has many benefits

STRATEGY

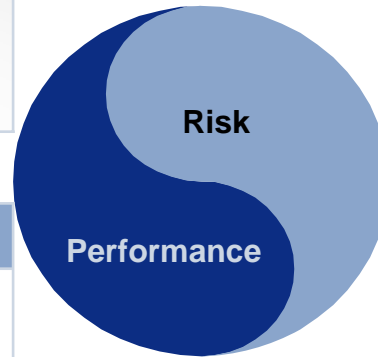
- Business and Risk strategies are strongly linked to each other; business objectives are directly linked with corresponding strategies to deal with related risks
- This enables the company to evaluate alternative business options in a consistent way

„Clear and comprehensive strategy“

RISK TOLERANCE

- The insurers risk tolerance is derived in quantitative terms starting from business strategies
- Related risk tolerance levels for different kind of risks may be used to construct limit systems which translate risk tolerance to the operational level
- This enables business decisions which are consistent with the insurers risk tolerance

„Better informed reinsurance decisions“



GOVERNANCE STRUCTURE

- Realigned objectives of the Risk Management function with shareholder goals result in an close involvement in operational business decisions
- A corresponding governance structure enables growth without negative surprises

„Integrated governance structure is crucial zu pass the ‚Use-test‘ for capital models“

CAPITAL

- The allocation of capital to business units will be based un return and risk considerations simultateously
- By application of an unbiased and accepted riskand performance based measurement approach an internal competition about capital is supported

„Capital is used more effectively“

Integrated management of performance and risk has many benefits

PLANING PROCESSES

- Traditionally a risk perspective is taken often very late in the planning process which may lead to revise the plan on short notice
- Integration of risk considerations in all phases of the planning process helps insurers to increase the effectiveness of the planning process

„ The planning period can be shortened“

BUSINESS PROCESSES

- Traditional focus is on volume which leads insurers sometimes to accept large volume but also high risk insurance business
- A risk and return management framework provides a balanced and consistent approach for decisions in underwriting, investments and reinsurance

„Sustainable profitability of products“

REPORTING

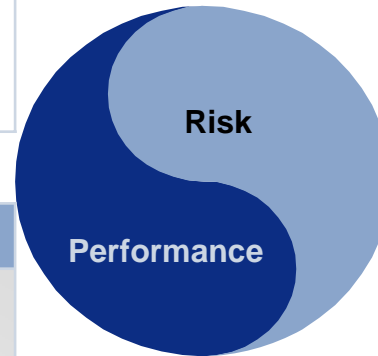
- An aligned timing and content of business and risk reporting combined with market value based integrated risk and performance indicators helps creating a 'risk and performance' culture within the whole organization

„Integrated view on performance and risk “

MODELLING

- Traditionally insurers operate several actuarial models simultaneously (ALM, pricing, reserving, reinsurance, capital allocation,..)
- In an integrated environment these models are based on consistent sets of assumptions about past or future events

