MCEV: A practical perspective

Presented by

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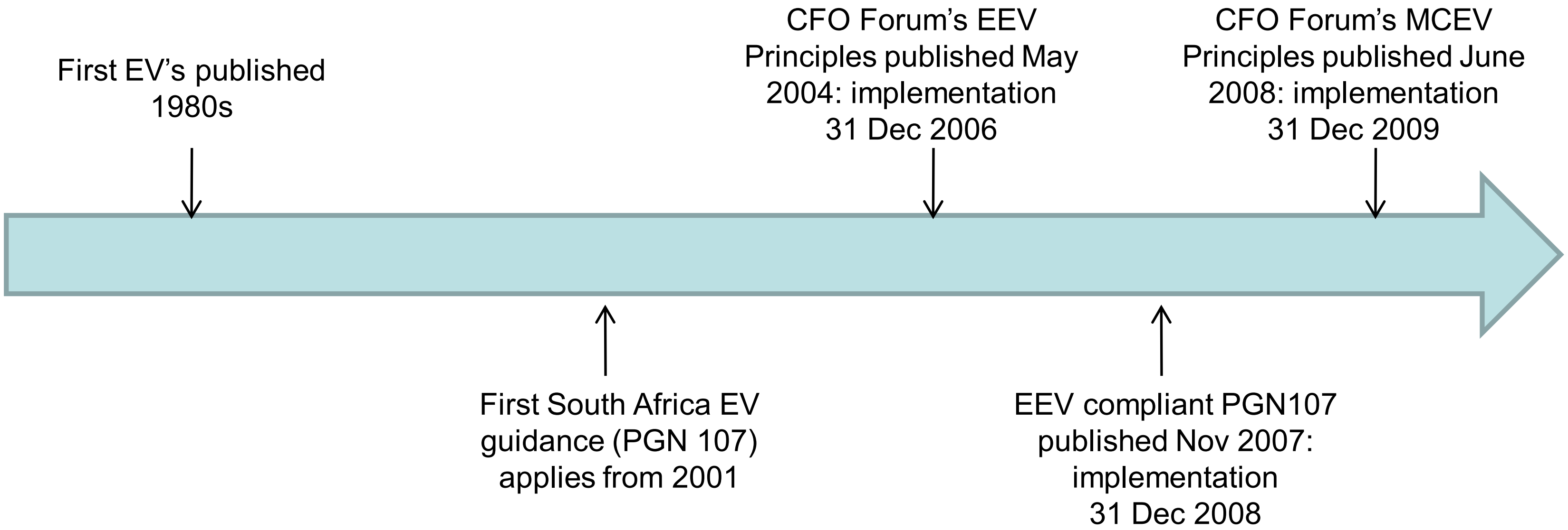
Agenda

- The journey so far
- Practical implications
- Impact and reaction
- What happens next?

