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Bermuda: Reinsurance Market Capital in Focus

Bermuda is an island the size of Manhattan. As anyone who has ever tried to buy real estate in a big city like Manhattan knows, there is a wide range of choices to suit every appetite. So it is with Bermuda reinsurers. We assure you, however, investing in Bermuda reinsurance is easier than buying a Manhattan co-op.

Although Insurance-Linked Securities (ILS) have received the most attention lately, investors looking for diversifying low-beta risk in the reinsurance market can chose anything from plain vanilla debt and equity to highly bespoke instruments that can deliver precisely targeted forms of risk. There is a right form for nearly every professional investor, and Bermuda's professionals can help guide them to the right way to invest depending on each investor's needs and appetites.

Below, we cover at a very high level several investment vehicles. For simplicity, we refer to reinsurers, but practically most reinsurers also write insurance, and Bermuda has several companies that focus on insurance.

1. **Debt & equity**. Insurance has existed since ancient times, and reinsurance has been written since the 14th century. Modern reinsurers developed in the 19th century in response to devastating fires in major cities. Today, the sector has approximately 40 companies having at least $750 million of equity each. Investor ownership tends to be concentrated, with many Bermuda-based reinsurers having half or more of common shares held by the top 10 shareholders.

   Although the number of 'convergence' structures (sidecars, cat bonds etc.) has grown in recent years, the majority of reinsurance capital is in traditional companies capitalized with public debt and equity. According to estimates from Aon Benfield, traditional capital – including debt and equity – comprises over $500 billion of reinsurance capital, with $64 billion from "alternative" sources, this figure having doubled in three years. Within the $500 billion, roughly $350 billion is from re/insurance companies, and the balance is from a range of sources such as multi-nationals with reinsurance arms and government-sponsored reinsurers. Reinsurance remains a niche business, as the entire industry is smaller than, say, Apple Inc, whose market value is around $750 billion.

   For investors, public equities, preference shares, and debt instruments of reinsurance companies provide liquidity and market pricing, as well as diversification through the companies' portfolios of risk. Investors benefit from the reasonable degree of leverage available from a reinsurer being able to issue policies on a rated basis (discussed later). Insurers and reinsurers typically trade at a multiple of book value rather than earnings and investors may benefit from multiple expansion. Free cash flow is often close to net earnings, and regulatory risk is arguably quite lower than for banks or other financial institutions.

Public company financials can be complex for investors to disaggregate. A year's results combine current-year returns from a variety of reinsurance and insurance lines, prior-year reserve development, and investment returns. Reinsurers privately report detailed forward-looking risk-taking measures to rating agencies and regulators have yet to coalesce on simple, consistent public disclosures of forward-looking risk-taking.

2. **Sidecars and joint ventures**. So-called sidecars allow investors to participate in more specifically targeted portfolios than traditional debt and equities, often for a defined period, via private investments. Participants in such vehicles typically enter and exit at book value, to avoid market price fluctuations, and can be privy to more detailed forward-looking risk disclosures than public investors. However, sidecars can be illiquid and are often small - typically a few hundred-million dollars among several investors.

   Sidecars developed over a decade ago to supply annual capacity—most reinsurance contracts are annual but recently have become a more permanent part of many Bermuda-based reinsurers' capital structures, enabling the sponsor to write larger shares of peak risks and build longer-term relationships with third-party capital providers. Some Bermuda-based reinsurers also sponsor joint ventures, which are similar to sidecars but with somewhat different features. Other Bermuda-based reinsurers have converted their sidecars into permanent funds.

