Deloitte Insurance Week

Where Reinsurance Meets

Competing Dialogs of Reinsurance Financial Landscape

May 15th, 2025

Deloitte.

Agenda

- Introduction
- Challenges with Competing Financial Dialogs
- Financial Performance Storytelling - LDTI, IFRS17
- Economic Capital/Embedded Value
- Best Practice Considerations
- Q&A Session
- Closing Remarks

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Competing Dialogs of Reinsurance Financial Landscape

The Changing Market

Many L&A insurers utilize some combination of third-party reinsurance, offshore/captives, and/or sidecars to navigate a shifting landscape, alleviate operational strain, and drive capital efficiency

Reinsurance is an increasingly useful and efficient tool to release regulatory capital that can be redeployed across businesses to create capacity and improve overall return on equity.

The reinsurance market is being shaped by several factors:

- The influx of private equity capital
- The rise of alternative reinsurance jurisdictions
- Macroeconomic forces
- Rating agency and regulator evaluation of reinsurance strategies
- Changes in accounting standards (LDTI, IFRS17)
- Changes in tax regulations (BEAT, GLITI)

Why Use Reinsurance

Reinsurance is an important tool to help insurers manage risk and capital

The primary objectives of the reinsurance transaction help determine the structure. Things considered when developing structure include:

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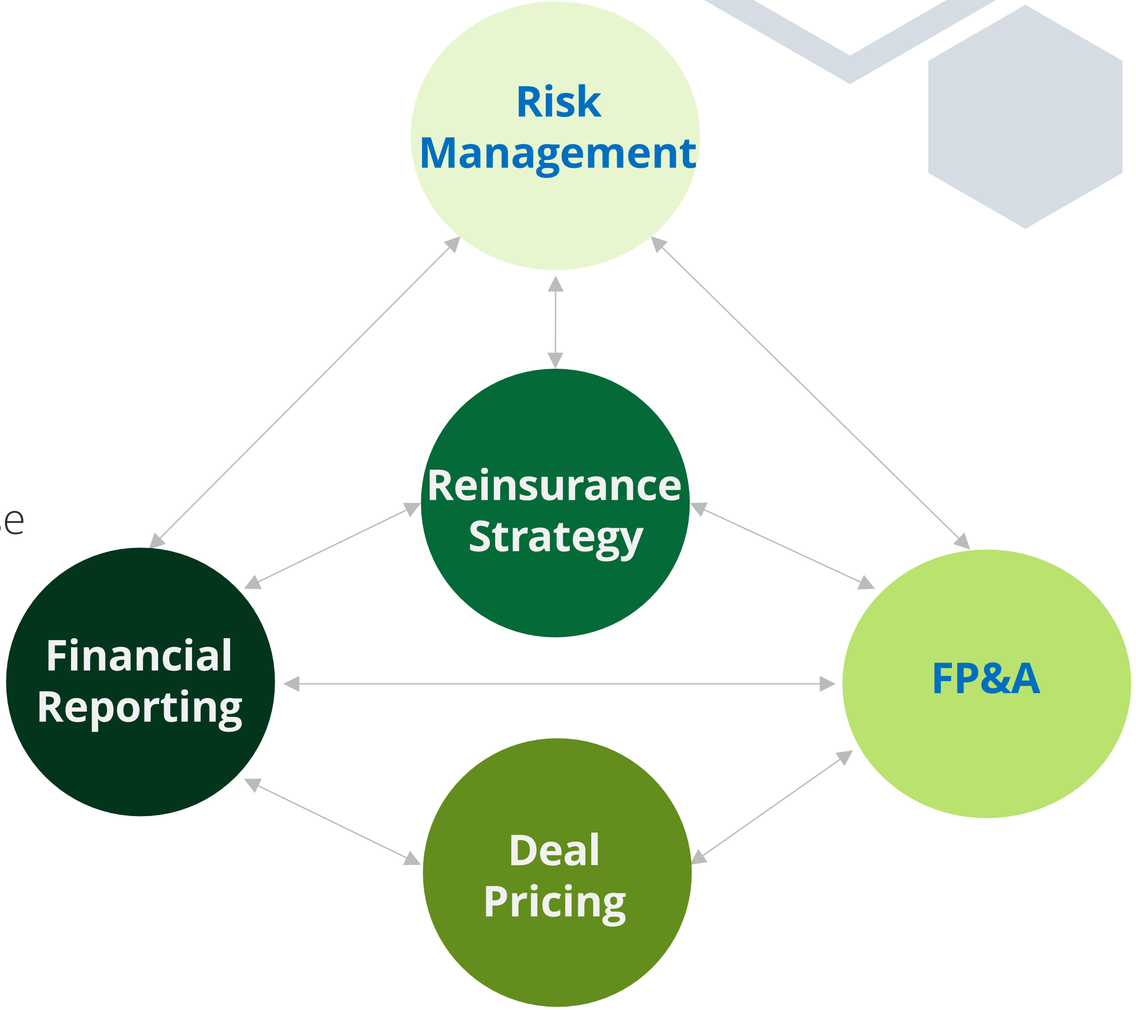
Competing Dialogs – Reinsurance Financial Landscape

