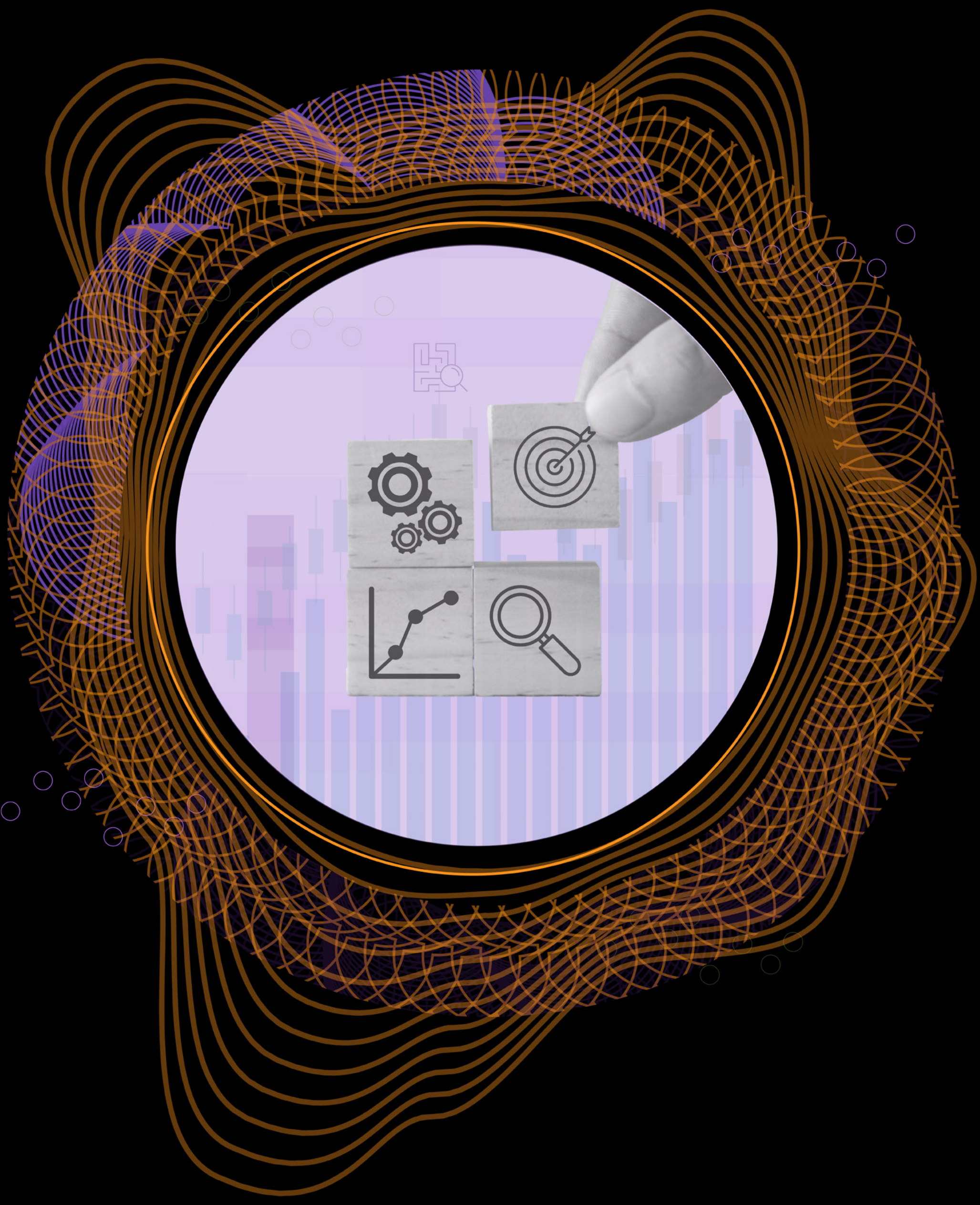

Unraveling insurance financials amid accounting change

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Introduction

Managing an insurance company is difficult. The Life & Annuity (L&A) subsector is uniquely challenged by long-duration revenue recognition and profit emergence, complexities that are compounded by regulation, macroeconomics, and consumer demands. Balancing competing priorities around Generally Accepted Accounting Principles (GAAP)/International Financial Reporting Standards (IFRS) earnings, cash flow management, operating capital, and more requires constant attention. Communicating value, quantifying company successes, and managing performance of these priorities is a challenge. While key performance indicators (KPIs) can provide leaders with targets to drive their business, selecting the "right" metrics is essential to meeting an organization's strategic objectives.

