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THE NEW CAPITAL

An influx of third-party investors in the forms of hedge funds, private equity firms and pension funds is altering the insurance and reinsurance markets.

by Angelo John Lewis

Item: Last August Athene Holding, an insurance holding company, attained regulatory approval of its $1.8 billion purchase of two of Aviva plc's life insurance units.

Item: The Carlyle Group, a New York-based private investment group, agreed last November to take a controlling stake in retail insurance broker Edgewood Partners Holdings LLC. That investment followed other major PE investments in brokerage firms, including Hellman & Friedman's $4 billion purchase of Hub International Ltd. in August 2013 and last November's Kohlberg Kravis Roberts & Co.'s purchase of Alliant Insurance Services Inc. from Blackstone Group for an undisclosed amount.

Key Points

▶ **The Trend:** Alternative investors now own significant portions of some life insurance lines of business and are both owners and investors in the P/C reinsurance sector.

▶ **Behind the Trend:** Transactions are motivated by insurers' desire to exit unprofitable lines of business and purchasers' beliefs that they can run these businesses more profitably.

▶ **On the P/C Side:** Alternative investments include investments in the stock of insurers and reinsurers and risk transfer vehicles such as sidecars and catastrophe bonds.

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Item: West Virginia Investment Management Board, a pension fund with $13.2 billion in assets under management, last year invested $40 million in Elementum Advisors LLC's specialist catastrophe reinsurance hedge fund.

These transactions represent a small portion of the increased range of activity that some believe are transforming the insurance industry. Alternative investors—hedge funds, private equity firms, and pension funds—are buying insurers or insurance blocks of business or making major investments in insurance and reinsurance companies.

Purchase transactions appear to be motivated by insurers' desire to exit what they view as unprofitable businesses and investors' beliefs that they can run these companies more efficiently and profitably. Investments appear to be driven by the strategy that the insurance asset class provides diversification and generates better than adequate returns.

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—Tom Love, Insuralytics

Life Insurance

The highest profile investments are the recent rash of purchases by private equity firms of life insurers and annuity blocks of business. According to New York State's top regulator Benjamin Lawsky, private equity-controlled insurers now account for nearly 30% of the indexed annuity market (up from 7% a year ago) and 15% of the total fixed annuity market (up from 4% a year ago). Lawsky is superintendent of New York State's Department of Financial Services.

An example of this activity was Athene's purchase of Aviva plc's U.S. annuity and life operations, which, according to NAIC's Center for Insurance Policy and Research, made it the second-largest issuer of fixed indexed annuities in the United States. Athene's transaction followed the December 2012 Guggenheim Partners' purchase of Sun Life Financial's domestic U.S. annuity business and certain life insurance business. That purchase included both fixed and variable annuity blocks of business.

Before approving the Athene deal, the New York state regulator negotiated a number of concessions with Apollo Global Management, which funds Athene, that provided "enhanced safeguards for policyholders." The policyholder protections included heightened capital standards; the establishment of a separate, additional "backstop" trust account dedicated to further safeguarding policyholder claims; enhanced regulatory scrutiny of investments, operations, dividends, and reinsurance; and other strengthened disclosure and transparency requirements. Guggenheim previously agreed to a similar set of protections.

According to Tom Love, principal of Acworth, Ga.-based Insuralytics, a life insurance advisory and management firm, New York has been the regulatory regime that has placed the most scrutiny on these deals.

"I don't know if [other state regulators] are asking the right questions or if they have the resources to stay on top of all the moving parts here because it's so complex… You've got 50 state insurance regulators and they all have different levels of sophistication and resources to try to look at these transactions. And you've got some of the most sophisticated financial firms in the entire world who are outgunning the insurance regulators," Love said.

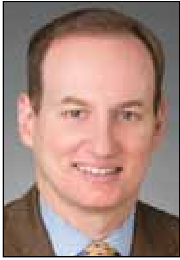
Love is skeptical about the motivations of private equity firms.

"PE firms are doing this for a couple of reasons. One is that they're willing to run a business in the way that a traditional carrier could not or would not run it. They're willing to take lower amounts of capital. They're not concerned as much with the sensitivity of rating agencies. And they're willing to use a lot of financial engineering with things like captive reinsurance deals, surplus notes and pushing liabilities out to the future," he said.