This session is focused on financial aspects of reinsurance, primarily around the following considerations:

- Deal Pricing
    - Typically based on statutory capital
    - Review of pricing metrics, along with other strategic considerations
- Financial Reporting
    - Reinsurance typically separately measured from the direct business (for the cedant)
    - Potential accounting mismatch which may come as a surprise under the new reporting standards
- Financial Planning & Analysis
    - Performance management metrics
    - Post-deal financial projection and forecast
- Risk Management
    - Economic capital analysis and embedded value
    - Risk governance and monitoring



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Disconnects and Challenges

Due to the competing dialogs, we have seen disconnects and challenges when (re)insurers engage in deal-making, financial forecast, performance management and risk governance.

Financial Reporting

- "Phantom income" under accounting due to valuation mismatch
- Impact of new standards like LDTI and IFRS 17

Performance Management

- Accounting performance vs. economic value
- E.g. Internal reinsurance may create value that's not measured under accounting

Risk and Capital

- Deal making is typically based on regulatory capital
- Economic capital is typically used for risk governance
- Additional consideration on rating agency capital basis

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Financial Performance Storytelling upon adoption of LDTI

Emerging consensus on adjusted earnings

Market Risk Benefits

- Most elected to **exclude change in fair value of MRBs (net of related hedges)**
- Retain 'excess' fees within operating earnings
- Most elected a **consistent measure for VA and non-VA (e.g., FIA) blocks**
- Few changes to hedging strategies on MRBs

Asymmetrical Reinsurance

- Some electing to **eliminate mismatch between direct and ceded amounts**, primarily driven by differences in timing of discount rates
- Applicable for non-contemporaneous coinsurance
- Currently **generally immaterial** due to transition mechanics **but may rise in significance**

Other Earnings Adjustments

- Includes additional **'normalizing adjustments'** to present a more stable view of income.
- Potential adjustments under LDTI may include variable investment income, seasonality, one-time items (e.g., restructuring), etc.
- Deferral of Day 1 losses on pension risk transfer business

Book Value

- Continue to **exclude AOCI** from definition of book value
- Generally deemed that **mismatch will continue to exist between asset and liability marks** through AOCI (duration mismatch, spread, one-sided asset marks, etc.)

