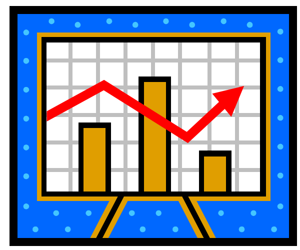
How ERM is consistent with EV Reporting

ERM Symposium

Washington, DC

CS-3



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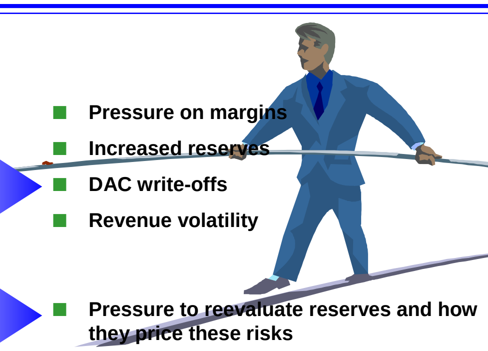
July 30, 2003

Tillinghast - Towers Perrin

Recent events have posed serious challenges for insurers and heightened their appreciation of risk



- Plunging interest rates
- Volatile stock market
- Heightened credit losses
- Slow economic recovery

→

- Pressure on margins
- Increased reserves
- DAC write-offs
- Revenue volatility

- Threats of losses from terrorism
- Escalating tort liability costs from asbestos, health care professional liability and D&O liability

→

- Pressure to reevaluate reserves and how they price these risks

- Financial scandals in other industries

→

- Greater focus on corporate governance, transparency and disclosure

Due to the spotlight on corporate governance, insurers are emphasizing transparency and disclosure

Corporate Governance Failed

— *Business Insurance*, July 15, 2002

Corporate Governance In The Spotlight

— *Pensions & Investments*, November 25, 2002

Ten New Commandments For Corporate Governance

— *ABA Banking Journal*, November 2002

Corporate Governance: Back On The Agenda

— *European Venture Capital Journal*, October 1, 2002

Building Investor Confidence With Corporate Governance

— *Institutional Investor*, September 2002

U.K. Corporates Wrestle With Governance Issues

— *Corporate Finance*, October 2002

Stakeholders are really interested in only two things:

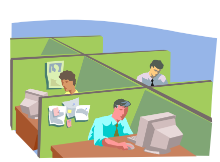
- How a company creates value
- What risks the company takes to create that value

But the stakeholders are a diverse group:

Policyholders

Investors

Rating Agencies



State Insurance Departments

Best practice companies are improving financial transparency by:

- Developing a financial reporting system that gives them a clearer understanding of the business
- Linking it to an overall framework for enterprise risk management (ERM)

Management Wants to Avoid Unpleasant Surprises!

Embedded Value (EV) is an important tool used by best practice companies

- To address stakeholders' primary concern — how a company creates value — best practice companies are evaluating performance using value-based techniques like EV
- Questions about GAAP accounting practices and demands for greater transparency have led to increased interest in EV reporting

Best practice insurers have a reporting system that measures and reports shareholder value

What is EV?

A method of reporting financial results that clearly articulates where companies are adding value

Why use it?

To quantify risk and value creation

To help communicate with stakeholders

To make decisions about capital deployment

To reward good performance

Who is using it?

U.K. and Canadian insurers, multinationals

Increasingly, U.S. life insurers

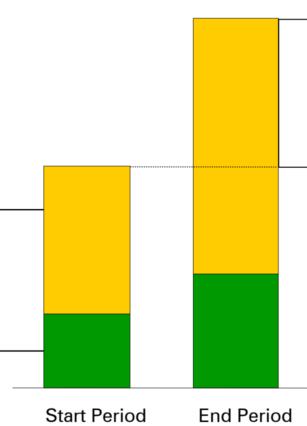
Embedded value measures the "economic" performance of a life insurer over a period of time

Value of In-force Business

- P.V. of statutory book profits after tax, less cost of target surplus
- Based on best estimate assumptions