John Marra, a partner at PwC, which has advised both buyers and sellers in these transactions, said it isn't clear that these purchases have had any negative effect on policyholders.

"I think that what the buyers have been demonstrating is that there is no impact to the policyholder," Marra said. "The acquired, licensed and regulated entity has an existing legal obligation that the buyers understand and acknowledge. They have made it clear that they will honor the contract terms and are experienced insurance industry veterans who are familiar with and will operate within existing regulations. They've said, 'we'll honor the contract terms. The seller sold that contract five years ago, and it's been performing and our buying the company [demonstrates] that we've got a significant commitment to the company's capital level. We're going to make the company more efficient and we're going to honor the contract terms or better.' And they would argue that they're probably a better owner in some ways."

Aaron Sarfatti, a partner with Oliver Wyman, said that the jury is still



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—Aaron Sarfatti, Oliver Wyman

out on the eventual policyholder impact of these transactions.

"No policyholder has experienced a loss as a result of any of the transactions. But you wouldn't expect any policyholder losses given fairly stellar performance of most fixed-income asset markets over the last few years. The real test of the new asset allocations and structures will occur if there's a downturn at some point, because the downturn maybe would result in the assets not performing well. I think that's the dominant risk.

"It's probably safe to say that policyholders were exposed to more risk than if [their policies] were backed by a typical traditional insurer's investment portfolio. But it's hard to quantify exactly how much because some of the private equity firms did actually increase the overall amount of capital," Sarfatti added.

Love agreed that it is too early to tell about the eventual impact of these deals.

"I don't know that we've seen everything that's going to come from this. It's still pretty early. I think we're in the first couple of innings of a nine-inning ball game."

His major concern is the future.

"What happens five or 10 years from now if a PE firm doesn't stay in the business long-term like they claim they're going to do and decide to exit the business and there are no buyers? What happens if one of these firms says, 'you know what, we're just going to put these companies in runoff. We're not going to add additional capital and whatever happens, happens.'"

If that occurs, Love said, it would be up to the state guaranty funds, which consists of assets contributed by carriers in the same business, to back up policyholder guarantees.

"That's going to affect the capital levels of traditional insurance companies and it's also going to trickle down to the policyholders in terms of maybe what earnings are credited to their policies, what dividends they get and things like that. I think the big-picture risk is if PE firms decide to exit the market, the traditional carriers are left holding the bag."

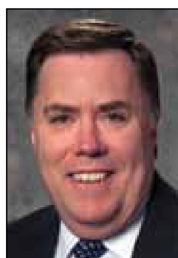
Alternative Investors

Although PE purchases of insurers have received more publicity, the fact is that alternative investors have been involved in other ways in the industry for some time, especially on the property/casualty side. These involvements include investments in the stock of insurers and reinsurers and risk transfer vehicles like catastrophe bonds and insurance sidecars. A more recent trend is the purchase or establishment of offshore reinsurers.

"Private equity on the property/casualty side has been investing in the market for years," said Sean McDermott, P&C M&A practice leader for the Americas at Towers Watson. "If we just look at Bermuda, go back to the years when the first companies were starting up or the class of 2001 as well as the recent companies, private equity has usually had a pretty big stake at the table," McDermott said. "What they often do is diversify across many different companies and have investments in a variety of start-ups, sidecars or hedge funds. Unlike the life side, they really haven't gotten a lot of negative press or tangled in regulatory issues."

What's developed after the Sept. 11, 2001, terrorist attacks and Hurricane Katrina, McDermott continued, is "the concept of the sidecar, where an existing company will get capital from third parties and then underwrite as they normally would but with an increased capital base. In the last few years, hedge fund-type company set-ups have emerged where the assets are managed differently than traditional insurance companies. Or most recently, we see PE or other involvement in the ever expanding ILS market. It's not so much that private equity has driven these vehicles, but rather private equity is an available form of capital and when these concepts come up, private equity invests."

The ILS market, including sidecars and catastrophe bonds, are used for alternative risk transfer. Most of these techniques permit investors in the capital markets to take a more direct role in providing insurance and reinsurance protection. According to an August report by the Goldman Sachs Group Inc.'s global investment research unit, assets invested in reinsurance by nonindustry investors rose 800% to $45 billion as of June 30, 2013—from just $5 billion in 2005.



