

CMD Storebrand
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1. Cover

Thank you for this opportunity to dive into some of the fun, but also challenging parts of risk managing life insurance balance sheets in Norway and Sweden. As many of you know both countries are in the midst of significant regulatory changes – Norway has this year implemented new insurance legislation and Sweden moved just a few years ago to fair market valuation of liabilities.

2. Topics

I have planned my discussion with you along these lines:

First I will look at the structure of financial risks on our balance sheets from a fairly holistic perspective, including a recap of our risk managing principles and the risk return characteristics of our major blocks of business.

Then I'll take you into a little more detail on what we have done in 2008,

Before highlighting the three to four major areas of risk to shareholders as we now stand. Attached to this will be a discussion of managing that risk going forward.

3. The life insurance balance sheet is a key driver of risk and performance

For those of you not intimately familiar with our business model we begin by giving you a brief introduction to our balance sheet structure.

Liabilities

Starting on the liabilities' side, this part of the balance sheet is dominated by the insurance liabilities or technical reserves as they are also often known.

In Norway these are discounted at the guaranteed rate embedded into the products regardless of the level of prevailing long-term interest rates in the market. Thus, this part of the balance sheet is stable in value, merely influenced by volume changes of business – and as we all know from time to time there may be a change from reserving changes – e.g. as when longevity reserves were strengthened in Norway in 2007.

In Sweden it is different. Sweden has moved to a realistic valuation of reserves, and SPP use an approximation to the long part of the Swedish interest rate market for discounting purposes. When long rates change, the value of the liabilities changes significantly due to their long duration. However, the exact value change profile is *not* replicated by any bond available in the market.

The next layer is the client buffer capital. The insurance industry came from a position where such buffer capital was a common pool of reserves that could be used where needed when needed. Not so any more. For the demutualised companies in Sweden, and with the new insurance law in effect in Norway, almost all of Storebrands client buffers are individualized to each contract. And no cross subsidization is allowed. This means that if the sum of the asset return and the buffer on any account is not deep enough to cover the guaranteed return on that account, then the company will have to use equity to cover the gap – one is not allowed to use the buffer capital of one policy to cover insufficiencies in other policies.

Next on the liabilities side comes the paid in equity and the retained earnings, and last the subordinated capital. The subordinated capital is protected in seniority by equity. Norwegian and Swedish Life insurers cannot issue senior debt so this is not part of the liability structure.

Assets

The asset side is the traditional type of diversified investing you typically find for pension assets.

At the top left we have a large portion of money market and bond investments. These will typically have high credit quality with significant volumes in governments, supranationals, government agencies, and senior debt and covered bonds issued by domestic financial institutions in Norway and Sweden.

Next we have a portion of listed equities. This looks rather small, and this is currently the case. Normal exposure, with normalized risk capacity will be in the area of 20-30% for Storebrand Life and perhaps somewhat on the upside of that for SPP, but it may certainly take some time (years) to get back to that level. Both companies follow a diversified approach with MSCI developed world as the beta benchmark.

Storebrand Life has a long tradition of directly owned real estate as a key part of the investments. Total return is by experience fairly stable and the inflation hedge is good. We intend to introduce real estate to the SPP balance sheet in due course as the return and performance characteristics of real estate also is viewed as attractive for SPP.

Last, we have indicated that both companies have some active risk, albeit greatly reduced during 2008. A budget is defined for active risk on an annual basis. If the risk capacity of the life insurer changes significantly during the year, then the alpha risk budget is adjusted accordingly.

The private equity portfolio of Storebrand Life is seasoned, with 11 vintage years. At SPP we are just starting with vintage 2007, not fully invested yet.

Let us then turn to the interaction between the two sides of the balance sheet. Managing this interaction is all about one thing – whatever happens to the twists and value changes of either or both sides of the balance sheet – the changes must not be of a nature that wipes out the client buffer capital and the equity. As the major building blocks on the balance sheet behave very differently in Norway and Sweden, I will discuss the interaction on a country by country basis.

Interaction Norway

As the liabilities are discounted at fixed rates in Norway, it is only the asset side that changes profoundly in value. And even on the asset side we have stabilizing mechanisms as we can classify regular bonds as hold-to-maturity as opposed to having all of them valued at market prices. Roughly one third of total assets are often found as hold-to-maturity bonds in Norway. Most of the duration will usually be invested here. Hold-to-maturity bonds cannot be sold before they fall due and there are penalties in place if the non-trading rules are violated.

As the remaining part of the assets are usually fairly insensitive to interest rate changes– and with a high credit quality profile of the bonds marked to market - it is the volatility of equities

that dominate risk in the short term, and volatility of the beta portfolio constitutes about all of the tradable risk.

