Newsletter August 2019

Modelling investment income

Increased transparency on the free portfolio

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Modelling investment income

The purpose of this document is to give capital market participants a better understanding of the reporting of the investment income and thus the ability to more closely align expectations with actual results.

Tryg's equity story is based on producing a strong and stable technical result while the investment income is seen as a support for the insurance operations. It is important that the investment risk is kept on a moderate level, as this reduces volatility and lowers capital requirements.

Tryg is dividing the investment income into three components; free portfolio, match portfolio and other financial income and expenses, with the purpose of lowering risk and capital requirements on the assets matching the insurance reserves while taking a risk-adjusted view on the assets matching Tryg's capital.

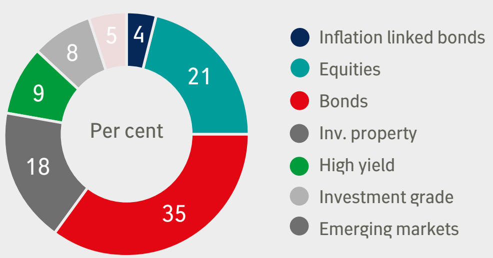
Tryg marks-to-market all asset moves in the profit and loss (P&L), which is different from the approach taken by many Nordic and European peers, but in line with all Danish insurers that follow the local Financial Supervisory Authority, FSA legislation. The investment result in the P&L as well as our assets and liabilities will therefore change as market values change.

Free portfolio return will become more transparent in the future

As per Q2 2019, Tryg had a free portfolio of approximately DKK 11bn. This basically represents the free funds or the capital of the company. Tryg's approach is to maximise returns on a risk-adjusted basis, and any investment decision is made looking at potential returns while taking into consideration the capital needed to back single asset classes as well as the liquidity risk of the total portfolio.

Below, we show the overall components and typical allocation of the 'free' portfolio representing approximately DKK 11bn of invested assets. Tryg uses a global approach for credit, equities, real estate and inflation-linked bonds. Currently, Tryg has a local (Nordic) focus on covered bonds and we hedge currency risk. The launch of Tryg Invest (Please see page 9 in Q1 2019 report), a new unit aimed at offering asset management services to large customers and insurance partners will result in increased transparency for the return of the free portfolio. This is driven by the fact that the net asset value of the fund will be observable via a link on Tryg.com on a daily basis. Tryg has decided to make this information fully public, since customers of Tryg Invest will invest their money in the asset allocation of Tryg Invest which mirrors Tryg's free portfolio. Customers will be able to see their returns on a daily basis in their bank account. The link on Tryg.com will show the return of the NAV of Tryg Invest which is a proxy of the return of Tryg's free portfolio therefore an important, and at times volatile, part of our investment return will become more observable reducing forecasting uncertainty.

Free portfolio



It is important to highlight that Tryg Invest will manage Tryg customers and partners assets and the product will NOT be offered to retail clients but only to MIFID II defined professional and semi-professional[a]. Tryg Invest is charging a fee for its services, additional costs to primarily cover auditors costs and fees to underlying managers are not included the aforementioned fee. It should also be noted that the overall cost is linked to the holding period, the shorter the period the higher the cost and vice versa.

The setup of Tryg invest is impacting Tryg's balance sheet as external customers investments are booked under "total other financial investments" with opposing liabilities entries such as "debt to group undertakings" and "other debt". As per Q2 2019, DKK 1,259m of assets and liabilities were third-party related. Tryg has booked DKK 295m (these are investments from TryghedsGruppen) under "Debt to group undertakings" which are liabilities in the balance sheet while additionally another DKK 964m was booked under "Other debt" which are investments from other (external) partners deciding to join Tryg Invest. The assets side of the balance sheet therefore includes DKK 1,259m , which is the sum of DKK 295m and DKK 964m, split in the different asset classes representing the free portfolio.

From a P&L perspective there are two lines impacted by the new setup (both are under investment activities); "value adjustments" where the return on third party assets is booked and "administration expenses in connection with investment activities" where the costs related to Tryg Invest are booked.

a) Semi-professional are investors that have qualified according to the danish law on alternative investment fund management

The net result of these two lines pertaining to third party customers will be deducted under "value adjustments". It is very important to highlight that the new Tryg Invest setup does not change Tryg's risk profile nor the investment policy or has any impact on the company's capital position. Initially, the impact of the new set-up on the overall investment income will be negligible, while longer term some modest positive income is expected.

The new setup means that it is very important going forward to distinguish between Tryg's own invested assets and third-party investments. Tryg will add a note in the quarterly reports to explain this. Additionally, it is recommended for modelling purposes to use the invested assets numbers published in the investor presentations and in the text of the quarterly reports under the investments section, where only Trygs own investments are presented. Using the balance sheet numbers without adjusting for the third-party investments may result in excessive expectations for the investment income in the long-term assuming a continuous growth in the third-party funds.

