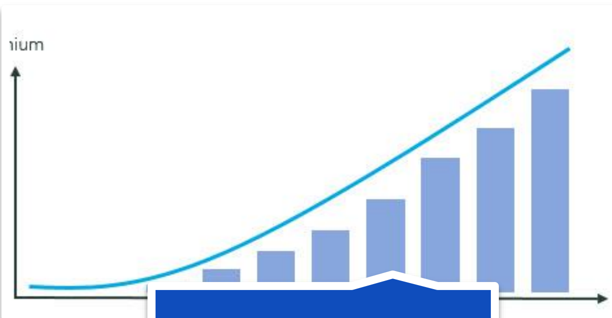
Capital management

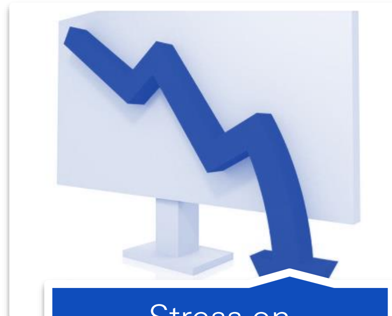
Swiss Re
April 2018

Capital Management Priorities

Key trends that impact insurers today



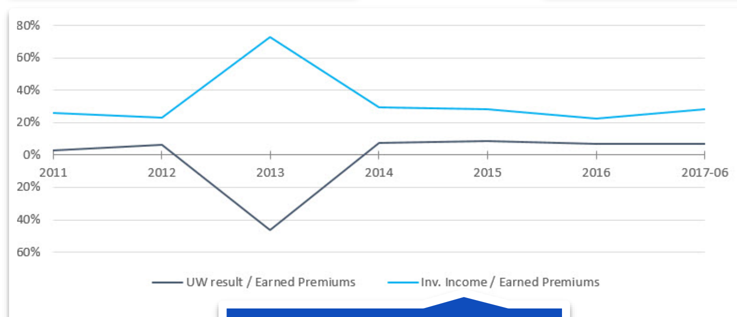
Growth



Stress on Profitability

Inflation and F/X

M&A



Interest rate decline

http://mspmentor.net/msp-mergers-and-acquisitions/msp-mergers-and-acquisitions-where-do-consultants-fit
https://www.autoevolution.com/news/what-to-do-after-witnessing-a-car-accident-98998.htmlg
http://russtd.com/analytics/about-15-travel-agencies-have-closed-russia

Retrospective Solutions

Capital Management Priorities
Motivation

Free up capital

. . . locked up in insurance reserves

https://www.dreamstime.com/royalty-free-stock-photography-100-real-brazilian-money-closed-padlock-image8938817

Capital Management Priorities

Motivation

M&A - Minimize exposure

& protect against adverse reserves development

https://www.dreamstime.com/royalty-free-stock-photography-100-real-brazilian-money-closed-padlock-image8938817

Loss portfolio transfer (LPT)

Structured Features:

- **Loss Portfolio Transfer ("LPT")**
  Transfers carried reserves for protection against claims, and the deviation of the expected payout pattern of claims (timing risk)
  Much like a Quota Share on prospective business, losses are covered ground up and ultimately capped at some loss ratio