Adjusted Net Worth

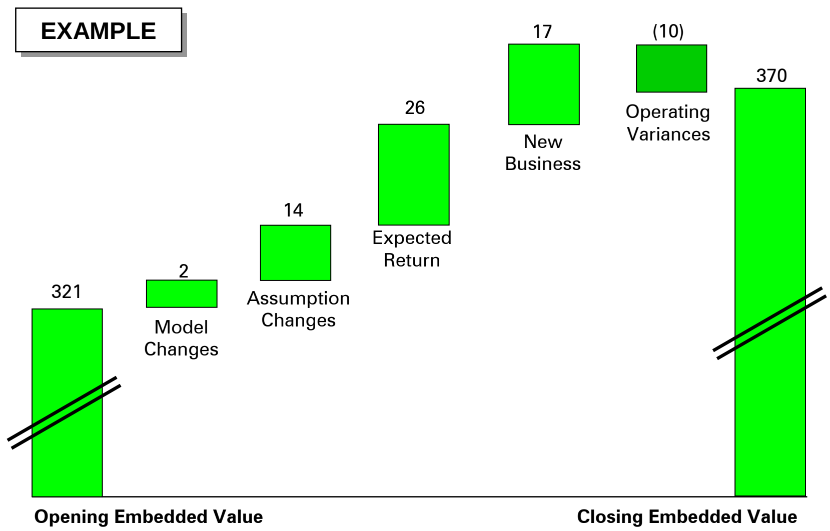
- Value of excess assets above in-force liabilities (target surplus at book value, free surplus at market value)



Change in Embedded Value

- Expected return on opening embedded value
- Value of new business (VNB) sold
- Variance on in-force value
- Capital movements

An analysis of embedded value earnings reveals the underlying drivers of value



Many insurance companies consider EV a better measure of performance than US GAAP

- It is the most widely used and understood technique for evaluating economic performance
  - Establishes link between pricing and valuation assumptions
- It offers advantages over GAAP and statutory accounting by answering two key questions:
  - Is the company writing profitable new business?
  - How well is it managing in-force business?
- EV reporting is currently being enhanced to:
  - Accurately allow for the cost of credit risk or market risk for mismatched products
  - Account for the cost of embedded options
- EV is increasingly used for incentive compensation plans
  - VNB is used for short-term plans
  - EV (or rolling average) used for long-term plans

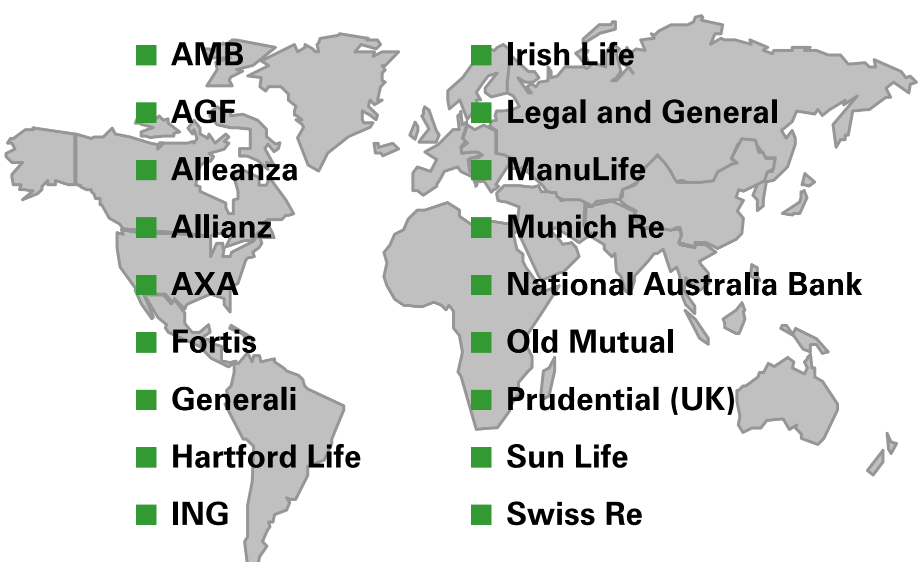
An Embedded Value incentive plan can be structured in a variety of conventional forms, either annual or long-term