How to model the match portfolio

The match portfolio is composed of low risk fixed income assets (primarily Nordic covered bonds) that "match" the insurance liabilities, so that fluctuations resulting from interest rate changes are offset to the greatest possible extent. It is impossible to make a perfect 'match', but Tryg aims to have assets and liabilities as closely matched as possible. The net result of the match portfolio after transfer of value adjustment of the provisions and technical interest can be split into a 'regulatory deviation' and a 'performance' result

The 'regulatory deviation' is defined as the difference between the FSA curve used for discounting the liabilities and the return of a matching model portfolio for investing the assets. The result of the 'regulatory deviation' is therefore primarily driven by the difference between the market-based interest rate swaps used for hedging: DKK or EUR, NOK and SEK, and the constructed EIOPA curve used for discounting the liabilities, which is based on interest rate swaps in EUR, NOK and SEK on the liability side.

The result of the 'performance' is primarily driven by the spread movements of Danish, Norwegian and Swedish covered bonds versus swap rates. If the spreads narrow, the overall performance is likely positive otherwise it is likely to be negative.

Regulatory deviation

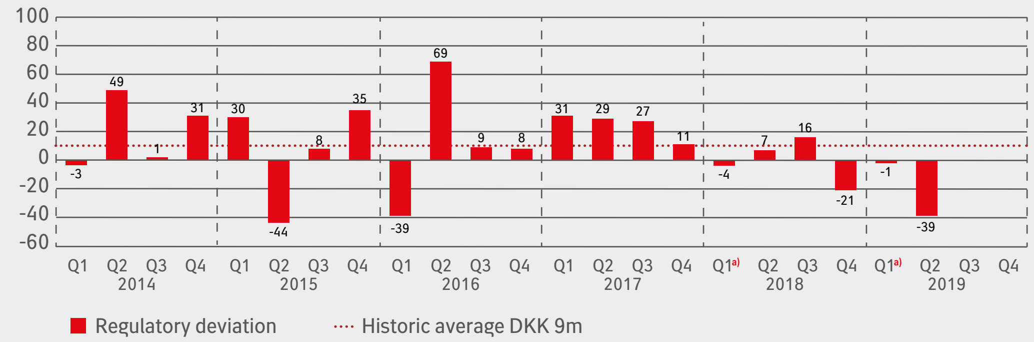
An important indicator of the regulatory deviation is the yield difference between Euro swap rates (10-year EUR swap in the example below) and Danish swap rates. In Norway and Sweden, Tryg hedges using local swaps corresponding to the EIOPA curve; whereas the Danish branch uses either DKK or EUR swaps. During the last 3 years Tryg has chosen to partly unwind the DKK swaps and currently Tryg uses an increase proportion of EUR swaps. This could change but the regulatory deviation result is less impacted by movements in the yield spread between EUR and DKK swaps considering that a higher proportion of hedges are in EUR swaps. The historic average of the quarterly Regulatory Deviation between 2014-2019 Q2 is DKK 9m. It will fluctuate but in the long run it will be close to zero.

Match performance result

The most important driver of the performance is the difference in yields between Danish, Norwegian and Swedish covered bonds and equivalent swap rates (ASW). If spreads narrow (versus swap rates), the overall performance is positive otherwise; the overall performance is negative.

Regulatory Deviation Q/Q

DKKm



a) In Q1 2018 and Q1 2019 the UFR-rate was lowered 0,15%-point and contributed by -10 mDKK in Regulatory Deviation

Tryg seeks to maintain stability in its covered bonds portfolio, also in terms of maturity; hence, spread movement should be a good indicator of overall performance. As a very rough guidance to the performance result, the decrease (increase) in the spread(s) will cause positive performance and vice versa. The figure to the right shows changes in the Danish covered bond spreads since the beginning of 2016, it is important to remember that also Norwegian and Swedish spread are an important factor for the performance result.

As a very rough guidance to estimating the performance result, the decrease (increase) in the spread(s) should be multiplied by the total interest rate risk of the assets of the Group (DKK 1.079m, See Annual report 2018, page 62) to calculate the positive (negative) deviation. On the previous page, we show the developments of credit spreads on Danish covered bonds (approximately 55% of the total interest rate risk of the Group) with a maturity of three years as well as a table where we link the change in spreads to the actual 'performance' result. Note that the actual 'performance' result is also impacted by the change in Norwegian spreads and to a lesser extent Swedish spreads.

The historic average of the quarterly Match Performance return between 2014-2019 Q2 is DKK 19m. This was mostly driven by decreasing Nordic covered-bond spreads which are all-time low currently.

