



# BADEN-BADEN 2012: PROFITABILITY IS WHAT COUNTS FOR INSURERS AND REINSURERS

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# Current challenges for the insurance industry

Economic environment, especially the low interest rates and the volatility of the capital markets

Globalisation, increased accumulation risks

Rise in weather-related natural catastrophes – climate change plays a part

Technological advances, new risks, e.g. cyber risks

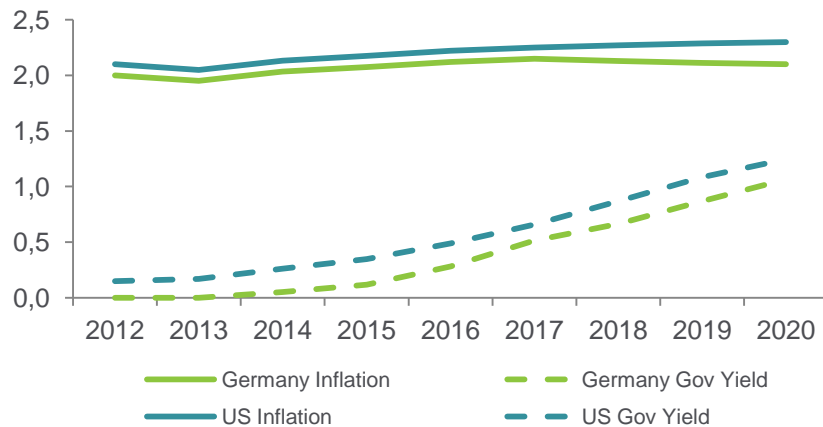
Changes in the regulatory framework

Societal changes, demographic change

# Persistently low interest rates impact the business model of the insurance industry

## Implications for (re)insurance

### Yield curves and inflation expectations



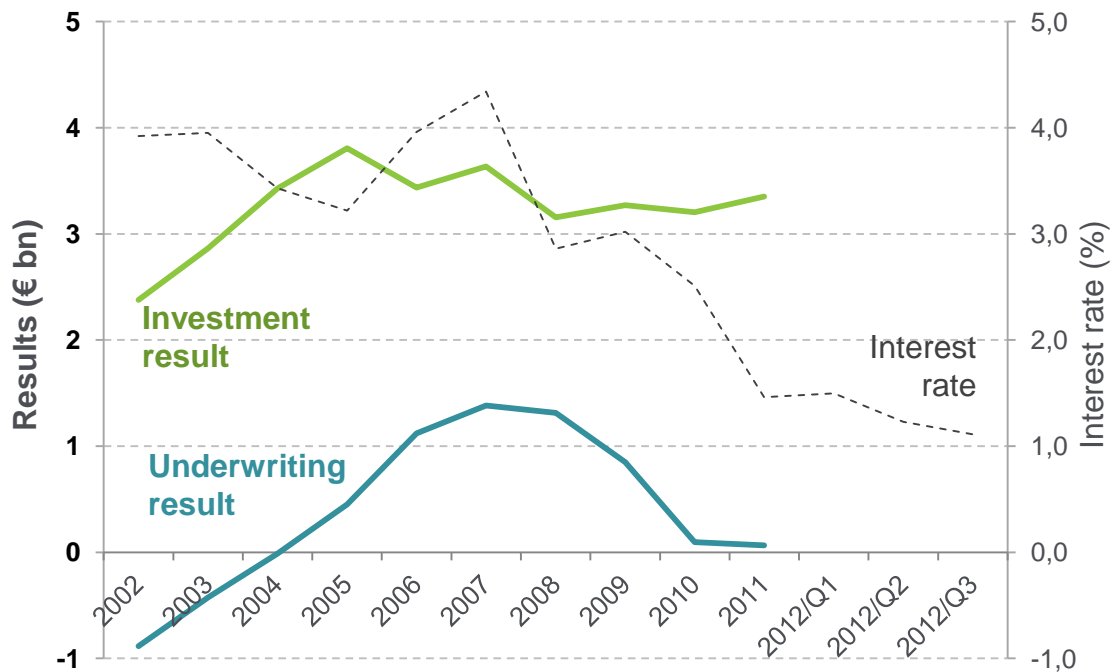
- Since mid-2011, nominal interest rates have decreased significantly, to historical lows for “safe havens”
- Inflation is expected to remain at moderate levels over the next few years – even then, this would not be enough to offset yet lower nominal rates in many “safe haven” markets (across the full 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 reinsurance industry rose by 11.7% to the end of q2/2012 while government bond yields fell by around 180 bp
  - Due to the corresponding rise in bond prices, the investment result (incl. unrealised gains) was one of the main drivers in the rise in shareholder equity
- Outright deflation also possible in the event of further crisis escalation

# Underwriting results increasingly under pressure in the German market – risk-commensurate pricing is key

## Investment result vs. underwriting result



Analysis derived from individual company figures, representing ~60% of German market. Underwriting result incl. equalisation provision (obligatory reserve for German P&C insurers). Investment result curve adjusted for exceptional effects. Interest rate curve based on yields on outstanding German Federal debt securities.