- As a *target performance plan*

Growth vs. Objective	Payout vs. Target Award
120%	200%
100%	100%
70%	50%

- As a *phantom share option/appreciation unit*
  - Total growth = payout per share
  - Growth over hurdle rate = payout per share
- As a *phantom restricted share*
  - Total share value at end = payout/share
  - Grant shares instead of cash
- To fund a *bonus pool*
- As a *deferral medium*

Although not yet widely used in the U.S., major companies worldwide report embedded values

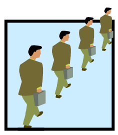


- AMB
- AGF
- Alleanza
- Allianz
- AXA
- Fortis
- Generali
- Hartford Life
- ING
- Irish Life
- Legal and General
- ManuLife
- Munich Re
- National Australia Bank
- Old Mutual
- Prudential (UK)
- Sun Life
- Swiss Re

Embedded value is just one part of financial reporting best practices

Identifying the drivers of a company's market value and developing internal metrics that provide a clear line of sight from market value back to operational drivers

Developing a well-rounded performance scorecard for internal use and embedding it in the organization



Adopting methodologies and techniques that align external financial reporting with shareholder value-driven concepts and drivers

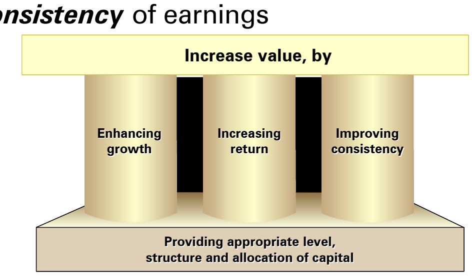
Communicating openly and effectively with regulators, rating agencies and the investment community

ERM is a key tool used by best practice companies to avoid unpleasant surprises

ERM is a rigorous process to optimize the dynamic relationship between risk and value throughout the insurance enterprise

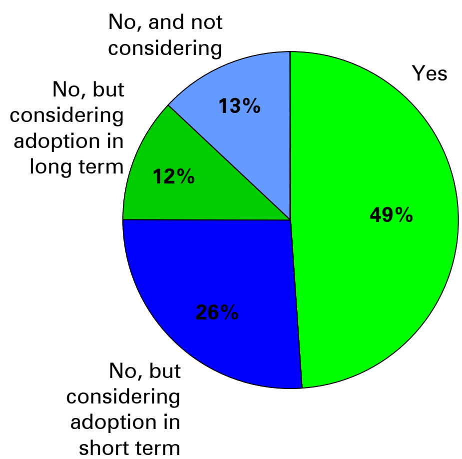
Enterprise value is driven by:

1. Providing the appropriate level, structure and allocation of ***capital***
2. Enhancing ***growth*** opportunities
3. Increasing ***return*** on capital
4. Improving ***consistency*** of earnings



Companies are increasingly adopting ERM because it is good business practice

Is ERM in Place in Organization?



Of the companies surveyed:

74% say their ERM process has been in place for two years or less

38% have a Chief Risk Officer (CRO)

38% have an ERM Committee

Source: Enterprise Risk Management in the Insurance Industry 2002 Benchmarking Study, Tillinghast – Towers Perrin.

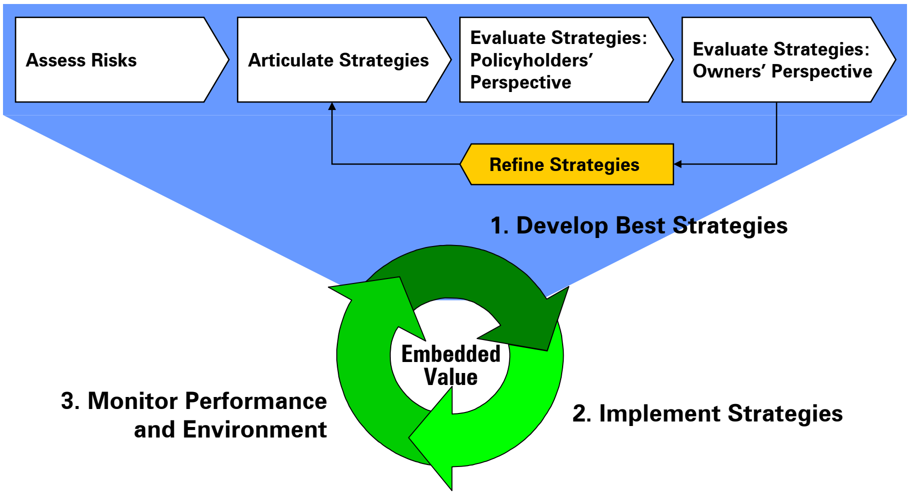
ERM can help companies address their most pressing business issues