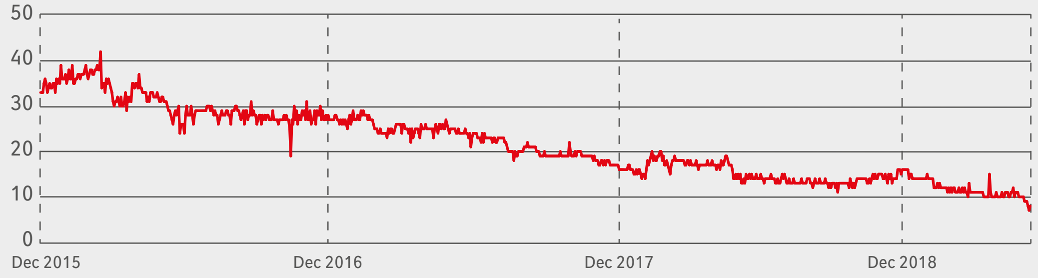
Other financial income and expenses
The item 'other financial income and expenses' is made by several different accounting items. The primary drivers are the interest expenses related to the outstanding subordinated debt (Tier 1 and Tier 2 debt), the cost of the currency hedge to protect Tryg shareholders' equity in Norway and Sweden and the cost of running Tryg's investment operations. Additional items are leasing costs, different banks fees and some value adjustments for strategic investments.

Interest expenses
Tryg has four outstanding subordinated loans (Tier 1 and Tier 2 instruments) for a total subordinated debt of DKK 2,885m on the balance sheet at the end of Q2 2019. Annual interest expenses are currently slightly above DKK 100m but can always fluctuate impacted by movement in interest rates.

Currency hedge
Tryg has a Norwegian and a Swedish branch and needs to protect the equity of these branches. This is accomplished via a currency hedge. The cost of the currency hedges increases if the yield difference between relevant interest rates increases (CIBOR versus NIBOR and CIBOR versus STIBOR).

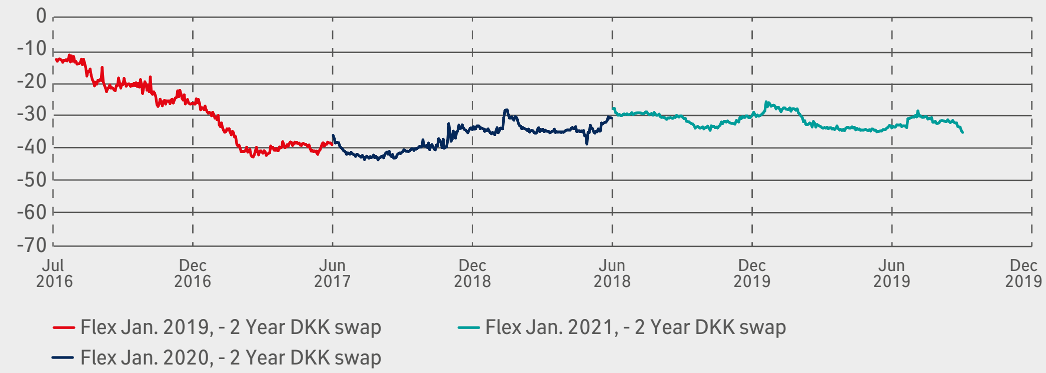
Regulatory deviation

Difference (bps) between 10Y DKK swap and 10Y EUR swap



Performance

Spread (bps) between DKK covered bond and swap rate (ASW)



Investment expenses

Tryg has decided to outsource a big part of the investment activities through different mandates. The expenses related to run the investments activities are therefore made up of internal and external expenses.

To sum up

Assuming normalised standard returns, i.e. 7% on equities, 6% on properties and a low overall return on the fixed income portfolio, the free portfolio should return around 3% (corresponding to around DKK 3-400m per annum), the match portfolio around zero and the other financial income and expenses component a negative DKK 2-300m. Tryg wrote in the Q2 2018 report that 'other financial income and expenses' would be more negative than previously driven by the new lease accounting standard. These are very rough indications as capital markets movement in each quarter are likely to ensure a fairly different outcome especially considering recent volatile developments. As an example a 1% move in equity markets would result in an approximate DKK +/- 20m P&L impact highlighting some of the difficulties in giving a precise guidance.

Modelling investment income

In this newsletter, we have described the main components in the investment income for Tryg. The purpose is to provide some insights into the different elements to ensure a better understanding and support a rough modelling of the investment income. The ambition has not been to provide full coverage of the investment area with the purpose of making an accurate estimate as this is not possible. History has shown that the investment results are volatile and will remain so, even for a company like Tryg where the approach to this area remains fairly cautious.