Investors’ Day 2006
Holistic ALM approach to add value and protect capital

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Hans-Jürgen Wolter, Group CRO
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Agenda

1. Risk management objectives  Thomas Müller

2. Framework and processes

3. Strategic risk positioning

4. Implications  Hans-Jürgen Wolter
   - Duration management
   - Equity allocation
   - Solvency

5. Summary  Thomas Müller
Risk Management has a key dual role

**Company goals**

**Risk management tasks**

**Holistic risk management culture**

- Commitment to a holistic risk management approach
- Swiss Life measures risk on an economic basis as starting point
- The risk management process covers all risk management approaches
- Risk taking and risk management functions are independent
- Active and robust risk management is embedded in the corporate calendar

- Enhance shareholder value

- Add value

- Protect capital
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Swiss Life subject to variety of constraints

- Competitors' market expectations
- Asset liquidity
- Local accounting
- IFRS
- Reserved funds
- Own market expectations
- Solvency II
- Risk budget
- S&P
- Risk tolerance
Holistic view covers all dimensions

**Statutory**
- Statutory accounting rules
- Focus of life insurers on coping with regulatory requirements

**Economic**
Risk management not restricted to regulatory requirements, but starting to focus on risks inherent to:
- Asset allocation
- Crediting policy
- Product principles

**Holistic view**
In addition, all constraints applicable to a life insurance company start to get relevant and are included in all risk management thoughts and actions.
Local- and group-level holistic ALM approach covers all constraints

Group-level

- Own market expectations
- IFRS
- S&P
- Solvency II
- Risk budget
- Risk tolerance
- Holistic ALM approach
  - SAA (Strategic Asset Allocation)
  - Crediting policy
  - Product principles

Local-level

- Local accounting
- Reserved funds
- Asset liquidity
- Competitors' market expectations

Guidelines

Methods

Risk measures

Market exp.
## Constraints on investing, taking Switzerland as an example

### Business-driven
- Liabilities require a fixed income portfolio with maturities concentrated at the very long end
- Internal group risk committee regulation (e.g.: financial risk directives, eligible counterparties list, eligible instruments list)
- Investment allowed only in certain investment types (plain vanilla instruments)

### Environment-driven
- Regulatory directives (AVO, VAG)
- Swiss bond market too tight to cover all long-term liabilities with CHF bonds
- Lack of hedge funds and alternative investments quoted in CHF
…could be partially mitigated through the right strategic positioning

Framework leads to a preference for bonds …

- Liability modelling exhibits very long durations. As a result bonds are the preferred asset class
- Swiss Solvency Test supports in-house models for large companies
- Accounting: IFRS as well as local statutory accounting rules offer major leeway for active bond management due to:
  - Amortised cost treatment
  - IFRS hedge accounting

… but new investment guidelines from the Swiss regulator support assets with higher returns

- Use of alternatives, derivatives and structured products facilitated
- Maximum exposure to alternatives lifted from 5 to 10%, whereby commodities and currency overlays as asset classes are accepted within alternatives
- Derivatives become key for equity and currency management, facilitated by the excess reserves in the security fund
- Tougher requirements for risk management and controlling than in the past
The risk management processes are embedded in the Group-wide planning process

Risk budgeting
- Available risk capital determination
- Current risk capital consumption
- Risk budgeting by business unit

ALM process
- Allocation of risk capital
- Determination of risk and capital limits
- Determination of strategic asset allocation
- Crediting policy
- Product principles

Closing
- Annual closing
- Embedded value
- Media / Analyst communication

MTP 1)/ annual budget
- Long-term objectives and strategic business priorities per core Life market unit
- Functional objectives and strategies
- Definition, monitoring and review of financial and functional KPI targets
- Capital transfers

1) Medium-term planning
Ongoing risk control as a closed loop system

Covered types of risk
- Market risk
- Credit risk
- Insurance risk
- Operational and strategic risk

Limits set by BoD and ExB
- Risk capital (market, credit, interest rate, insurance risk)
- Exposures (currencies, equity quota)

Close collaboration between
- Risk Management
- Investment Management
- Line management
- Group
- Market units

SwissLife
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Risk budgeting takes all risk categories into account

Extreme events covered within all risk types

1) I.e. operational, business and strategic risk

Note: Waterfall shows risk contribution of individual risk types net of diversification effect
Balanced market risk allocation is favoured

Normalised

- Balanced risk of interest rate and equity
- Substantial diversification benefit
- Exposure to a set of risk factors
Significantly reduced life insurance risk capital through diversification…

- Mortality
- Longevity
- Disability
- Recovery
- Expenses
- Lapse / Surrender
- Option exercise
- Diversification effect