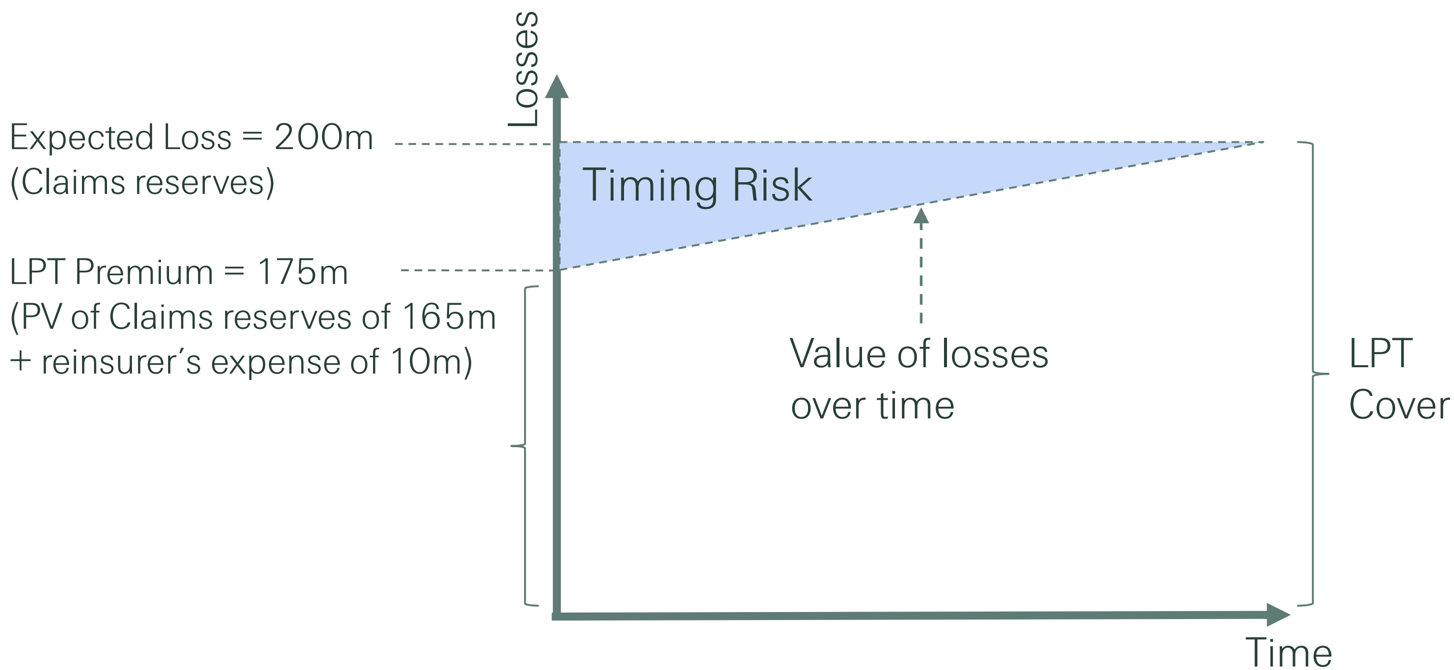
Client need

- An insurer would like to reduce the risk related with the run-off of its motor third party liability reserves. This is driven by the potential acceleration of claims payments (which have an severe economic impact).
- Any freed up capital from the transfer of this timing risk shall become available for other business purposes, like risks in other areas of their portfolio or for growth
- Swiss Re agrees to reinsure the outstanding claims reserves portfolio by means of a Loss Portfolio Transfer (LPT)
- The booked claims reserves are 200m, net of reinsurance recoveries
- Based on an anticipated five-year average claims settlement period and using a suitable risk-free interest rate to discount the value of reserves, Swiss Re charges a premium of 175m

Loss Portfolio Transfers (LPT)

Retroactive Quota Share priced on present value of booked reserves

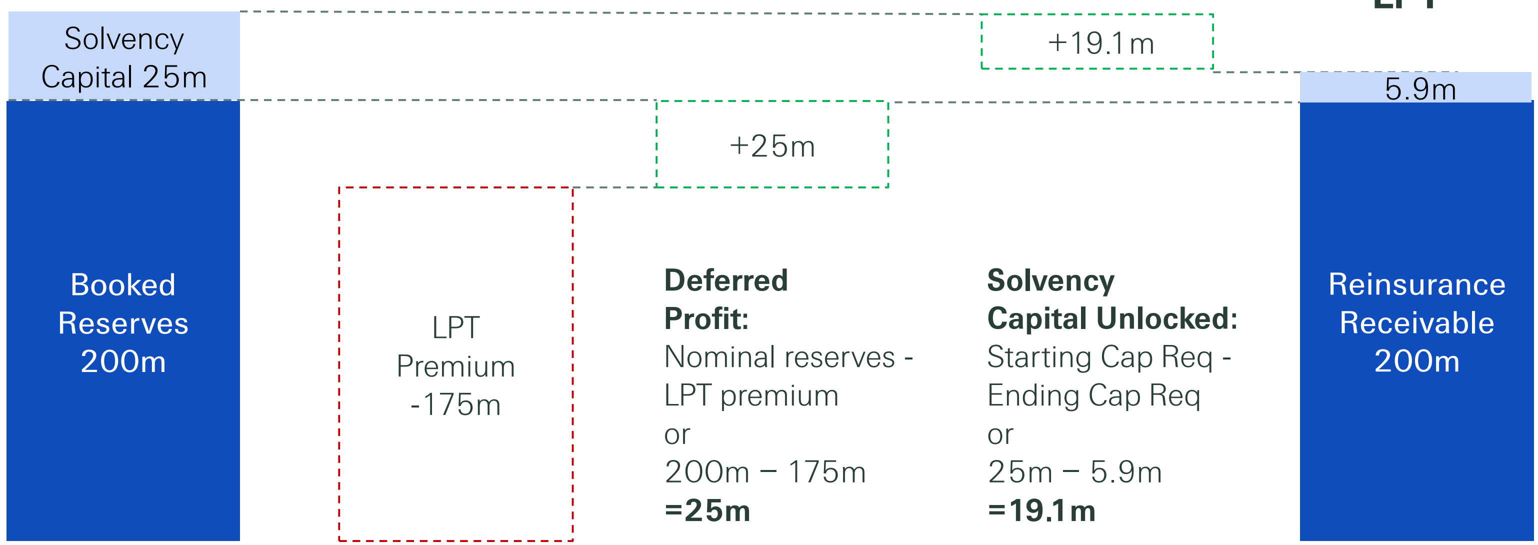
In return for the payment of a premium based on the present value of the client's company's net booked claims reserves plus some charge, Swiss Re provides reinsurance cover, typically from the ground up to the actual level of the net booked claims reserves