Risk managing the Norwegian balance sheet is therefore focused on matching the amount of equity risk to the total risk tolerance level. At least it was that way until the unprecedented credit spreads and credit illiquidity came around this fall... This I will revert to later.

Interaction Sweden

In Sweden assets and liabilities interact fully on a fair value basis. There are no volatility mitigating regulations in place – any more. I mentioned that liabilities are discounted at the long end of the curve, and this means that any change in long rates result in an almost ten fold change in the value of liabilities. Furthermore, the guarantees embedded into the products create a value change profile as long rates change - different from that of traded bonds. Therefore, one needs both considerable amounts of long dated bonds as well as derivatives to fully immunize the interest rate risk on the Swedish balance sheet. There *is* a market for long bonds and the right kind of derivatives in Sweden, but the market is much, much smaller than the combined need from the insurers should they want to immunize, and in periods like we have had this fall the market becomes illiquid.

This means that the amount of equities that can be held on a Swedish balance sheet like that of SPP depends not only on the developments in the equity markets themselves, but at least as much on the changes in the long interest level and the impact on risk bearing capacity from any duration gap associated to that.

As all companies in Sweden have some duration gap, falling long rates combined with falling equity markets and credit spreads widening is the worst of all worlds. Add high volatility and constrained liquidity in many other markets and you find the ingredients that made the third quarter very challenging for SPP.

As a considerable number of policies in SPP do not have any buffer capital, any value change gap between liabilities and assets would gain or hit SPP's own capital base. As the assets need to maintain a competitive profile in order for SPP to stay competitive in the market, a hedge portfolio with an inverse value change profile to that which needs to be hedged is constructed within SPP's own company portfolio. Unwanted equity risk is hedged using both linear and non-linear instruments, and the same goes for risks for changing interest level as well as for various spread relationships between the spread risks of the

instrument one can invest in, and the properties of the rates used for discounting. This hedge activity has not produced the necessary protection in 2008, and I will revert to improvements made.

This was a lot about the balance sheet structure. Now let us move over to the risk management principles.

4. Our framework for balancing the objectives in risk management

The risk management framework addresses all the key stakeholders:

- The shareholders – we should risk manage in a format that allows a sufficient expected return to enable upstreaming to the holding company, with a controlled earnings volatility
- The regulators – we should stay clear of all hard and soft regulatory requirements with a healthy margin. In times of hardship we should have an understanding of which of the limits may be of a softer nature
- The rating agencies – so that we maintain the desired rating over time that gives sufficient access and sufficient capital flexibility to be able to attract the capital needed from the market
- The clients – so that we offer them competitive returns over time and create the competitive position resulting in net transfers *in* of new clients

The balancing act between the often conflicting interests of these stakeholders is at times challenging, and this is therefore frequently on the agendas of top management and the board of directors.

In normal times the risk capacity is typically allocated to give policyholders a decent upside. This combines with at least a normalized level of expected profit sharing with shareholders, as well as an expected ability to build buffer capital. Regulatory and rating agency issues are more in the background.

In challenging times – like now – the hard regulatory requirements and the rating agency limits are in focus. Capital preservation is a higher priority than catching a potential upside – as this tends to come with an associated risk.

It is imperative for the insurer to have a predefined map for navigating between the priorities of the various stakeholders and deciding on risk actions to execute. At Storebrand and SPP the dynamic risk management principle is that of having a fairly constant relationship between risk and risk capacity. If the risk capacity diminishes, we do not ask so much why – or what is the likely to happen next – we reduce risk as prescribed in our road map. Risk is first reduced where it is easily traded out, and if it is of a significant magnitude, then other asset classes are adjusted accordingly, at a speed adjusted to their liquidity. These broad guidelines have been operational since 2001 and have worked since then. This year they also worked well until about mid September, but the speed of changing markets and the rapidly falling liquidity of many asset classes has become a challenge since. I will revert to this.

To further understand the fortunes of risk management we would like to take you into some details to our major blocks of business:

5. Recap – Norway

Odd Arild have discussed this slide, and I only want to remind you that from a risk management point of view a few observations come to mind:

- As the risk return profile is quite asymmetric it is *more* important to shield the capital base in difficult times than to run after the potential extra upside.
- The fee based portfolio – about half of all volume – has no upside participation but a steady, high quality income. I think it is fair to say that the competitive pressure is most intense in this segment, and we all know that all clients are free to move at any time, with full values, at no cost.
- As the paid-up policies have a fairly rich profit sharing they may in normal times have a decent risk level in their investments, but as their buffer capital structure is somewhat weaker the risk profile needs to be adjusted downwards rather quickly.
- And even more so for the individual lines of business. Here the guarantees are generally lower, but the speed of run-off is fairly quick due to new substitute products in one segment and high age level of policyholders in another.