Total insurance risk

40%

60%
… and only marginal benefit by adding non-life business

<table>
<thead>
<tr>
<th>Sum of financial &amp; life insurance risk</th>
<th>Economic risk capital life insurance used</th>
<th>Life diversification effect</th>
<th>19%</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Sum of financial &amp; insurance risk</th>
<th>Total economic risk capital used</th>
<th>Life and non-life diversification effect</th>
<th>22%</th>
</tr>
</thead>
</table>

Marginal non-life diversification benefit
Strategic positioning includes economic solvency

- We have a strategic target
- We use the tactical freedom available

Shareholder’s capital not fully used

~ 1/3

Tactical freedom

~ 1/3

Loss of tactical flexibility

Minimum

First FOPI intervention level

Time

Level %
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Different implications for capital based on rising interest rates scenario

- IFRS equity is not the appropriate measure for insurance value; IFRS equity, however, is protected by use of derivatives and hedge accounting in a first step.
- Active steering of the duration gap has a positive effect on economic equity and protects IFRS equity.
- IFRS equity further protected by policyholders: through DPF liability (incl. bonus reserves) and bonus adjustment potential.

1) Impact through P&L
Active duration management is key

Interest rate sensitivity and interest rates since 2004
Active asset and liability management to add value and protect capital

<table>
<thead>
<tr>
<th>Initial position</th>
<th>Anticipation of rising interest rates</th>
<th>Interest rates rose</th>
<th>Interest rates stable or declining</th>
</tr>
</thead>
<tbody>
<tr>
<td>Closed duration gap (strategic)</td>
<td>Open duration gap (tactical)</td>
<td>Open duration gap (tactical)</td>
<td>Close duration gap (strategic)</td>
</tr>
<tr>
<td>Bond duration = 9.8y</td>
<td>Bond duration = 7.8y</td>
<td>Bond duration = 5.7y</td>
<td>Bond duration ≥ 9y</td>
</tr>
</tbody>
</table>

- **30.06.2005**
  - Initial position
  - Closed duration gap (strategic)
  - Anticipation of rising interest rates
  - Interest rates rose
  - As needed
  - Flexibility to increase duration due to bonds classified as available for sale (AFS) and unwinding of derivatives and hedges

- **30.06.2006**
  - Risk capital used
  - Available risk capital
  - Limits: Regulatory Board

- **31.12.2005**
  - Anticipation of rising interest rates
  - Interest rates rose
  - Risk capital used
  - Available risk capital
  - Limits: Regulatory Board

- **30.06.2006**
  - Risk capital used
  - Available risk capital
  - Limits: Regulatory Board

**Appropriate measures used to protect our book, market and IFRS value**

In CHF million

<table>
<thead>
<tr>
<th>Cash flow pattern</th>
<th>Impact in different measures after interest rates rise</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>MV 1)</td>
</tr>
<tr>
<td>Unhedged bond</td>
<td></td>
</tr>
<tr>
<td></td>
<td>down</td>
</tr>
<tr>
<td>Hedged with a swap</td>
<td></td>
</tr>
<tr>
<td></td>
<td>stable</td>
</tr>
</tbody>
</table>

MV (31/12/05) = 271  
MV (30/06/06) = 254

MV (31/12/05) = 271  
MV (30/06/06) = 276

Unchanged book value, increased direct yield due to reduced market value

1) MV= Market value; BV= Book value
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Asymmetric risk/return profile of investment returns
Shareholders’ portion of “legal quote” investment

Pay off to the shareholder

- Shareholder provides 100% protection if returns fall below guarantee (short put option)
- Shareholder participates at rate of 10% in excess returns above guarantee (long call option)
Equity quota determined by interest rate spread and shareholder / policyholder participation

- Equity quote defined by the difference between direct return and technical interest rate
- Risk and return could be increased over proportionally if the difference between direct return and technical interest rate increases
- Product with lower guarantees should be preferred from a shareholder and policyholder perspective

Equity quota 5%
Equity quota 20%
Equity quota 40%

Costs carried by shareholders

Investment risk as volatility

Difference between direct return and technical interest rate

Break-even policyholders & shareholders

- 0%
- 2%
- 4%
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Rising interest rates: Real-life implications

Development during HY 2006

| Solvency I – parent company | -34% |
| Solvency I – Group          | -27% |
| Solvency II                 | 9%   |

Comments/explanation

- Legally binding
- Solvency I at a comfortable level and with downside protection (floored by statutory equity) in case of rising interest rates
- Different methods defined by different Group regulators
- Only used as a trigger point
- Business steered with Solvency II (SST, as defined by Swiss regulator)
- Active ALM has significantly increased Solvency II level
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We add value while controlling our capital level

- Complex environment and various constraints require holistic risk management approach
- Strategically well diversified risk positioning
- Assuring tactical flexibility to act on market opportunities
- Implications for Swiss Life are:
  - Active ALM; duration gap reduced by 2 years
  - Equity exposure defined by business line
  - Solvency I floored, Solvency II well prepared for the future

Dual function of risk management to add value and protect capital
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