Client benefits

Before LPT

After LPT



Deferred Profit:
Nominal reserves - LPT premium
or
200m – 175m
=25m

Solvency Capital Unlocked:
Starting Cap Req - Ending Cap Req
or
25m – 5.9m
=19.1m

Starting Solvency Capital Required:
9.0% reserve charge +
3.5% asset charge
or
9.0% x 200m +
3.5% x 200m
= **25m**

Ending Solvency Capital Required:
2.5% rein. recoverable +
3.5% asset charge
or
2.5% x 200m +
3.5% x 25m
= **5.875m**

Adverse development cover (ADC)

New Structured Features:

- **Adverse Development Cover ("ADC")**
  Works much like a prospective stop loss but protects against future deviations of the expected ultimate claims (reserving deficiency risk)
  It sits on top of the LPT or as a standalone

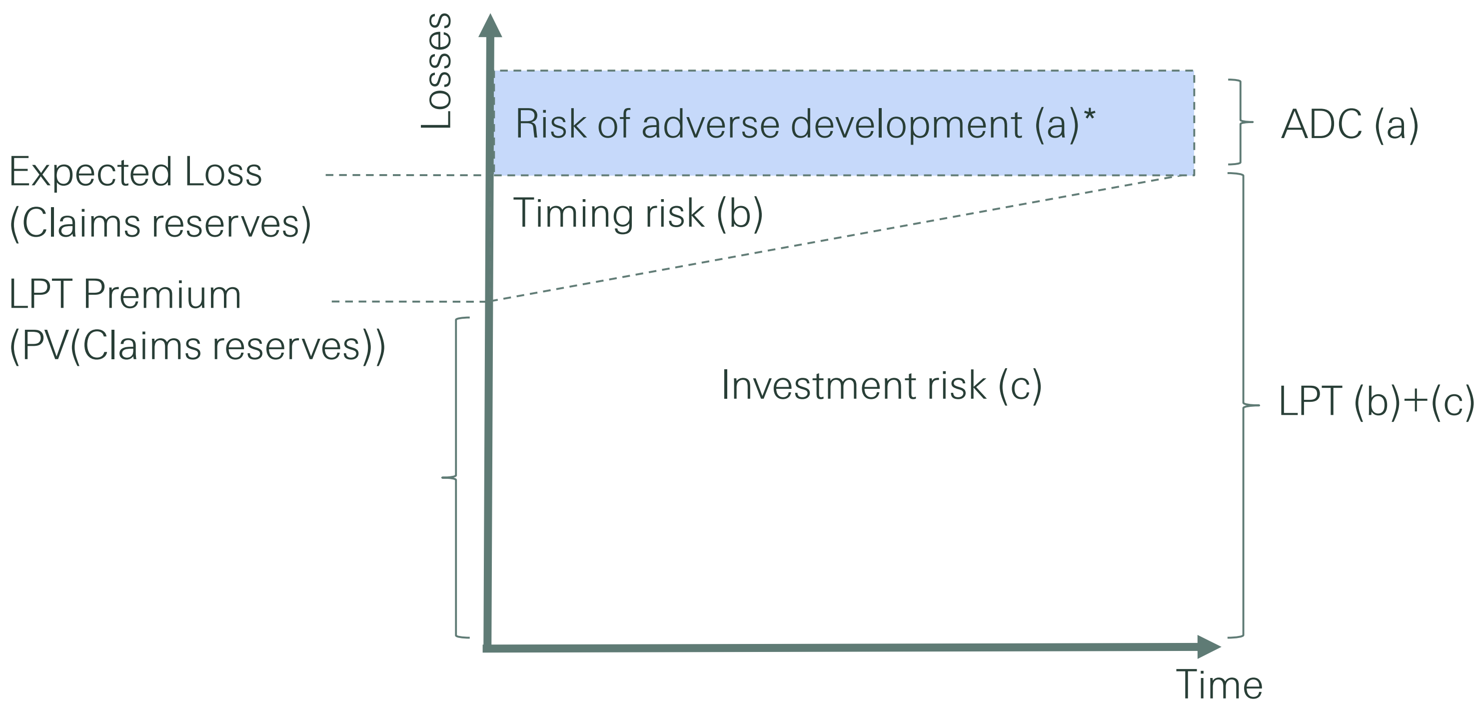
Client need

- An insurer is searching for acquisition in order to grow mid-market P&C commercial business
- The buyer is not entirely comfortable with some of the acquired risks, the seller cannot provide adequate indemnity. The prudence principle suggests that they think about protecting against reserve stress scenarios
- Thus the buyer wants to arrange a reinsurance cover that will allow to ʻring fence the claims portfolio, and to reduce the risk of potential adverse development or reserve deficiency
- The booked reserves are considered to be 270m. Swiss Re, after performing its own actuarial analysis of reserves and a confirmatory claims due diligence, believes that booked reserves for this portfolio should be set at 300m