Taking inventory of your company's current KPIs may reveal that:

- Quantity reaches an efficient point, beyond which it is inversely related to quality.
- Legacy minutiae distract the organization from North Star pursuits.
- Simplicity is tangible, while complexity can create an illusion of precision.
- Accounting frameworks leave room for cash- and capital-based KPIs.

In light of recent accounting changes, companies have begun to rightfully question the efficacy of their KPIs in driving toward the organization's objectives. Many (re)insurers are plagued by competing metrics, which have often accumulated over time. In many cases, these may arise from one-time management requests for additions to, subtractions from, or other alterations of the KPI portfolio. These KPIs often have ingrained legacy data sources and insights/analysis that are unlikely to serve a company's current strategy but require significant time and resources to compile. And yet organizations find it to be exceptionally tricky to retire KPIs and the underlying reporting framework.

This ailment does not have a one-size-fits-all cure, but Deloitte's performance management modernization framework can help your organization isolate and address its symptoms. Companies can move from an expansive but static set of KPIs to a more streamlined, updated, and actionable suite. This KPI suite helps companies manage key economic measures in the context of increasing complexity in the industry, as bespoke distribution channels, new product lines, modern underwriting, and increasingly sophisticated asset origination demand faster, better insights.

This enables insurers to drive real value through simplification and alignment to organizational goals. It begins by identifying what is most important to your organization, your "North Stars," having the discipline to look beyond legacy obstacles, and defining the outcomes you want to drive. From here, your North Stars can chart a clear path to effective metrics.

Defining the challenge

While recent regulatory changes have sought to promote transparency and comparability throughout the sector, many insurers still find that they struggle to effectively communicate performance solely through their financial statements. Companies are constantly juggling multiple valuation bases, each with its own interests, and many feel that a critical disconnect lies between accounting regimes and the underlying economics of their products. This can all too often create competing interests within an organization, adversely affecting daily operations, strategic decision-making, and long-term value creation.

Although KPIs are commonly adjusted for limitations of the underlying accounting framework, the complexity of L&A products and intertwined regulatory requirements introduces informational asymmetry between the organization and its external stakeholders. Table 1 demonstrates the competing agendas within L&A financials.

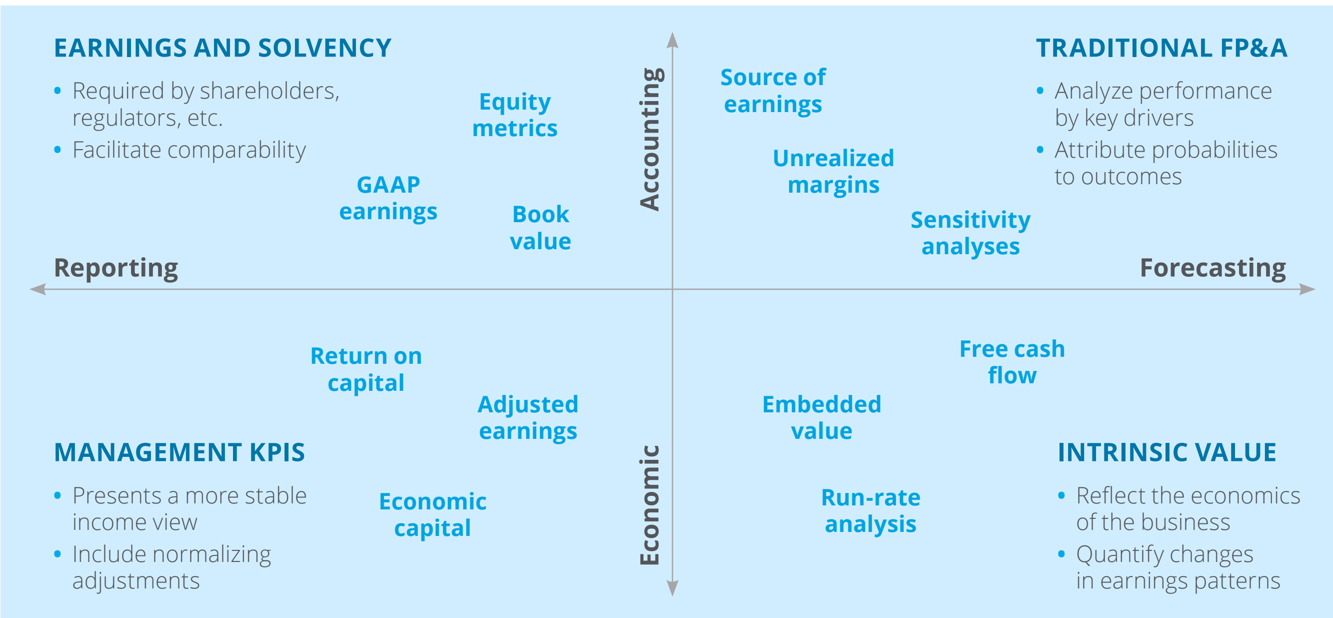
Table 1: Illustrative comparison of the various financial bases that (re)insurers must balance