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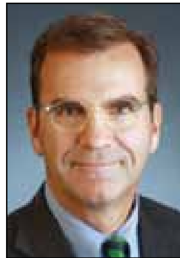

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And Willis Re's April 2013 market report estimated that $35 billion of alternative capital currently is in the Bermuda reinsurance market, with more expected.

The Best's Special Report, *Global Reinsurance—Segment Review* states that "hedge funds, pension funds, endowments and trusts looking for a bigger slice of the pie are lured by the relatively favorable returns, float and uncorrelated risk that the reinsurance business offers."

"On the property/casualty side, often what [hedge fund investors] are looking for is one of two things: non-correlated risks or risks that are not correlated to the economy or the stock market," said Mark Goodman, a partner at Freeborn & Peters LLP.

"And the other thing is they're willing to take big risks, because that's what they do. They're hedge funds; they take big risks and they get big returns."

A lot of this activity centers on Bermuda, where tax benefits to hedge funds are substantial. Currently, there are no taxes on profits, incomes or dividends, nor is there any capital gains tax. In addition, Bermuda imposes minimum capital requirements and generally does not dictate how reinsurers must invest their assets, making it easier for hedge fund managers to execute their investment strategies with reinsurance premiums.

The Best's Special Report, *2012 Special Report: Bermuda—Market Review* described a "new breed of reinsurers" — hedge-fund backed reinsurance companies that "claim to have the expertise to manage more volatile assets and therefore allocate a larger share of their capital to risks on the asset side versus the liabilities side of the balance sheet."

In 2012, four start-up reinsurers backed by hedge funds were established, according the NAIC's Center for Insurance Policy and Research. These included Third Point Re ($780 million), AQR Re ($260 million), PaCRe ($500 million) and SACRe ($500 million).

Although the amount of hedge fund investment in reinsurance is substantial, it is likely dwarfed by how much capital pension funds invest.

Although it is difficult to determine just how much of the estimated $300 trillion in pension fund assets under management are invested in insurance or reinsurance vehicles, one indication is the sector's investment in catastrophic bonds.

BNY Mellon recently reported that the number of cat bonds could more than double from the current level of $19 billion to $50 billion by the end of 2018. "The initial investor base was dominated by hedge funds and private equity, but we are seeing more long-term investors such as pension funds buying cat bonds," said Dean Fletcher, head of EMEA Corporate Trust at BNY Mellon.

The influx of alternative investments into reinsurance has caused some to believe that the industry is overcapitalized, and may eventually drive down reinsurance pricing. Best's Special 2013 Report *Global Reinsurance Review* summarized hurdles facing reinsurers since the 2008 financial crisis: a "weakened global economy; deteriorating investment returns; more volatile investments; suppressed growth opportunities; increased client retentions and competitive pricing."

Now, the report continued, "another hurdle has materialized on the horizon in the form of third-party capital. With excess capacity prevalent among the traditional reinsurers, pricing in the market is already very competitive."

"With third-party capital taking the higher layer of exposures and primary companies increasing retentions, reinsurers appear to be stuck in the middle," A.M. Best said. in its 2013 *U.S. & Bermuda Reinsurance Segment Review*. "Many industry observers agree that the reinsurance market may be at an inflection point.

"While the risk-sharing struggle between primary and reinsurance companies is a significant issue, it is much different from the increased inflow via the capital markets. This external threat of vast capital is concerning and could be a game changer," A.M. Best said.

The report added that coming risks include competitive securitization markets that can be prone to dramatic declines in underwriting standards.

"Securitization also can diminish the relationship aspect of the (re) insurance industry in which companies have prided themselves on a certain level of loyalty," the report said. "Taking that one step farther, often in major events, (re)insurance losses can have a gray area, with contract wording open to interpretation and thus, litigation."

The report said that "to preserve a relationship or franchise image, reinsurance companies may willingly pay claims at the margin. However, third-party investors may not have that same willingness to pay, which potentially opens the capital structure of insureds to credit risk. This has yet to be seen on a grand scale, but one day the industry will find out the answer." BR