Adverse Development Cover (ADC)

Retroactive Aggregate Stop Loss priced on volatility of reserves

The cover is similar to an aggregate stop loss layer. The ADC helps to transfer the risk of reserve deficiency by protecting against losses above the level of booked claims reserves.



* The attachment point of the ADC may be at the current reserve level or higher;
if it is higher it protects in a more efficient way against threat reserve development scenarios

Client benefits

- Safeguard current reserve levels
- Stabilize earnings by preventing volatility of reserves
- Protect the capital against adverse developments
- In an M&A context, facilitate a sale by providing peace of mind protection for specific portfolios that acquirers may be concerned with

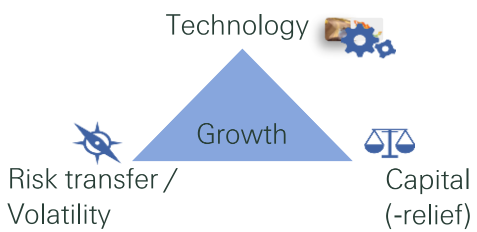
Prospective Solutions

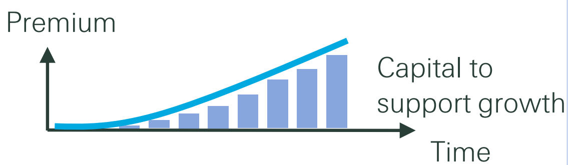
Capital Management Priorities

Motivation

Alternative source of capital

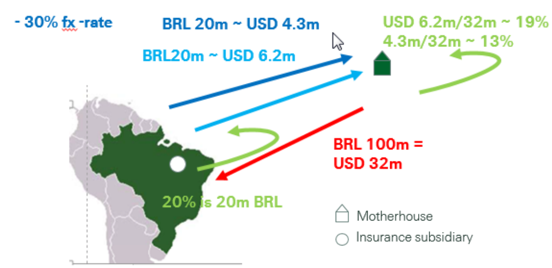
Support profitable growth - target triangle





Reinsurance supports growth by reducing capital requirements – smarter together

Alternative to capital injection



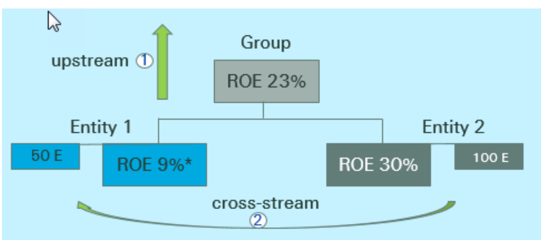
FX-environment transnational

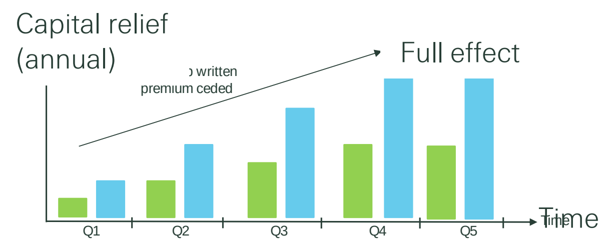
1a. Capital injection
2. Profitability
3a. Dividend out
3b. FX-rate impact