Public company reporting standards	Statutory accounting standards	Economic accounting framework
• Frameworks used to report financial results and provide a standardized view of performance • Matches the timing of expenses to revenue recognition, which is essential for comparability across companies and to institutions outside the insurance sector • May not always align with the economic realities of the business	• Most conservative form of accounting • Driven by regulation to protect policyholders • Tends to delay the recognition of earnings, providing a more cautious view of financial health • Impacts strategic decisions, particularly in capital management and regulatory compliance	• Marks assets and liabilities to current market values, leading to volatile earnings • Offers the most relevant measure of true value, reflecting the real-time economic conditions impacting the business • Understanding the financial position at a point in time is critical, but managing volatility can be a challenge

Setting the targets

Simple, salient metrics can help companies begin to bridge this gap. When identifying North Stars, an organization needs to be mindful of its goals, capabilities, and competitive position. Some insurers are prioritizing short-term growth—seeking to maximize top-line revenues to secure the largest possible market share. Others are seeking to maximize long-term return with a high tolerance for short-term volatility. Still more may be seeking to maximize profitability by targeting more niche markets.

Financial metrics 101



Below, we provide an overview of select metrics and frameworks that are often helpful as a company defines its North Stars:

- **Distributable earnings**: Net income, adjusted for noncash items, nonrecurring items, changes in working capital, and capital expenditures, available for distribution. This metric provides stakeholders with a clear understanding of actual cash earnings, aiding in sustainable dividend policies and accurate valuations.

- **Free cash flow:** Cash generated after capital expenditures to maintain or expand the asset base, representing funds available for dividends, debt repayment, or reinvestment. It is a crucial indicator of financial health and ability to generate cash from operations, providing insight into operational efficiency and financial flexibility.

- **Embedded value:** Consolidated value of shareholders' interests, combining the net asset value with the present value of future profits from existing in force. This comprehensive assessment of a (re)insurer's performance and long-term profitability provides intrinsic value insights beyond traditional accounting metrics.

- **Source of earnings:** An analytic framework that identifies and quantifies the various factors contributing to profitability, such as premium income, investment returns, benefit ratios, and operating expenses. This analysis helps stakeholders understand drivers of financial performance while assessing earnings quality and sustainability.

Each KPI has benefits and drawbacks, highlighting the importance of deliberate portfolio construction. Some seek to quantify performance on a true distributable cash basis, while others seek to measure profit emergence and volatility to market conditions over time.

Once clear KPIs are set, it is equally important to set clear and consistent definitions across the enterprise. If you were to ask a group of 10 cross-functional employees to define "distributable earnings," would you find one, consistent response? Experience suggests that you may receive as many as 10 unique definitions.

Identifying what is most important to your organization is much easier said than done. Companies need to know what is measured, but just as importantly, should establish an enterprise-wide appreciation for why it is measured.

Case study

A large global insurer with a diverse product mix spanning Traditional and Universal Life, Fixed and Variable Annuities, and Pension Risk blocks produces large volumes of actuals-based earnings KPIs but has under-invested in its capital projection capabilities.

Problem statement: While the insurer can effectively communicate results and have a profitable book, its investments office is often notified of capital contributions/dividends to affiliates as they are due. This has forced the liquidation of certain holdings at suboptimal times and resulted in a loss of additional potential profits.

Sample KPI: Deploy a capital-based framework, with robust forecasting capabilities, to quickly assess capital impacts across products and entities. This should provide robust scenario modeling capabilities that will allow the entity to project capital strain across a range of scenarios.

Eliminating the noise

Fortunately, industry catalysts have brought attention to the problem. This is the time to take a step back, set aside historic practices, and ask why an organization produces KPIs: (re)insurers require accounting information to explain results and must maintain certain KPIs to appease a specific stakeholder group, but these are not the reason for transformation.