3. **Reinsurance funds**. There is a range of flavors of fund offerings in reinsurance. Some reinsurance fund managers are independent, and many traditional reinsurers also offer funds, often to house risk that is less efficient on a rated balance sheet. This risk is typically concentrated in peak-risk zones, since diversified risk can be written efficiently using a rated balance sheet. The reason for this lies in how a reinsurer backs its promise to pay. Collateralizing a reinsurer's contingent obligations ties up capital, so in many cases it is better to back a promise to pay with the imprimatur of a rating agency. However, where risk becomes concentrated, rating agency capital models can severely penalize rated reinsurers and collateralizing the promise to pay can be a more efficient use of capital. The fundamental reason for the recent growth in reinsurance funds is that concentrations of risk cannot be diversified within the reinsurance sector, but in the broader financial sector they are highly diversifying with correlations to other financial markets close to zero.

   As of the beginning of 2015, more than 40 reinsurance funds have emerged, with assets under management exceeding $50 billion. They often write collateralized reinsurance with concentrations in the more profitable peak risk zones, such as Florida hurricanes, European windstorms, and Japanese earthquakes. These zones have high insurance penetration, valuable property, and catastrophic events. The largest reinsurance and catastrophe bond fund manager has around $10 billion of assets under management, with many more funds having more than $1 billion under management.

Investors in reinsurance funds tend to receive transparent risk information, enter and exit at book value, and may be able to exit quarterly with mark-to-model accounting.

4. **Catastrophe bonds**. A specific form of reinsurance investing is the catastrophe bond, which provides the investor a spread above comparable government bonds but could suffer loss of principal if a specified natural or man-made disaster occurs. (Man-made disasters could include an industrial explosion, loss of a ship or aircraft or terrorist attack.) Issuers are typically insurers or reinsurers seeking reinsurance cover, but some ultimate insured parties have also issued cat bonds – for example, government agencies seeking coverage for infrastructure damage.

   A third-party firm will typically assess the risk contained in the bond. Sometimes this risk is based on an event's parameters - e.g. the bond pays if a storm with certain specifications strikes a defined geography, as defined by a third party—but increasingly bonds are issued to cover the issuer's actual losses. The degree of insight into the underlying book varies from bond to bond, with some bonds priced on the basis of individual property addresses. Generally, the degree of transparency is greater than that of pre-crisis mortgage securities.

   The catastrophe bond market dates to 1997 with cumulative issuance now totaling $70 billion with outstanding notional of around $22 billion. Cat bonds are commonly issued for three years, though bonds as long as seven years have been issued.

   Investors can purchase cat bonds directly from a variety of investment banks and reinsurance brokers, who may also provide weekly quote sheets. Cat bonds offer investors the opportunity to build a portfolio comprising specific risk profiles, along with a degree of market liquidity, weekly pricing, and transparency into the underlying risk. Although cat bonds trade, many are held to maturity. Because cat bonds are collateralized, underlying risks are typically in peak-risk zones. Whereas sidecars and public equity are aligned with the sponsor's management, cat bonds place the investor opposite the issuer.

5. **Private equity**. Private equity ownership of reinsurers and insurers goes back as long as such companies have existed. Insurance services (including brokerage) has become a popular and competitive sector for well-known private equity funds, pension funds, and family offices. A smaller subset of these investors has invested in various Bermuda-based reinsurers and reinsurance asset managers over the years, with several deals being announced or proposed just within the past year. Such investors seek the growth of book value and the multiple expansion upon going public that successful Bermuda companies have shown, with investment horizons of three to seven years typical. Equity "cheques" typically run $25 million to $500 million, though at least one takeover attempt has been made this year at a value of nearly $7 billion. Partial exits via IPOs have been increasingly common. A variety of trade buyers have been active, with interest in Bermuda companies coming from the Americas, Europe, and Asia.

6. **Start-up capital**. Due to a concentration of talent and sophisticated regulation, the Bermuda reinsurance market has typically been the center of the industry's innovation, a tradition that has continued, with a number of new types of start-ups launching as recently as this month.