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Understanding Valuation Mismatch for Reinsurance

- Despite 100% coinsurance, the existence of non-zero net P&L may be the result of capitalizing/amortizing the profit or loss of the reinsurance deal due to accounting construct.
- Accounting policies may drive the disconnect.
- Net of reinsurance P&L may emerge differently from economic expectation due to other accounting reasons (e.g. use of locked-in discount rates, choice of amortization driver)
- Assumption updates and experience variance will further impact the P&L pattern which need to be analyzed/understood
- Important for FP&A function to integrate with the FR team and understand future P&L emergence, in light of the impact of new accounting standards

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Examples – Valuation Mismatch for Reinsurance (LDTI)

Under LDTI, potential valuation differences between gross and ceded may arise from

- Cohort definition
- Discount rate
- Net premium ratio cap and floor
- Cash flows differences

For example, when ceding an inforce block of annuity products with market risk benefits (MRB),

- Attributed fees for ceded reinsurance need to be recalibrated
- Credit risk needs to reflect that of the reinsurance company, and the impact of change would not go through OCI
- Mirror accounting does not apply
- Proceeds may need to be allocated to DAC vs. reinsurance balances

Earnings adjustments are made to remove some mismatches, if not material.

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Financial Performance Storytelling upon adoption of IFRS 17

A new set of external IFRS 17 KPIs were identified to complement traditional KPIs like return on equity and operating earnings

CSM related metrics

- **CSM Release**
  - Amount of CSM released as a percent of insurance service revenue
- **CSM growth ratio**
  - Ratio of new business CSM to CSM release
- **New business CSM**
  - Expressed as a percentage of new business premium

Incorporating the RA

- **RA release**
  - Ratio of RA release to insurance service revenue
- **RA to PVFCF**
  - Ratio of RA to present value of future cash flows
- **Adjusted return on equity**
  - (Underwriting profit + RA release and CSM release) over (equity + RA + CSM)
  - OCI adjustment may be applied to stabilize the ratio

Other P&L metrics

- **Profit margin**
  - 1 less Insurance service expenses over insurance service revenue
- **Loss component**
  - Ratio of loss component to present value of future cash flows

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Examples – Valuation Mismatch for Reinsurance (IFRS 17)

Under IFRS17, potential valuation differences between gross and ceded may arise from

- Cohort definition
- Contract boundary
- Measurement model: inclusion of risk of non-performance
- Discount rates, which may impact the speed of CSM release into P&L
- Cash flows: may include cash flows for contracts not yet written; ceding commission, expense allowance

For example,

Direct side: BEL= 100, RA = 20, CSM = 50; under 100% coinsurance, a ceded CSM would be established based on reinsurance price less the ceded BEL and RA, thus likely not equal to the direct CSM.

Future P&L would be a result of release from direct CSM and ceded CSM, which may be based on the same coverage units definition but discounted at different rates.

In the case of assumption unlock, impact on direct vs. ceded CSM may differ due to the use of different locked-in rates.

It's challenging to explain to senior stakeholder. This impact FR team and FP&A team.

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Performance Management

Accounting Performance vs. Economic Value

One example is the use of internal reinsurance

- Entity A: Liability $100, Required Capital $20, Free Surplus $10
- Entity B: Liability $50, Required Capital $5, Free Surplus $10

With internal reinsurance (entity A coinsuring 50% of insurance business to entity B), statutory balances become -

- Entity A: Liability $50, Required Capital $10, Free Surplus $20
- Entity B: Liability $100, Required Capital $10, Free Surplus $5

For consolidated financial reporting, there is no impact. However, from an economic value perspective, there is less RC for the business, thus less cost of capital and higher overall EV.

In the long run, given the capital efficiency that freed up surplus to deploy for other investment, the value of the enterprise will increase which will show up in accounting performance, but the immediate increase of the enterprise's economic value needs to be carefully and clearly articulated to the stakeholders.

