



# PRUDENT RISK MANAGEMENT IN TIMES OF UNCERTAINTY

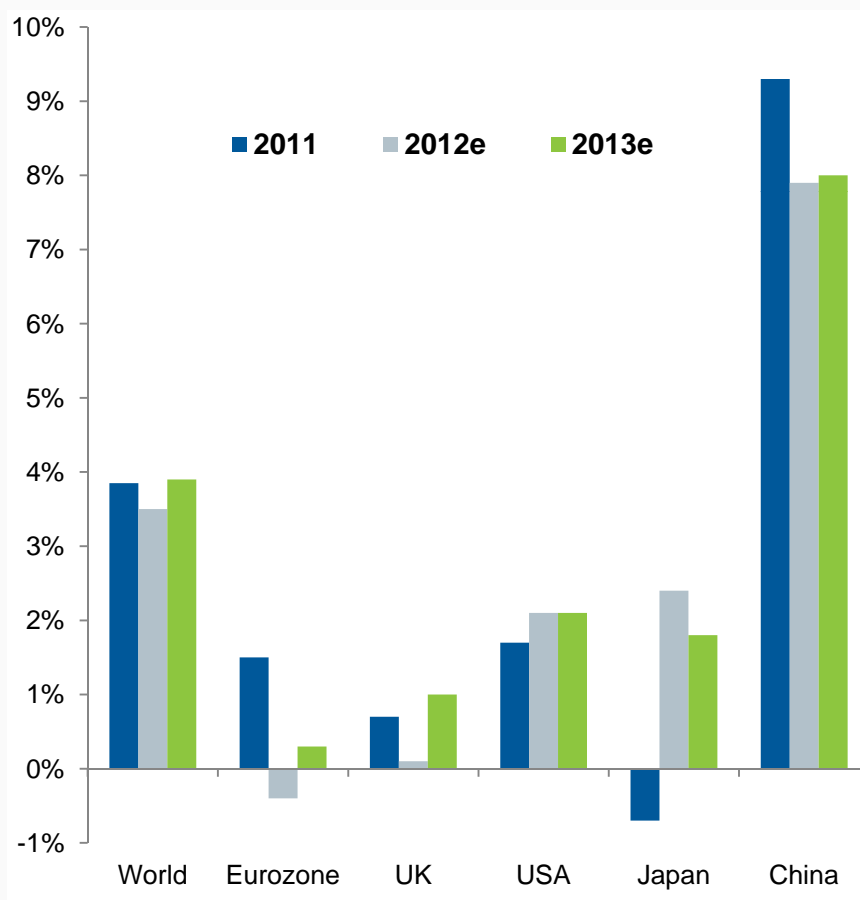
Torsten Jeworrek

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Munich RE 

# Global economy slowing down, outlook sees only modest improvements – highly uncertain environment

## Annual real GDP growth, 2011-2013e



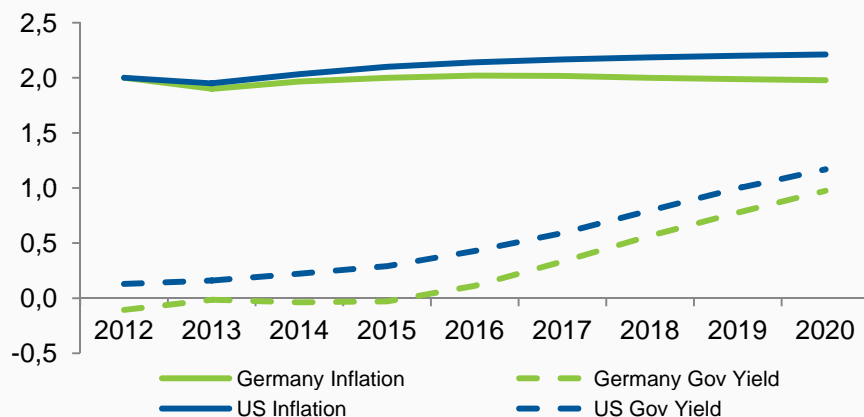
## Potential downside risks:

- Europe**
- Further deterioration in the eurozone, e.g. affecting financial situation of Spain or Italy, or Greek eurozone exit
  - Under such a scenario, recession would probably affect all of Europe
- USA**
- Fiscal outlook highly unclear due to expiring financial programmes (“fiscal cliff”)
  - With restrictive fiscal policy, growth in 2013 would be clearly weaker than anticipated
- Asia / MENA**
- China “hard landing” (i.e. severe economic slowdown resulting from internal factors)
  - Geopolitical conflict in the Middle East with potential negative effects for world economy

# Especially long-lasting low interest rates hurt the business model of the insurance industry

## Implications for (re)insurance

### Yield curves and inflation expectations





- Since mid 2011, nominal interest rates have decreased significantly further, to historical lows for “safe havens”
- Inflation is expected to remain at moderate levels over the next years – even then, this would not be enough to offset yet lower nominal rates in many “safe haven” markets (across the full spectrum of the yield curve)





### Risks are manifold:

- Real rates already negative, higher realised inflation would hurt even more
- Sudden increase in nominal interest rates would weigh heavily on balance sheets:
  - In the last five quarters shareholder equity in the RI industry rose by 11,7% while government bond yields fell by around 180 bp
  - Due to the corresponding rise in bond prices, the investment result (incl. unrealized gains) were one of the main drivers in the rise of shareholder equity
- Outright deflation also possible in the event of further crisis escalation

# Prudent risk management must consider potential risk scenarios ...

		Description	Likelihood	Impact on (re)insurance	Risk level
Government debt	Default of states/ haircuts	<ul style="list-style-type: none"> <li>Inability to pay back debt</li> <li>Governments impose haircuts for investors on their debt</li> </ul>	Risk scenario	<ul style="list-style-type: none"> <li>Medium-term write-offs of bonds in weaker currencies substantially impacting on P&amp;L accounts</li> <li>Refinancing rates could rise substantially, and even default of some players not excluded</li> <li>Higher claims burden, esp. in credit and financial lines</li> </ul>	
	Break-up of eurozone	<ul style="list-style-type: none"> <li>Partial (e.g. several countries) or full break-up</li> <li>Reintroduction of national currencies in exiting countries</li> </ul>	Risk scenario	<ul style="list-style-type: none"> <li>Potentially massive distortion on capital markets (severe impact on economy, (re)insurance)</li> <li>Possible reduction of available capital/decreased buffer due to write-downs or neg. inv. return</li> <li>Reintroduction of new "old currencies" could impact on operating model (e.g. IT, claims)</li> <li>Increased exchange-rate risk</li> </ul>	