„Better informed management decisions“

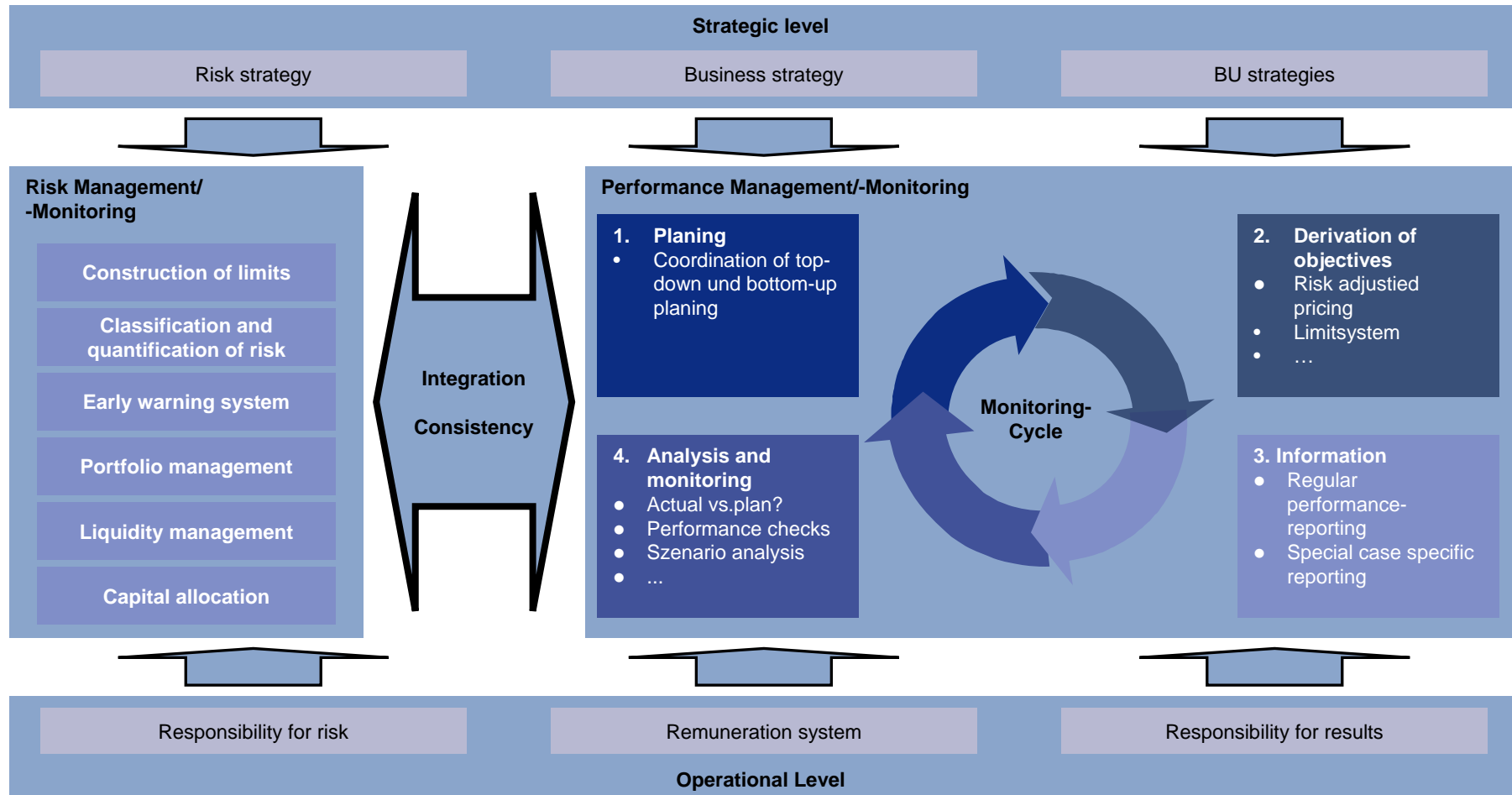


Integrated management is based on market valuation as a common concept for performance and risk

Market Value is the core concept for integration

- **All performance management will be on the basis of *market valuation***
 - Profits reported will be the change in market value of assets -/- change in market value of liabilities
- **Quantitative risk management will be based on *market valuation* as well**
 - The risk management output is internally consistent, accurately co-ordinated and complete, and streamlined to take account of the growing complexity of the available information
- **Indicators used to plan, monitor and manage risk and business are consistently derived by application of *market valuation***
 - Business objectives are fully aligned with risk appetite and worked out in action plans

One major challenge is the design of appropriate management structures linking risk and performance aspects on strategic and operational level





Presenter's contact details

Asheet Ruparelia

KPMG LLP (UK)

+44 (0)20 7311 5340

Ash.ruparelia@kpmg.co.uk

www.kpmg.co.uk

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