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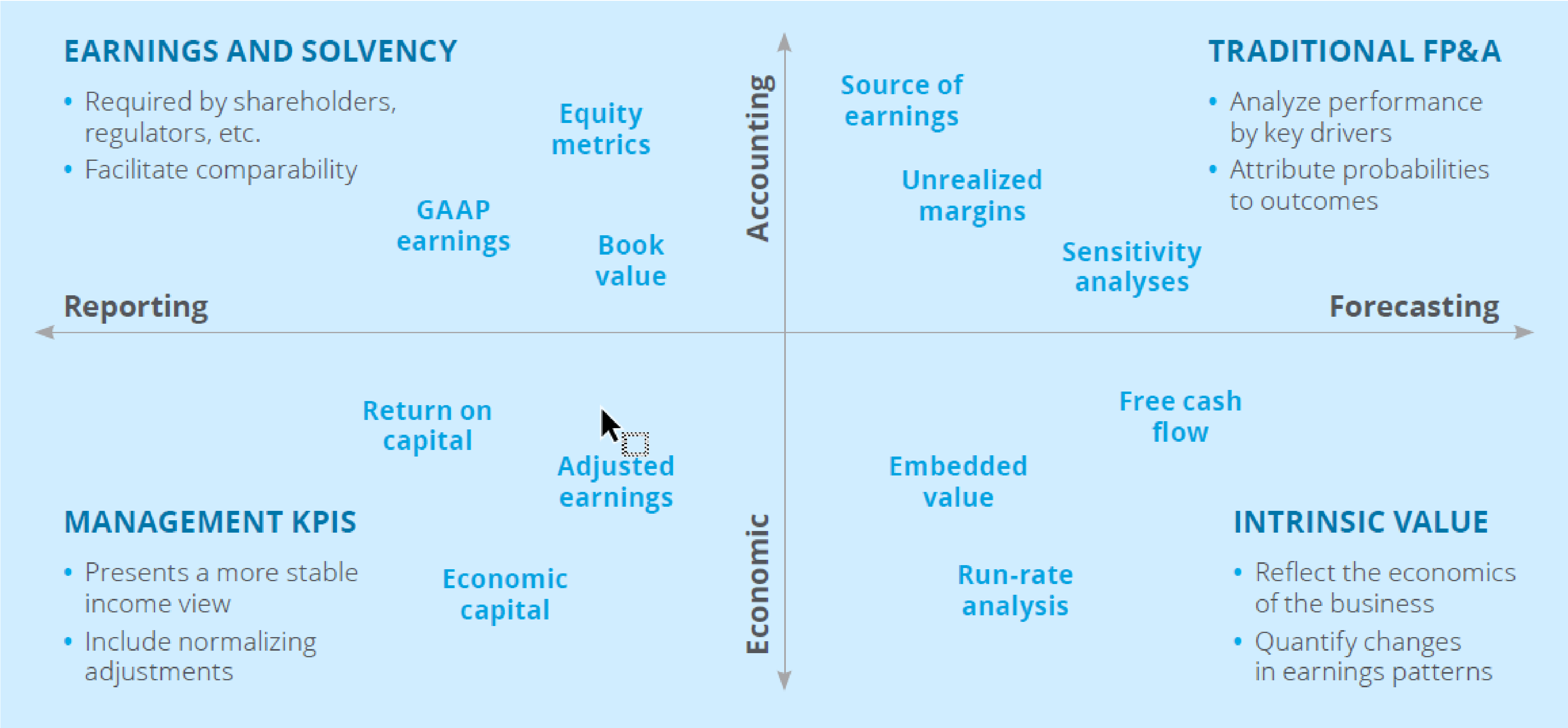
Financial Metrics: A Framework