1b. Provide reinsurance not capital injection
BRL 100m capital relief for cost < USD 2m -> solution

Reinsurance can be cheaper than fx-rate impact

Enhancement of capital flexibility / ROE





Reinsurance enables capital upstream and cross-stream with adjustable size of impact over time

Variable Quota Share

Structured Features:

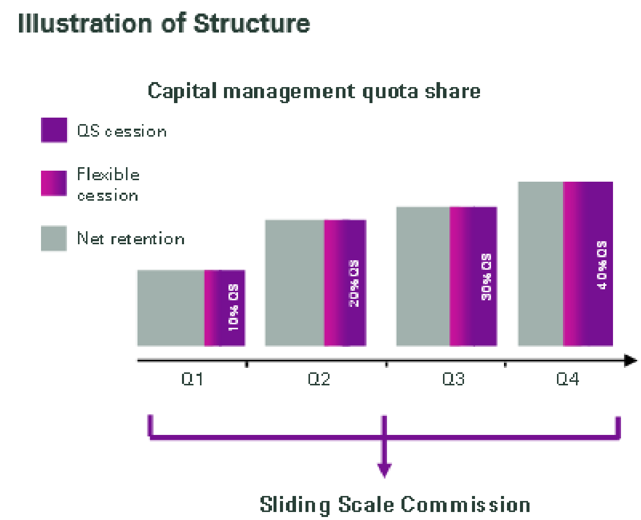
- **Multi-Year**
- **Sliding Scale Commission**
  The level of commission payable varies automatically in line with the actual claims outcome each year
- **Loss Ratio Cap**
  Limit on the amount of losses paid set to a specific loss ratio. A 150% Loss Ratio Cap for example pays up to 150% of the premium ceded

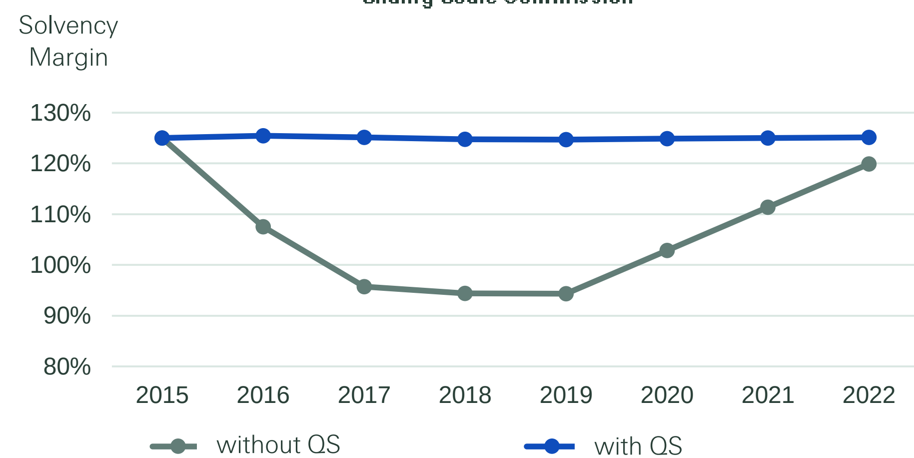
Client need

- An Insurer writes first motor coverage.
- The Client has identified market opportunities for substantial premium growth in a new region, but is unable to start writing that business because the capital intensity needs exceed their available capital base
- The Client is looking for a high quality reinsurance partner to help it to grow the business, manage its solvency ratio by leveraging reinsurance as risk transfer and capital substitute, and protect against downside threat scenarios (especially those that are outside of management control)

Variable Quota Share
Capital relief

- Growth in new products generates an **additional capital requirement**
  - 20% written Premium growth -> 20% additional capital
  - Required capital grows faster than the retained earnings
- As such, companies have different alternatives:
  - Not pursue growth/investment in new lines of business
  - Obtain additional capital through investors or debt
  - Reinsurance Solution

