Coffee Break
Breakout Session Topic 10:
Solvency, guarantees and risk capital
An integrated Cost of Risk model and its application to company valuation

Presentation by:
Alexander Baier
Agenda

• Motivation

• Development of model

• Properties

• Application
Conventional approach

- Value at Risk
- Tailvalue at Risk
- 99%, 99.5%, 99.93%,...

- Covariance
- Tailcovariance
- Marginal
- Stand alone

- CAPM
- QIS 3 (6%)
- Target return (15%, 25%)
Example: Cat bonds

• QIS 4 parameters: 99.5% VaR, 6% CoC
• Investment volume 100m€

• Cat bond A:
  – E(Claim) 0.5m€
  – VaR 99.5m€
  – Risk load 5.97m€
  – Multiple 13

• Cat bond B:
  – E(Claim) 2.0m€
  – VaR 98.0m€
  – Risk load 5.88m€
  – Multiple 4

Almost constant risk loads!
Cost of Risk – Idea (single bond)

• Nominal value: \( N \)
• Probability of default: \( \alpha \)
• Spread: \( s(\alpha) \)
• Result at redemption date: \( X \)

\[
F_X = \alpha \cdot 1_{[-N;0[} + 1_{[0;\infty[}
\]

• Cost of Risk: \( N \cdot s(\alpha) = -Q_X(0) \cdot s(\alpha) \)

\( Q_X(\omega) \) := upper \( \omega \) quantile of \( X \)
Cost of Risk – Idea (multiple bonds)

- Nominal value: \( N = n_1 + \ldots + n_k \)
- Partial defaults: \( l_i = n_i + \ldots + n_k \)
- Probabilities of default: \( \alpha_1, \ldots, \alpha_k \)
- Spreads: \( s(\alpha_1), \ldots, s(\alpha_k) \)
- Distribution at redemption
  \[
  F_X = \sum_{i=1}^{k} \alpha_i \cdot 1_{[-l_i, -l_{i+1}[} + 1_{[0; \infty[}
  \]
- Cost of Risk:
  \[
  \sum_{i=1}^{k} n_i \cdot s(\alpha_i) = \sum_{i=1}^{k} (Q_X(\alpha_i) - Q_X(\alpha_{i-1})) \cdot s(\alpha_i)
  \]
Cost of Risk Model

Transition from differential sum to integral

\[ \text{CoR}_s(X) = \int_0^1 s(\alpha) dQ_X(\alpha) - s(1)Q(1) \]

If \( s \) is smooth and \( s(0) = 0 \)

\[ \text{CoR}_s(X) = -\int_0^1 Q_X(\omega) ds \]
Properties of CoR$_s$

- Under regularity conditions for $s$, CoR$_s$ is a spectral risk measure.
- x\%VaR and x\%TVaR can be represented by appropriate selection of $s$.
- If $s$ is concave CoR$_s$ is coherent on all centered random variables.
- For discrete $X=X_1+X_2$ CoR$_s$ has a natural decomposition to $X_1$ and $X_2$. 
Application

1. Estimate result distribution for company.
2. Value with best estimate assumptions.
3. Calibrate spread by linking to default probabilities via rating classes.
4. Compute integral numerically, e.g. Monte Carlo simulation.
5. Risk adjusted value is 2. less 4.
Example company

- Motor monoliner
- Premium and reserve risk as in QIS 3
- Assets as at 31.12. (risk free) 85m€
- Annual premium (written 1.1.) 20m€
- Expected C/R: 100%
- Reserves (best estimate) 59m€
- Accident year pays out over 8 years: 20%; 15%; 15%; 10% each other
Calibration – Rating to default

Data: S&P annual 2006 global corporate default study.

\[ 2.6 \cdot 10^{-5} \cdot e^{0.52} \]
Calibration – Rating to spread

Model fit of Return

3.84% + 0.27% \cdot e^{t \cdot 0.2}

Risk free rate 3.84%

Data: Börse online 3rd calendar week 2008.
Economic valuation (excl. risk)

- Assets: 85.0m€
- Reserves: -59.0m€
- Balance sheet capital: 26.0m€
- Discounting of reserves: +5.0m€
- PV of new business (1 year): +2.4m€
- Economic value (excl. risk): 33.4m€
- Return (interest on assets): 3.65m€
- Return on capital: 14.0%
Risk adjusted valuation

- Balance sheet capital: 26.0 m€
- Economic value (excl. risk) (A): 33.4 m€
- 99.5% VaR (1 year; simulated): 24.9 m€
- Cost of Risk (8 years; nominal): 4.9 m€
- Cost of Risk (present value) (B): 4.6 m€
- Risk adjusted value (A)-(B): 28.8 m€

Shares of this company should trade at 111% of the book value per share.
Suggestions for further research

• How consistent does this model work in the market turmoil of 2008?

• How to take information coded in a CAPM (if available) into account?

• How can the spread function be estimated without using ratings, which include also other aspects?
Thank you for your attention.
Contact information

Alexander Baier
Allianz Re
CRO Division
Head of Risk Controling
Alexander.Baier@allianz.com