All-in-all this illustrates that the derisking undertaken in 2008 has reduced the expected return only slightly as shown on the screen, it has reduced the upside participation

somewhat, but first and foremost it has reduced the possibility of falling off the cliff (again) on the left hand side considerably.

And these illustrative normal distribution curves are actually skewed on the left hand side as the dynamic derisking limits downside risk more than is illustrated here.

6. Recap Sweden

Recap from Sweden emphasises much the same. The profit sharing in Sweden is generally richer than in Norway, but somewhat more difficult to access. The profit sharing kicks in solely based on asset returns above guaranteed returns. Profit sharing is therefore not easily available in times of rising long interest levels and significantly falling equity markets. They are also difficult to harvest when interest rates are close to or below the guaranteed rate.

But when profit sharing kicks in – it kicks in with a healthy 10% of total asset return. For policies with a deferred capital contribution the profit sharing is somewhat modified.

We now talk much about risk – but do bear in mind that there are also opportunities for earning back conditional capital contributions when long rates increase, when alternative investments perform well, and as unhedged equity positions perform well.

Now – turning to our actions in 2008:

7. Actively managing the most important risk – example Norway

We covered just a few slides ago that with the stabilizing factors in place in Norway – the liabilities valued at guaranteed rates and the Hold to Maturity bond portfolio at about 1/3 of total assets and containing most of the duration, our market exposure to equities clearly becomes the expected largest volatility factor short term – by far.

In this slide we show how risk management associated with equity beta exposure in one of our large investment profiles is carried out. On the left hand side you have the equity exposure of total assets, and on the right hand side the change of position in pure volume – since start of the year.

Since January was challenging in itself, you see a rapid reduction in our equity position from the start. In spite of significantly better equity markets in the second quarter, the position beta exposure was only slightly increased, a reflection of our gradually increasing focus on capital position and solvency.

During the third quarter the CPPI¹ factors, the strength of risk reduction was doubled, and then doubled again. The first measure was to reflect the increased focus on capital preservation, the second reflected also that a significant, and fairly illiquid risk factor entered the scene more quickly and much wider than in previous cycles. Credit risk widened for almost all but government bonds. At the same time our active mandates gave poor return, and tail risk became correlated. Our response was to cut all liquid beta exposure, but that tool was not fully sufficient to stem the marked to market risk from more and more positions becoming illiquid.

A fair part of the poor third quarter result, beyond falling equity markets, is therefore attributable to these factors, and hit the paid-up policies severely, in particular due to the speed of market changes.

Come October and further falling equity markets, and we were naturally happy that we undertook such significant actions in September.

Come November and markets returning somewhat; we are already in the *infant* stages of our re-entry strategy for listed equity beta exposure.

8. We have taken many steps to reduce risk - Sweden

As SPP was acquired we immediately started to work with our colleagues in Sweden. An investment strategy along the principles used for Storebrand Life was quickly hammered out, but recognizing the significant differences between valuation principles in the two countries.

A first generation CPPI, or dynamic risk management framework, was put in place and equity positions taken down accordingly during the first quarter.

¹ Constant Proportion Portfolio Insurance

In the Defined Benefit portfolio – on the lower part of the slide – you see that the interest risk for the DB portfolio was recognized, albeit at that point in time I guess few expected the protection instruments that were purchased should kick in with value just a few months later, but indeed they did so in October this year.

Following on to the second and third quarters the increased focus on capital preservation was also prevalent in SPP as we reduced equity exposure step by step to maximize the likelihood of meeting the 100% consolidation target for the 36bn SEK Defined Benefit portfolio.

As you know the guarantee groups came in as announced on October 1st. I will revert to them.

And we are finally in the stages where we to a larger degree formalize a solvency based dynamic approach for the Defined Benefit book of business also.

This is a framework we are constantly working on to improve. We have action plans both of 2nd generation Guarantee Groups, of improving the conditions for risk managing Defined Benefit and for product development. We will revert to you with significant milestones as they mature.

9. Guarantee Groups at launch

The guarantee groups came around as a response to strong variations of the degree of buffer capital within the Defined Contribution block of business. Most of the policies with high guarantees had virtually no buffer capital; medium had some, but most conditional bonuses were with the lowest guarantee. As you can see from the asset profiles the three buckets address this, with the equity ratio increasing to above 30% for the lowest guarantee, and less as we move up. In order to have some diversification effects, and some possibility to earn back some of the conditional capital contribution already supporting the high and medium guarantees, a modest exposure to equities and alternative assets are to be found in those buckets also.

As the equity risk may hit the company capital with significant numbers, we have from launch decided to hedge it out in the company portfolio, and with linear instruments until non-linear instruments have decreased in price enough to add value for us.

With the guarantee groups in place we had the opportunity for improved duration matching. The two higher Guarantee groups – which are closed for new business – were fairly closely matched, while the lower guarantee level group, the P250, remains on a competitive basis which does indicate a duration gap, albeit we believe it is smaller than for the competing products in the market.