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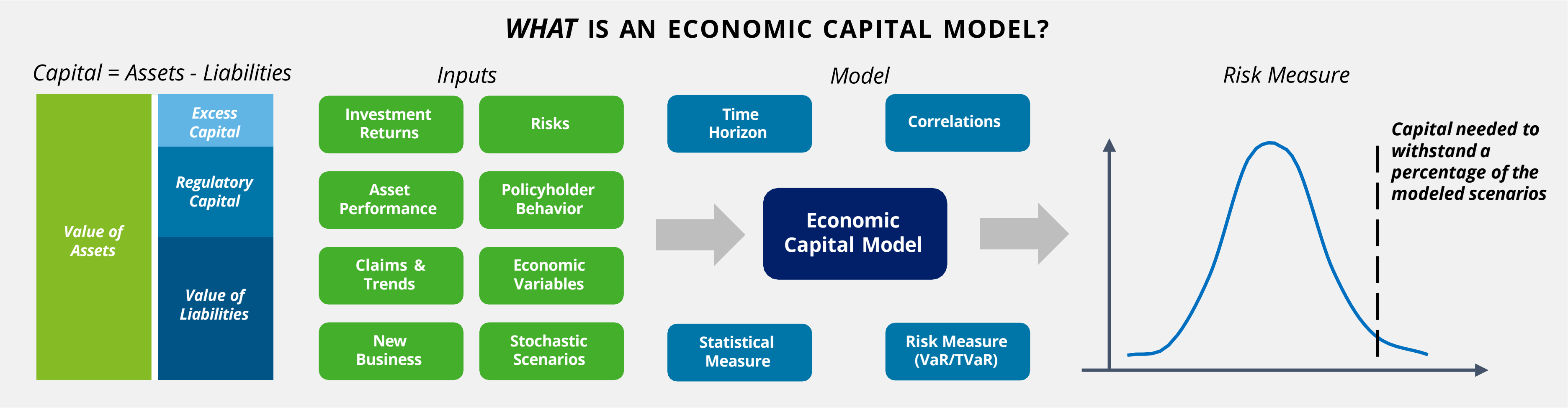
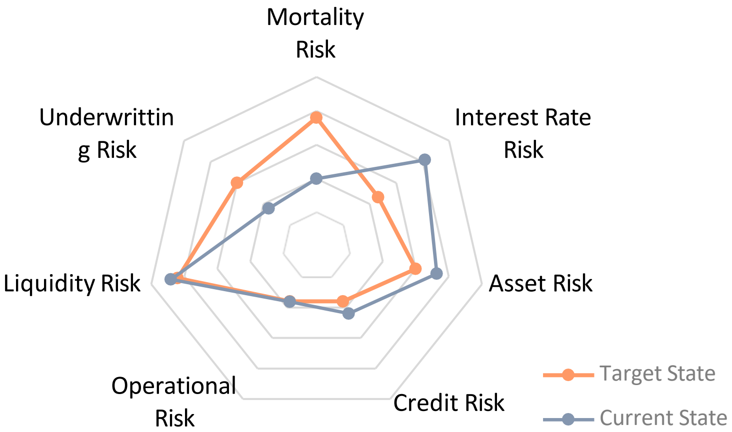
Economic Capital Consideration

Companies use EC model for risk governance and monitoring, but use of EC is often not extended to business decision-making and performance management (except for jurisdictions where regulators allow insurers to use their EC models to determine RC).