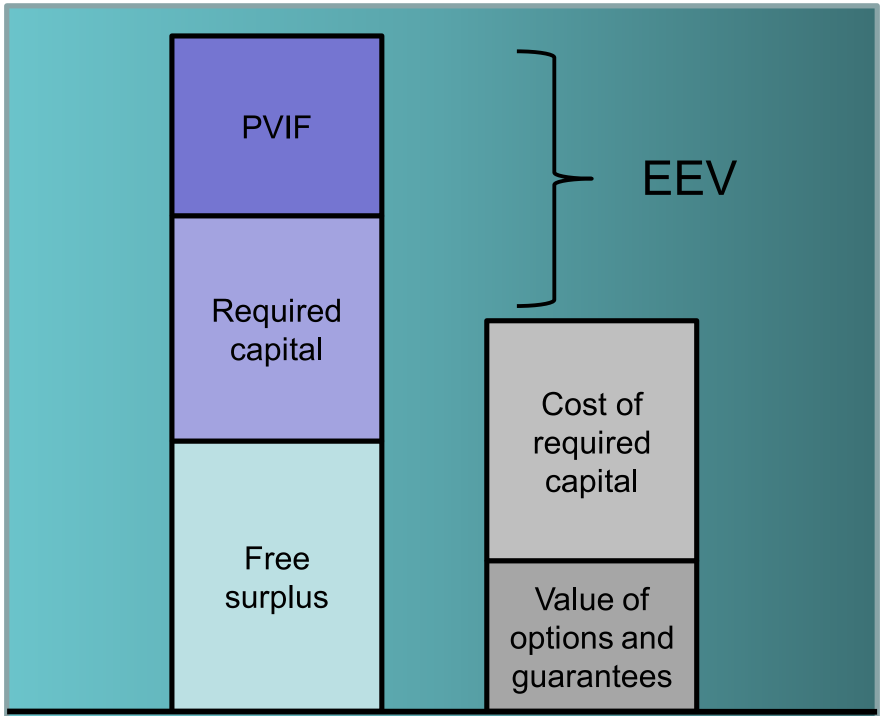
The journey so far

Why EV in the first place?

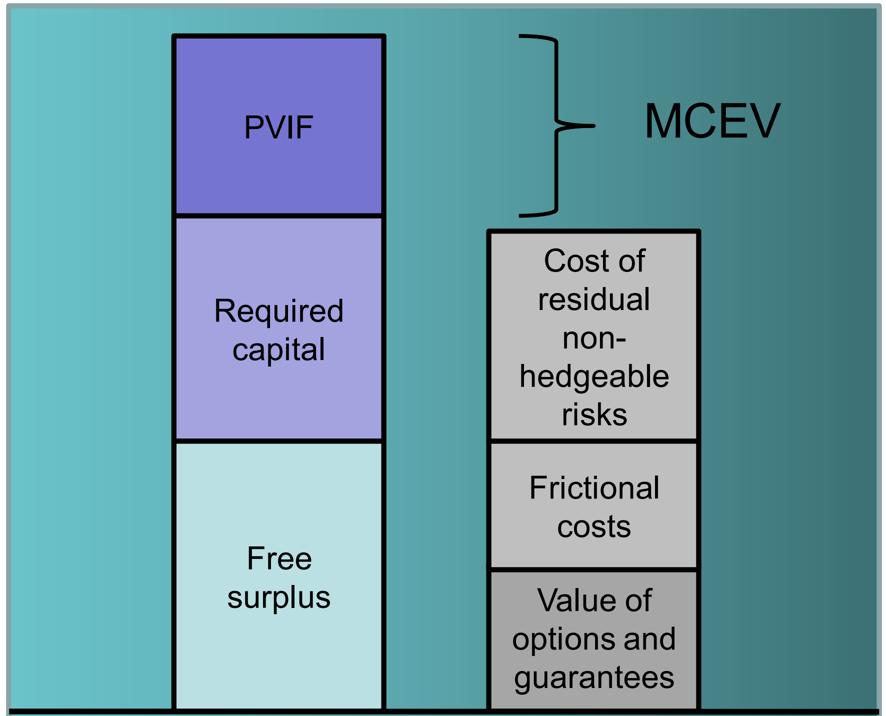
- Value the prudent margins in statutory and accounting valuations for life insurers
- In order to provide stakeholders with a more relevant, meaningful measure of value and performance



EEV vs MCEV



- Economic assumptions reflect expected future returns and RDR set as risk free plus a risk margin
- FOG's valued consistently



- PVIF and FOG's valued using a market consistent approach
- Reference risk free rates based on the swap curve

Move to MCEV

MCEV (with exceptions)	MCEV under EEV	EEV
Compliant with CFO forum MCEV principles (with specifically disclosed exceptions)	Bottom-up market consistent economic assumptions Variety of approaches to cost of capital	Top down economic assumptions Traditional cost of capital
OLD MUTUAL plc AVIVA Allianz SCOTTISH WIDOWS	FRIENDS PROVIDENT ZURICH AXA redefining / standards GENERALI Solutions d'assurances METROPOLITAN	Legal & General FORTIS Münchener Rück Munich Re Group STANDARD LIFE Sanlam Thinking ahead