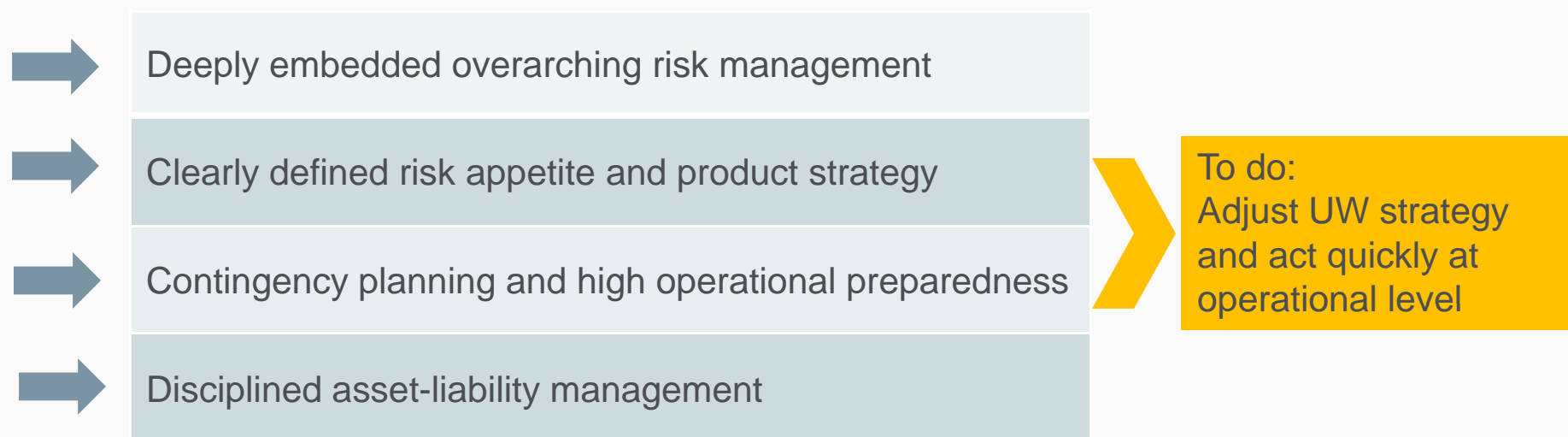
# ... with some scenarios already real

		Description	Likelihood	Impact on (re)insurance	Risk level
Interest rates	Low interest rates	<ul style="list-style-type: none"> <li>Ongoing period of low interest rates in “safe haven” countries</li> </ul>	Already reality	<ul style="list-style-type: none"> <li>Appreciation of bonds</li> <li>Less inv. income for new assets</li> <li>Higher market risk to earn spread</li> <li>Life: Challenge due to guarantees</li> </ul>	
	Negative real interest rates	<ul style="list-style-type: none"> <li>Inflation exceeding nominal interest rates in selected countries</li> </ul>	Already reality	<ul style="list-style-type: none"> <li>Higher claims costs only partly compensated for by investment income, esp. for longer-tail and asset-intensive business</li> </ul>	
Inflation	High inflation	<ul style="list-style-type: none"> <li>Medium- to long-term period of sustained inflation</li> </ul>	Risk scenario	<ul style="list-style-type: none"> <li>Top/bottom-line pressure since insurance spending focused</li> <li>Higher absolute claims amount, esp. in longer-tail casualty lines</li> </ul>	
	Deflation	<ul style="list-style-type: none"> <li>Inflation rate falling below 0% for an extended period of time</li> </ul>	Risk scenario	<ul style="list-style-type: none"> <li>Overcapacity in PI market</li> <li>Potential downgrades/defaults – consolidation</li> <li>Pressure on some LoBs, e.g. credit</li> </ul>	

# The business model must cope with continued unpredictability – Dealing with uncertainty key to success

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## Mitigating options



**Mitigating options to detect challenges and capitalise on opportunities at an early stage**

# Adjust underwriting strategy – Reduce impact of economic scenarios




Risk appetite and product strategy <i>(examples)</i>	✓
<b>Review segment strategies and risk appetite</b> <ul style="list-style-type: none"><li>▪ Definition of strategies with specific risk potential, e.g. credit, financial institutions, ...</li><li>▪ Life: Modification of savings products and guarantees</li><li>▪ Property/Casualty: Definition of risk appetite for reserve-intensive business</li></ul>	
<b>Adapt underwriting principles to cope with high inflation</b> <ul style="list-style-type: none"><li>▪ Evaluation of impact on different types of business (e.g. reserve intensity, development pattern, tail ...)</li><li>▪ Transparency on exposure and future inflation risk assessment</li></ul>	
<b>Adapt models/parameters</b> <ul style="list-style-type: none"><li>▪ Review of capital intensity, e.g. due to higher reserve or counterparty risk</li><li>▪ Evaluation of terms and conditions, e.g. deposits, currency clauses</li></ul>	
<b>Retrocession strategy</b> <ul style="list-style-type: none"><li>▪ Evaluation of options to transfer reserve risk</li><li>▪ Increase commutation activities</li></ul>	

# Act quickly on operational level – Mitigate economic risk



Contingency planning and high operational preparedness <i>(examples)</i>	✓
Impact analysis on group, segment and LoB depending on economic scenario	
Set up task force for capital management strategy (e.g. strategic asset allocation, circumvention of “home bias”)	
Structured liquidity crisis planning	
Set up IT task force (e.g. implementation of new currencies, implications on financial statements)	
UW: Exposure limits for critical countries	
UW: Assessment of political risk and social unrest	
UW: Review of currency clauses in contract wordings	
...	

 Operational preparedness makes it possible to act in underwriting and in capital management even in high-risk scenarios



# Industry must concentrate on returns from core business

## Key takeaways

Economic environment will stay challenging, especially low interest-rate environment and capital market volatility

Thus focus on value creation on the liability side is paramount – no alternative to prudent technical underwriting

Reinsurers' capital base artificially inflated – sudden increase in nominal interest rates would weigh heavily on balance sheets

Insurance and reinsurance industry has to reflect breadth of levers to create value in these times, e.g. market/product strategy, pricing and wording, disciplined ALM

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