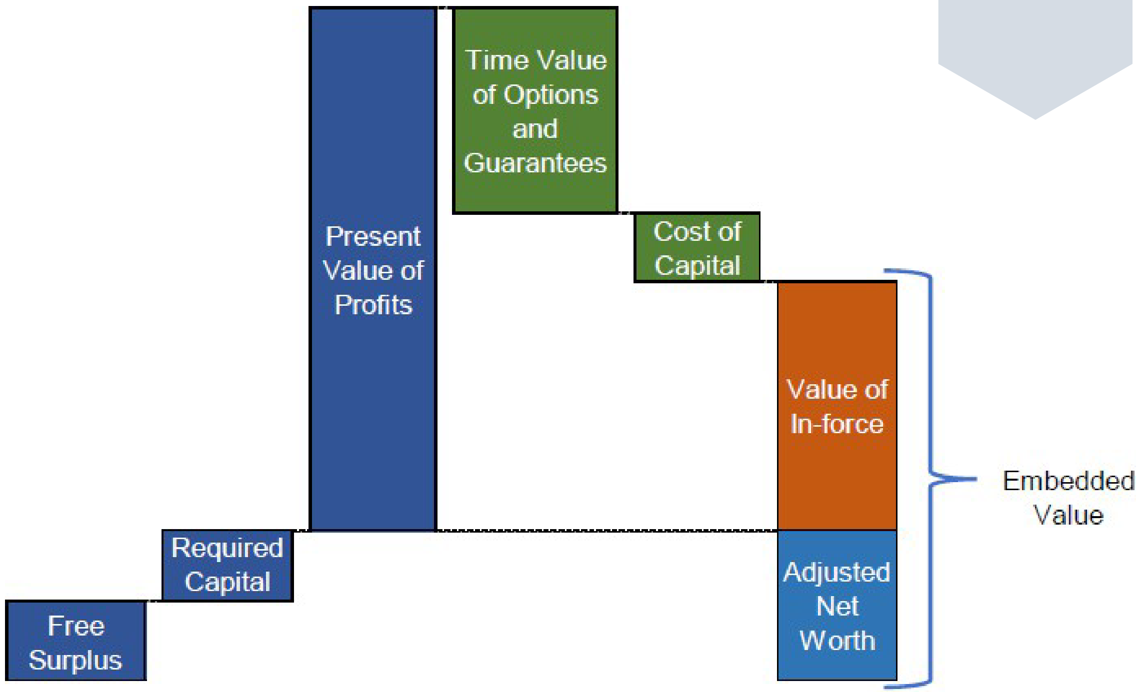
- EC is informative to monitor stress scenarios to offer a risk-adjusted view of capital adequacy and potentially help determine a buffer above min required regulatory capital
- EC, as a result of very sophisticated and dynamic model, is often used in a reactive manner
- EC is useful in ensuring capital efficiency plays (especially those with retained risks) are carefully executed and not overly aggressive

Embedded Value

- VIF is the present value of future distributable earnings (PVFP), representing the maximum amount that can be distributed under local statutory rules, adjusted for cost of capital (CoC) and time value of options and guarantees (TVOG).

- ANW is the market value of statutory surplus, which can be viewed as the sum of Required Capital (RC) and Free Surplus (FS).

- Under the MCEV framework, there are other components such as CoNHR.



Components of EV - for illustration purpose only

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Example of Risk-Adjusted Metrics

- RAROC
  - Many different variations to the name and calculation of this measure
  - Equals to (after-tax risk-adjusted net income) / (allocated capital)
  - It allows for a consistent comparison across different types of products and risks

- Example: an analysis of RAROC, supplemented by breakeven year
  - Depending on whether there is initial capital constraint or limitation on length of capital investment, different product could be chosen for further investment.

- Other Metrics
  - Breakeven year – first year in which accumulated profits turn positive and remain positive thereafter
  - VNB / PV of NB Premiums
  - IRR

	Product A	Product B
Initial RC	100	50
PV(RC)	300	200
CoC Rate	6%	6%
CoC	18	12
PVFP	30	20
VNB	**12**	**8**
RAROC	**12%**	**16%**
Breakeven Year	**4**	**6**

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Discussion of Best Practices

An integrated and connected framework that considers all three legs below in reinsurance deal making and performance monitoring:

- Risk and Capital
  - Regulatory vs. economic capital – reference to both frameworks ensure that insurers are not only compliant but are also managing capital effectively in line with their unique risks and strategic goals
- Financial Reporting
  - Understand how value creation is reflected in accounting and manage valuation mismatch
  - Connect with reinsurance pricing, FP&A, investor communication.
- Performance Management
  - Additional KPIs such as RAROC, embedded value to form a risk-adjusted value framework, taking into account cost of capital

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Questions?