10. Guarantee Groups one month later.

Have the Guarantee groups worked as they should in October?

Well – we all know that a lot happened in October!

Equity markets tumbled – and our dynamic strategy with a focus now on capital preservation was put to a tough test and performed well. You see the equity proportion is down considerably.

The long term interest rate level in Sweden fell as a stone for some days; as you see in the discount rate going forward.

And spreads started to widen, which is difficult to be protected against.

All in all therefore, October did come around with a negative result, but *much* improved from the third quarter, and much stabilized in volatility.

As explained by Odd Arild, profit sharing occurs if asset return is above the applicable guarantee. Even in the current low interest environment profit sharing may be expected from two of the three Guarantee groups.

11. Actively managing the risk profile

Here's another cut from the first month of Guarantee groups – the asset return. With little equity exposure and long duration the P520 is a “winner” – as should be expected. When we look behind the scenes, so to speak, we see that the risk management for the first month worked, both for changes in equities and for changes in the level of interest rates. But we see good reason for further improvements.

Take one example:

Within the P520 portfolio we have persons with 2 years to retirement and 20 years to retirement. With rates decreasing, the person with 2 years to retirement receives a value increase in his assets far above the value increase of his liabilities – and conditional bonus – buffer capital is created on his account – but does not flow through the P&L. For the person with 20 years to retirement it is the opposite: He receives less value increase on his asset side to make up for the very large increase in his liabilities – so a conditional capital contribution is created – and this hits the P&L for October. A change in SPP's legacy systems is needed to create a breakdown based on this profile. We will keep you informed as new changes are made, but this one may take some time.

12. Convexity

I have used the word convexity a few times. It represents two challenges. The first is that as general interest rate levels change, the value change profile of liabilities is not the same as the value change profile of the bonds one may have purchased to replicate the behaviour of the technical reserves. For minor changes in interest level this does not mean all that much, especially if a healthy level of buffer capital is available, but for an interest rate level trending in a single direction, or for significant, sudden shifts, it matters.

The second is that especially for the Defined Benefit products in Sweden there is a double guarantee structure that matters more to risk management issues now as buffer capital is low, than it does in normal times. That is the reason you see the curve bending over to the right hand side of the slide.

We have provided you with some sensitivities to this issue, quantifying that at the end of Q3 the financial result would be hit by about minus 100 mill SEK if rates immediately came down 50 bp or one half per cent, and we would take a hit of about minus 450 mill SEK if rates came down 100 bp or one full per cent from the about 4,5%-level at the end of the third quarter.

In the short term this may be a significant risk and should be recognized as such. In the longer term we also recognize that long rates seem to be mean reverting – i.e. fluctuating around a certain level or corridor. Therefore the more extreme results from rapidly falling or

rising rates tend to correct themselves before too long, and the correction also comes through on the Profit & Loss.

Do we do nothing about this?

Yes, we can (the new slogan these days...)

12. Mitigating convexity

Convexity issues can be mitigated in at least two ways.

We can dynamically adjust our neutral position with cash instruments, and we do, dynamically, as the market allows – as we have indicated on the slide for actions taken in 2008.

We can also use derivatives, so that the value change profile of the assets better match the value change profile modelled for the liabilities – and we do this too. We may even use foreign currencies, considered to be relatively stable to the SEK to achieve our objectives.

The mitigating actions are dynamically executed and adapted to market conditions.

Longer term, we may also look into the double guarantee structure that is embedded in the products.

Do we see results from all this work?

Yes we do!

14. SPP performance 2008

We are happy to note that SPP in first 9 months of 2008 report returns to policyholders in the top quartile.

For SPP this is a significant improvement. SPP has for a number of years reported returns in the lowest quartile. We believe there are three factors contributing to the progress:

1. Equity allocations have been taken down

2. Duration has been extended
3. These changes have been carried out in a framework well known to the organization

It is a very challenging task to always provide returns in the top quartile. We have a good track record for this in Norway, and we will together with our Swedish colleagues do our best to keep that up also for SPP going forward.

We should also note that many competitors still lump various products and categories together, while we unwrap and will disclose for example the returns for the P250 – open for new sales – going forward.

15. To sum it all up...

I hope that the little “tour” of financial risk management that I have taken you on has demonstrated a robust framework and dynamic approach to a number of issues.

Our focus is now where it should be – on capital preservation.

Expect us to be more focused on risks than on the upside in the markets for the very near future.

We have taken a number of steps during 2008, including the risk management framework itself, reducing equity risk and adding duration – all as part of a road map.

And we look forward to the challenges of the rest of this quarter and into 2009. Nothing indicates that we will be out of work for the immediate future, but the excellent working environment between Stockholm and Oslo should contribute to the best possible solutions going forward!