Accounting information will have a place in the future state; however, today's efforts should be concerned with the number of distracting KPIs. Suppose a company considers improving capital generation to be a North Star. The reader may already be thinking of the KPIs to measure performance, but a more powerful exercise is considering the metrics in today's portfolio that are not focused on generating capital.

An illusion of success is tangible when strategies cater to suboptimal KPIs. (Re)insurers face punitive, long-duration consequences each day, compounding the importance of sound decision-making capabilities. The opportunity cost of these decisions is typically a fleeting chance to pursue a better long-term strategy, but the clarity afforded from explicitly prioritizing the most important organizational outcomes can immediately improve a company's strategic decision-making.

Case study

A large, public US-based carrier of traditional insurance products has faced market headwinds due to a lack of profitability, coupled with limited transparency into underlying US GAAP earnings and loss drivers.

Problem statement: While the organization produces significant volumes of granular cohort-level analysis, the information is not distilled to senior executives to provide clear and succinct insights into the core earnings drivers.

Sample KPI: Deploy a comprehensive source of earnings framework that connects earnings back to core drivers such as underwriting margin, investment spread, or expense margin. This provides management the tools to better explain how results are tied to underwriting efficacy, market conditions, or other factors.

Enabling selected KPIs

Defining the portfolio of KPIs is crucial, but successful transformation requires commitment and follow-through, namely investment in the right capabilities, tools, and technologies. Consider the large global insurer in our first case study: To project capital strain under the wide range of potential outcomes, robust scenario modeling is essential. Without existing forecasting excellence, there is a gap to address.

Many recognize current shortcomings in this area, with nearly all organizations still relying on manually produced metrics that are stored in workbooks or on desktops. Enterprise systems can automate these processes to improve both controls and calculation abilities. These simple solutions provide seamless integration with existing finance and actuarial tools, democratizing information across functions and ensuring stakeholders are accessing one source of data truth.

(Re)insurers can realize further benefits by leveraging recent accounting implementation projects to streamline data sourcing and cleaning. By ensuring data accuracy, consistency, and availability, improved data warehousing forms the foundation for advanced analytics capabilities. A modernized technology stack facilitates more effective "what-if" analyses and allows organizations to make informed decisions more quickly.

Along the way, improved governance is needed to manage metrics with formal oversight rather than ad hoc "rules of thumb." Implementing governance solutions offers critical structure and accountability: real-time monitoring and reporting fosters continuous oversight of key metrics, allowing management to promptly identify and address issues.

While some systems offer out-of-the-box solutions, companies should not expect vendors to produce custom-fit solutions without additional design and configuration efforts. Investment in the ancillary tools and technologies will help deliver the organization's transformed portfolio of KPIs. While back-office limitations are seldom prioritized, companies should recognize the strategic imperative to create a more data-driven reporting function.

Ready to get moving? We are.

Today, most companies are inundated by the volumes of KPIs that help measure success and manage performance. Accounting change, economic volatility, M&A trends, reinsurance markets, and product shifts are only a few of the catalysts that have led (re)insurers to question KPIs. Their timing is just right: Recent transformational efforts have data, models, and systems in a state where KPIs can be generated relatively easily. Major technology platforms, such as Anaplan, Oracle, SAS, Workiva, and others, offer out-of-the-box reporting functionality to support transformational financial reporting.

(Re)insurers may be tempted to modernize around KPIs that are required, have become historically ingrained, or are popularized by others, but should be careful of starting down the wrong path. Competing priorities in day-to-day operations have led to hundreds of metrics, only some of which are truly valuable. Certain KPIs have a critical role in reporting and compliance but often will not serve the organization's strategic goals. Understanding why, how, and when to employ a metric can be more valuable than the information conveyed.

The first, and likely most arduous, step will be redesigning the organization's KPIs to align with its North Stars. This requires taking a hard look at the portfolio of KPIs, simplifying it, and tailoring its purpose:

1. **Know your metrics:** Understand your most important questions.
2. **Set aside old habits:** Step back to prioritize, rationalize, and/or retire metrics.
3. **Craft a portfolio:** Supplement what is required only if it serves a North Star.

The solutions that usher the industry into a new era of performance management require a custom fit. What is it that you, as an organization, want to accomplish? Answer this question well and an optimized portfolio of KPIs begins to emerge naturally.

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