February 9, 2012

Hedge Fund Sponsored Non-Life Reinsurers Build Momentum

Hedge funds are showing renewed interest in the reinsurance business as they seek to diversify their investment strategies and deploy accumulated capital. The catastrophic losses experienced by the reinsurance industry in 2011 have piqued the hedge funds' interest. Given the importance of Best Credit Ratings in the reinsurance community, some of these hedge fund backed reinsurers are rated, and others have inquired about initial ratings. A.M. Best's analysis employs standard rating criteria with special attention to the risks of both the investment strategies and business/underwriting profiles of these companies.

Background

In 2004-2005, a handful of hedge funds began looking into opportunities in the non-life reinsurance market. Flush with capital and seeking to diversify investments away from the capital markets, the funds looked to catastrophe insurance, for which prices had increased after losses from the 2004 hurricane season led by Ivan and the 2005 season, led principally by Katrina. The returns on catastrophe and property/casualty reinsurance are seen as uncorrelated with those of stocks, bonds and other assets.

The initial entry was through the purchase of catastrophe bonds, which are issued with maturities of three to five years and provided attractive yields to the funds. Catastrophe bonds issued by the insurance sector provide a form of reinsurance via spreading the risks and costs of natural disaster to the capital markets. The buyers of cat bonds are at risk to lose some or all of their capital investment in the event of triggers, which could include flood levels, Richter scale readings and/or wind speeds.

While the cat bonds provided a point of entry to the reinsurance market, the length of exposure and extremes of risk/reward do not match the long-term strategy of a number of funds. As a result, hedge funds put up capital for the start-up of new reinsurance companies. The funds kept a portion of the targeted risk in the catastrophe bond market because of the yield and limited exposure, but their sponsored companies incorporated a primary strategy that focused on the low-volatility property/casualty (P/C) market. While expectations at the time were that additional hedge-fund capital would follow, the market stresses that arose in 2006 and 2008 through 2010 were enough to keep other funds on the sidelines until recently.

New players look to replace industry capital lost from the property/casualty reinsurance markets through the March 2011 earthquake and tsunami in Japan; U.S. hurricanes, specifically Irene; and the rash of other global natural disasters in 2011. Industry estimates are that worldwide catastrophic losses exceeded USD 105 billion. Historically, the investment banking industry would have funded such new reinsurers, but hedge funds took the lead this time. Whether it is the attractiveness of the investment opportunity for the hedge funds or the continued hesitancy of investment banks to run the regulatory risk of entering the market is not clear. In addition to the funding of the start-ups, the fact that hedge funds will hold and manage the reinsurers' assets raises question as to increased risks that may be present in this structure.

Issues When Rating Hedge Fund Sponsored Non-Life Reinsurers

While many insurers' and reinsurers' investments are held and managed outside of the company, the level of volatility often associated with a hedge fund and its investments is not typical of that related to the insurance industry.

With this volatility in mind, A.M. Best applies the quantitative and qualitative analysis outlined in Best's Credit Rating Methodology (BCRM). To assess the financial strength and financial flexibility of a rated entity, a variety of balance sheet, income statement and cash-flow metrics are reviewed, including corporate capital structure, financial leverage, interest expense coverage, cash coverage, liquidity, capital generation, and historical sources and uses of capital.

While balance sheet strength is the foundation for financial security, the balance sheet provides an assessment of capital adequacy at a point in time. A.M. Best views operating performance and business profile as leading indicators when measuring future balance sheet strength and long-term financial stability.

As such, A.M. Best reviews the volatility associated with the segment of the insurance industry in which the reinsurer operates or plans to enter. The inherent risk of the reinsurer's business profile is analyzed for the spread (both geographically and by product) and the potential volatility associated with the segments of the markets in which it will operate. A focus on low-volatility P/C reinsurance is an offset to capital requirements driven by investment strategies when analyzing hedge fund-owned reinsurers. Combining a high-volatility business profile with hedge-fund investment strategies would make it difficult to achieve a Financial Strength Rating of Excellent or Superior (A- or higher).

What makes the analysis of each reinsurer unique is that a vast majority of unencumbered assets will be subject to an additional form of risk/reward through their respective asset strategies.

The investment strategies and inherent risk may vary among hedge-fund sponsors. One sponsored reinsurer may follow a partially hedged equity portfolio that consists primarily of publicly traded securities with a long and short philosophy that produces a partial hedge on market performance and asset value; another may be invested primarily in publicly traded debt and equity securities, as well as government debt, asset-backed securities, gold and other precious metals.

While the reinsurer's assets are managed by the hedge fund's investment manager, in each case the portfolio's risks are mitigated by the reinsurance company's assets being part of segregated pools from those of the general fund. As with all investment strategies, specific risks must be addressed in any analysis, and therefore the portfolios are viewed for their respective risk and volatility. And while a hedge-fund portfolio has more risk than a bond aggregate investment strategy, it also has significantly less risk than a straight, well-diversified, long equity portfolio because of its natural hedging activity that is not present in an unhedged, fixed-income or equity portfolio. An offset to the increased risk of a hedged portfolio versus a bond aggregate is also present in the lack of leverage used by the rated entities. It should be noted that an increase or incorporation of financial leverage in the asset strategy would add precipitously to the asset charge used in the rating methodology.

The companies are reviewed using the traditional BCRM. As such, the criteria state that "when common stocks are more than 50% of invested assets, or 100% of surplus, the baseline capital risk charge of 15% will be increased to a level appropriate to the risks of the portfolio." The fund strategies and portfolios of the investment managers are reviewed for performance and volatility over the life of the funds – in each of the two rated companies to date, greater than 12 years. The asset volatility risk then is layered onto the underwriting risk to determine the ultimate rating. This analysis, with a focus on the worst performing and highest volatility period, is incorporated into the ultimate increase in the capital risk charge, which may exceed 30%.

A.M. Best has a dedicated team of analysts who perform surveillance on the asset managers' performance and update the analysis of the portfolio risk on a more frequent basis than with non-hedged strategies of other rated reinsurers, with a typical minimum of a quarterly review. In addition, periodic meetings are held with the asset managers and insurance team to review investment and underwriting strategies for changes that could impact the factors used in calculating the capital analysis or review of the most recent Best's Capital Adequacy Ratio (BCAR). This surveillance strategy is employed to monitor risk of developing or changing investment strategies.

While the investment strategies of a reinsurer owned by a hedge fund and/or the assets managed by a hedge fund may have a different volatility measure than that of a reinsurer with other types of ownership/investment strategy, the basic tenets for rating remain the same. The evaluation of underwriting risk, capital and investment risk all are accounted for and stressed through the BCRM.

Analytical Contacts
Martin Kennedy, Oldwick
Nicholas Dranchak, Oldwick

Editorial Management
Brendan Noonan, Oldwick

A.M. BEST COMPANY
WORLD HEADQUARTERS
Ambest Road, Oldwick, N.J. 08858
Phone: +1 (908) 439-2200

NEWS BUREAU
830 National Press Building
529 14th Street N.W., Washington, D.C. 20045
Phone: +1 (202) 347-3090

A.M. BEST EUROPE RATING SERVICES LTD.
A.M. BEST EUROPE INFORMATION SERVICES LTD.
12 Arthur Street, 6th Floor, London, UK EC4R 9AB
Phone: +44 (0)20 7626-6264

A.M. BEST ASIA-PACIFIC LTD.
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827-3400

SR-2012-B-396