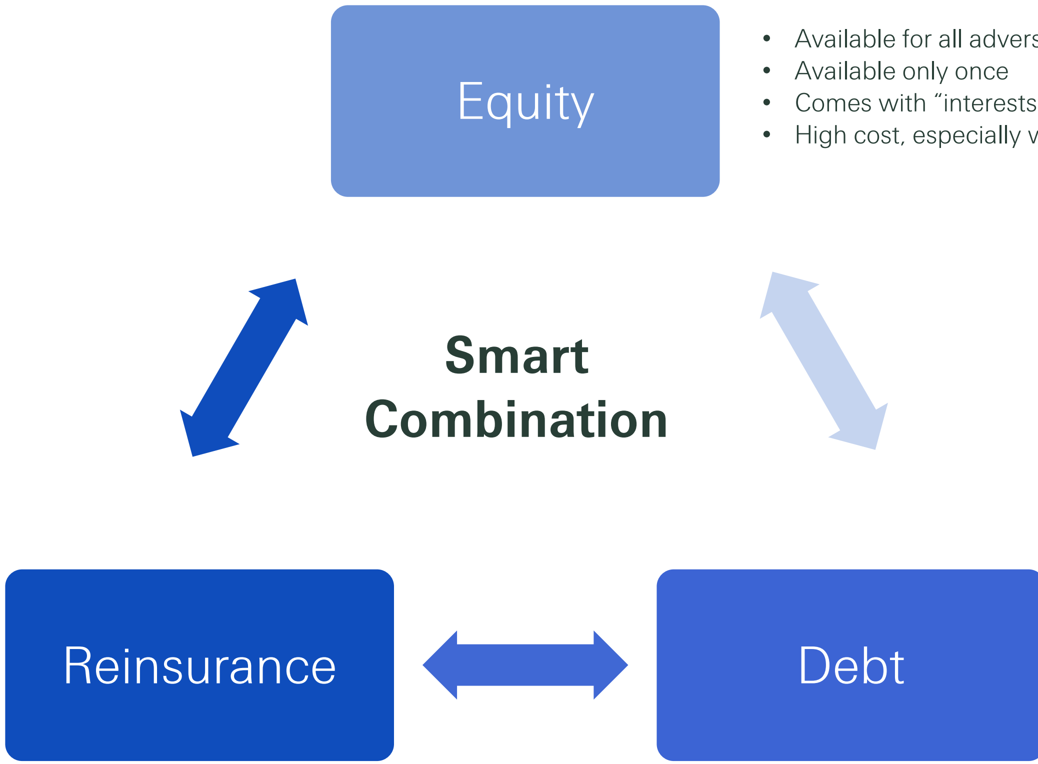




Growth	20%	20%	10%	10%	0%	0%	0%
Quota share cession	17%	28%	29%	29%	21%	13%	5%

- A Quota Share reinsurance treaty allows to **reduce the capital requirement** for the company. The cession base can be defined according to the company's specific KPIs

Client benefits
Reinsurance – flexibility and reversibility



Equity:
- Available for all adverse scenarios
- Available only once
- Comes with "interests"
- High cost, especially when coming from abroad

Reinsurance:
- Available for insurance related adverse scenarios
- Restores through renewals
- Exists for one or multiple years; exit option is in the hands of the insurer
- Reduction of required capital cost efficiently and sustainably
- Avoids deep dives by banks or dilution of interests of owners

Debt:
- Not really available for adverse scenarios
- Needs to be restored
- Flexibility is prohibitively expensive
- Potentially some cumbersome discussions with future debtholder
- Low cost, i.e. lower surcharge on top of risk free/CDI

To conclude: Reinsurance is as an attractive complement to other corporate finance instruments

Significant advantages compared to traditional corporate finance instruments (debt/equity)

High degree of adaptability	Reinsurance can be flexibly tailored to the specific transaction circumstances; exit options and scaling options are on the clients' side instead of the investors' side
No financial leverage	Unlike hybrid capital or debt instruments, financing through reinsurance does not increase financial leverage of the firm
Reduced execution risk	Reinsurance solutions not only enable acquisition financing but also stabilize earnings and protect capital
Positive impact on KPI's	Reinsurance influences financial KPI's positively, absorbing potential pressure after an acquisition
Independent of economic development	In context of the weakening economy in Brazil, a potential devaluation indirectly makes capital from e.g. Europe substantially more expensive.
Low cost of capital	Embedded capital cost for strategic reinsurance with Swiss Re in Brazil typically is lower than cost of equity and in the range of cost of debt; depending on structure sometimes even lower than that

Legal notice