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Economic Capital

Insurers are grappling with increasing uncertainty as a result of **increased economic volatility and emerging regulations.** Deloitte has experience implementing comprehensive Economic Capital Frameworks to assess, evaluate, and manage risk and capital requirements

How an Economic Capital Framework can help
EVALUATE RISKS DURING UNCERTAIN TIMES:

01 **Incorporate New Information**
Scenarios that were considered "once in a lifetime" are more common, changing the way insurers measure risk

02 **Navigate Regulatory Changes**
Regulations move towards market value basis, which makes Economic Capital more relevant due to its use of market-based approach to evaluate risk,

03 **Allocate Diversification Benefits**
Interlinks diversification benefits with hurdle rates, incentives and strategic objectives at a business unit level

04 **Consider Capital Requirements for M&A**
Buyers will need to consider Economic Capital requirements of target companies

05 **Develop Complex Products**
As insurers develop new products with complex risks, Economic Capital provides a greater insight into the risk-adjusted return

WHAT IS AN ECONOMIC CAPITAL MODEL?

Capital = Assets - Liabilities

Value of Assets

Excess Capital
Regulatory Capital
Value of Liabilities

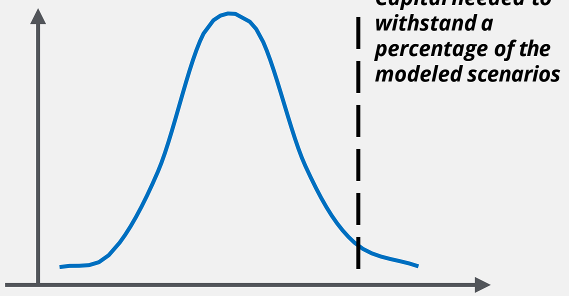
Inputs

Investment Returns
Risks
Asset Performance
Policyholder Behavior
Claims & Trends
Economic Variables
New Business
Stochastic Scenarios

Model

Time Horizon
Correlations
Economic Capital Model
Statistical Measure
Risk Measure (VaR/TVaR)

Risk Measure



WHY USE ECONOMIC CAPITAL FRAMEWORKS

1. **Strategic Business Decisions** | Maximizes value when setting strategic goals by finding optimal balance between performance and risk
2. **Capital Allocation** | Determines risk-adjusted rate of return at a more granular level (business unit, risk driver, policy group etc.)
3. **Performance Management** | Allows management to evaluate various strategic alternatives designed to reach performance goals
4. **Holistic Risk Measure** | Comprehensive and widely accepted risk measure that is a suitable extension to Solvency II requirements
5. **Pricing** | Facilitates a common internal risk language that can be mapped to communications with external stakeholders

HOW TO BUILD A ROBUST ECONOMIC CAPITAL FRAMEWORK

EDUCATION & BUY-IN

Working with key stakeholders and leadership to **align on the what, why and how** of an Economic Capital Model.

Buy-in from leadership is critical to the effective development and use of an Economic Capital Model.

MODELING & DEVELOPMENT

Complete preliminary **calculations of market, credit and insurance risks** and **determine correlations** between risks.

Leverage existing actuarial modeling platforms and industrialized aggregation tools.

GOVERNANCE & USAGE

Expand Economic Capital **to be a holistic framework broadly understood** by leadership; risk-adjusted return metrics are used consistently across Business Units.

Many insurers are finding it challenging to develop a robust and mature model governance program

EMERGING CONSIDERATIONS

Incorporate solvency regulation developments focusing on capital requirements, reinsurance, risk management.

GAAP LDTI, IFRS 17, MCEV and Economic Capital Model utilize similar approaches to determine assets and liabilities.

WHO IN THE INDUSTRY IS USING AN ECONOMIC CAPITAL FRAMEWORK?

74% of organizations **use Economic Capital** to measure Insurance Risk

Primary Methodology 42% | *Secondary Methodology* 32%

87% of respondents said they **used stress tests** for assessing adequacy of Economic Capital

Extensively Used 49% | *Somewhat Used* 38%

81% of respondents said they are **subject to group solvency and economic requirements**

Subject to group solvency tests 81% | *Anticipate group solvency tests* 19%

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