- Low-interest-rate environment not fully reflected in investment results so far
- Sufficient capitalisation within German Non-Life market ( $\emptyset$ SI ratio ~250%)
- Underwriting result increasingly under pressure since 2007
  - Measures required to compensate overall result effects
  - Generally limited options for further cost measures
  - **Risk-commensurate pricing and stringent underwriting**

# Underwriting under additional pressure due to cost inflation

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Rate of inflation for long-term care costs in excess of 9% per year  
(care costs make up 40% of the average claim)

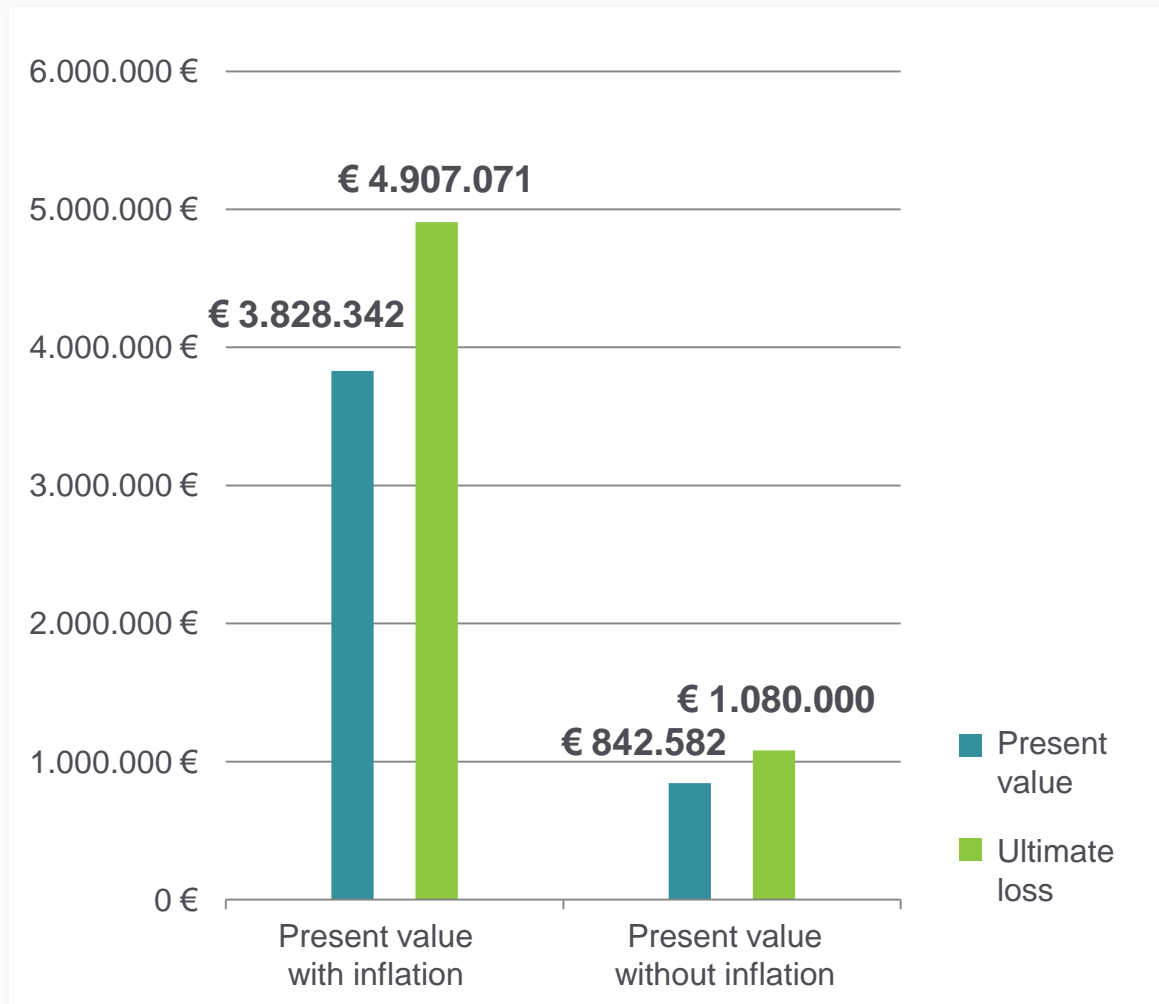
Loss-of-earnings costs increase by over 11% per year.

Damages awarded for pain and suffering rise by over 3.6% per year.

**By contrast:** Rate of inflation of consumer price index below 2% per year.

Source: 2010 German Insurance Association (GDV) study on the inflation risk for severe bodily injury in healthcare.  
The rates of inflation outlined relate exclusively to claims with settlement expenses exceeding €50,000.

# Reserving requirements for long-term care costs for a settlement period of 30 years



- Assumed requirement of €1,200 per month
- Discount rate as per reserve ordinance = 1.75%
- Inflation rate: 9% p.a. according to the German Insurance Association study
- The above period is thus under-reserved by 78%

→ **Growing risk of inflation for severe bodily injury claims due to rising costs in the healthcare sector greatly underestimated in reserving**

# There is no alternative to value creation in core business

- Sustained low interest rates impact the business model of the insurance industry
- Reduced investment income
- Cost inflation in the healthcare sector poses an additional challenge for insurers
- Technically adequate underwriting is the key to successful business
- The insurance industry must generate income in its core business

**Focus on profitability in core insurance business essential**

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