Changes in practice

Key issues highlighted in disclosure:

- No change to economics of the business, just the emergence of profits
- Concern regarding impact of recent market volatility
- Additional liquidity premium allowance made by several companies (not MCEV Principles compliant)
- Careful explanations about the impact on profitability of no longer up-fronting risk premiums
- Detailed disclosure of size and reasons for impact
- Some additional disclosure of cash flow information e.g. IRRs and payback periods

Non-hedgeable risk

- **Recall that most financial risks are hedgeable and covered in PVIF and TVOG**

- **Non-financial and non-hedgeable financial risks**
  - Principles don't specify an approach but require disclosure of charge as a % of capital required to meet 99.5% confidence level over 1 year time horizon (i.e. consistent with Solvency 2)
  - Biggest component typically operational risk
  - Wide spectrum of results so far

Impact of moving from EEV to MCEV

Change:	**Impact on EV**
MC economic assumptions	Increase/Decrease
Release of EEV CoRC	Increase
Allowance for Frictional CoRC	Decrease
Allowance for CRNHR	Decrease

Impact: spread business

- MCEV reference rates:
  - Based on swap curve
  - No allowance for credit or liquidity spreads
- Product pricing / management (e.g. bonus rates) may assume credit and/or liquidity spreads
- Significant component of US life business e.g. impact of move from EEV => MCEV:
  - Aviva: North American business EV reduction of 43.2% as at 30 June 2008
  - Old Mutual: US business EV reduction of 56.8% as at 31 Dec 2007

Market uncertainty

Many companies have made additional allowance for liquidity premiums at 31 Dec 2008:

Aviva:

- Risk free rate adjusted by 150bps for UK and Netherlands immediate annuities, and 250bps to 300bps for US products
- Explanation: Stable markets, swap rates are suitable proxy for risk – free returns. In current markets, risk free returns in excess of swaps can be earned

Old Mutual:

- Risk free rate adjusted by 300bps for US business only
- Explanation: US onshore products largely backed by corporate bonds and portfolio is able to earn liquidity premium by holding bonds to maturity

Stakeholder commentary

- "MCEV is a good instrument, but the past few days show that it is not well understood nor accepted by analysts and investors, and the absence of harmonisation between players can create some confusion." – Denis Duverne, AXA CFO and Chairman of CFO Forum until January 2009
- “The majority of CFO Forum member firms had expressed an intention to move early, in 2008, to MCEV. I believe that a number of firms have changed their intentions on that” - Mr. Duverne told the Financial Times.
- “But the MCEV calculation is falling out of favour. Said Credit Suisse: "It seems increasingly apparent we're in 'lowest common denominator' territory now, with tangible book (not MCEV) being the new benchmark against which stocks are measured." – Fin24.com
- “Disillusioned with MCEV” – J.P. Morgan

What happens next - EU

- CFO forum is reviewing the impact of turbulent market conditions on the MCEV Principles
- Specific areas for consideration include:
  - implied volatilities
  - cost of non-hedgeable risks
  - use of swap rates as a proxy for risk-free rates
  - effect of liquidity premia
- Some member companies are delaying implementation (i.e. not adopting early):

"Prudential, Legal & General and Standard Life have refused to use MCEV until the CFO Forum completes a review into the measure." – The Telegraph

What happens next - SA

- MCEV developments monitored closely by the EV subcommittee of the LAC
- Stakeholder survey in progress
- Possible outcome is a revision to PGN107 to ensure that it is possible to comply with both PGN107 and the MCEV Principles
- MCEV will not be best practice at this stage

QUESTIONS?