Top Ten Business Issues	% Saying ERM Will Help Address Issue
1. Earnings growth	77%
2. Revenue growth	55%
3. Return on capital	89%
4. Competition	55%
5. Earnings consistency	92%
6. Strategic/operational planning	97%
7. Pricing adequacy	77%
8. Capital management/allocation	92%
9. Expense control	50%
10. Asset/liability management	93%

Source: Enterprise Risk Management in the Insurance Industry 2002 Benchmarking Study, Tillinghast – Towers Perrin.

Life insurers need a practical, company-specific ERM process supported by embedded value

The RiskValueInsights™ Process has three stages



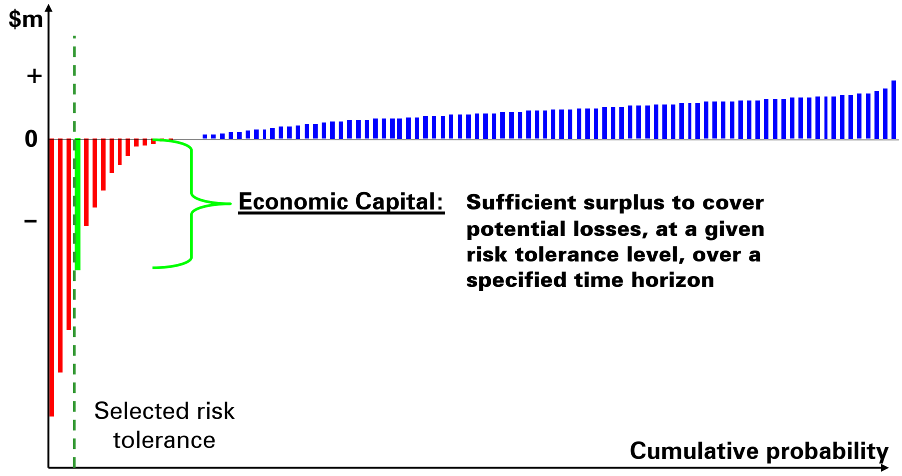
Source: Tillinghast's *RiskValueInsights™: Creating Value Through Enterprise Risk Management — A Practical Approach for the Insurance Industry*.

Used with EV and ERM, stochastic modeling provides the link between risk and value

- Expresses the interaction of financial and operational risks and strategies in terms of bottom-line financials
- Needed to determine:
  - volatility of future earnings
  - economic capital
  - current/future reserving needs
  - meaningful risk-adjusted return targets
  - proper cost for embedded options/guarantees
- Enables implementation of market-consistent product design and pricing
- Helps understand the implications of operating assumptions being wrong

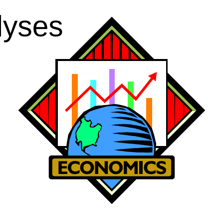
Example: Determining Economic Capital for selected risk tolerance level

Ranked distribution of present values of future profits from each simulation



Increasingly, companies apply ERM methodology in EV calculations

- Larger companies are moving away from using regulatory/rating agency capital, and are using economic capital instead
  - Supported by the rating agencies
- Proper measurement of risk for options / guarantees embedded in products
  - Includes GMDB, GMIB, GMWB, secondary mortality guarantees, credit risk, etc.
- Including stress-testing in EV sensitivity analyses
  - “EV at Risk”



In conclusion, EV and ERM will help insurers achieve financial transparency

- Stakeholders will be better able to understand the business and place appropriate value on it
- Management will have the information needed to make better strategic and operational decisions
- Performance is adequately rewarded