Some have combined reinsurance underwriting with more active investment management, financed by a combination of private equity and high-net-worth capital. For reinsurers, fundraisings have typically been $750 million to $1.5 billion, with smaller fundraisings for the GPs of reinsurance asset managers, which are not as capital-intensive. (*see "Why Bermuda" below for a discussion of why the island is the jurisdiction of choice for both start-ups and mature reinsurers).*

7. **Derivative and parametric investments**. The market for exchange-traded parametric catastrophe products remains quite small after many years of existence. Such products allow investors to place bets on the likelihood of a specified event happening, such as a hurricane of a certain size and intensity officially making landfall. Any form of risk transfer that is not based on the buyer's actual losses contains basis risk for the buyer - the risk the payoff from their risk transfer exceeds or falls short of their actual losses. Thus, buyers have typically preferred indemnity-triggered forms of risk transfer, as discussed above, even though these products tend to be more expensive per unit of protection. The market's continued push towards efficiency may result in some form of actively exchange-traded derivative or parametric product gaining popularity in the future. Pure weather derivatives, based on heating degree days or cooling degree days in a particular city, have become part of the hedging practices of companies such as power utilities and natural gas distributors.

8. **Unique investments**. For investors seeking to deploy medium to large quantities of capital or with specific appetites, Bermuda-based insurers will customize bespoke investments, allowing the investor access to specific forms of risk or even specific reinsurance treaties on similar terms as the reinsurer. While such risks are concentrated, investors have gained comfort from the fact the reinsurer is invested in the same risk *pari passu*. Further, such risks offer very specific low-correlation exposure with a high degree of transparency. A range of investors from sophisticated pension and superannuation funds to quant-oriented hedge funds, have invested in this way.

Although we have just enumerated eight different ways to invest in the reinsurance market, there are many other flavors and combinations to suit nearly any form of capital and risk appetite. Further, the distinctions between many forms of investment are blurring. While this provides the investor more options, it can also make the industry more complex to new investors. Bermuda's industry-leading insurers and reinsurers stand ready to help the investor understand their market and the investment opportunities it provides.

Investors interested in the sector should consider attending the Bermuda Convergence 2015 networking event on November 11-13. The event provides both educational sessions on the latest industry trends and ample opportunities for networking with Bermuda market practitioners and service providers. For more information visit *www.ilsbermuda.com*

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Why Bermuda?

While the popular imagination may associate Bermuda with tax benefits, there are many tax-efficient jurisdictions. Bermuda's advantages are much more than a prudent government and beaches. Some of the unique benefits of Bermuda for reinsurance investors lie in regulation, concentration of talent, and proximity to major markets.

REGULATION: Bermuda has the most sophisticated reinsurance regulation in the world. Bermuda's reinsurance industry dates to the 1940s, and today is the largest single non-governmental source of GDP on the island. Thus Bermuda's insurance regulator, the Bermuda Monetary Authority (BMA), has strong incentives to maintain an efficient and effective regulatory environment that ensures policyholder claims are covered. Bermuda's reinsurers have a world-class track record of paying valid claims, such as paying half the liability from the Costa Concordia cruise liner sinking and 29% of losses from the Japanese earthquake and tsunami of 2011. (see: *ABIR Fact Sheet 2015*)

Bermuda's publicly-traded reinsurers are Sarbanes-Oxley and SEC compliant or comply with other globally recognized governance standards. Bermuda's reinsurers remained ready and able to pay claims throughout the 2008 financial crises.

Bermuda companies, unlike US admitted insurers, have nearly complete freedom of rate and policy form. Combined with efficient regulation, Bermuda companies and start-ups have been the most nimble companies in the industry and the first to respond to opportunities created by market dislocations. Overall, the sector has considerably less regulatory risk than banking and similar financial services – with good reason: Bermuda's reinsurers have an exceptional track record of being conservatively managed, well-governed, and ready and able to pay claims.

TALENT: Bermuda has a far greater concentration of talent than any market except New York and London. Over 20 reinsurers and insurers have major presences that directly employ more than 1,500 people on the island and nearly 39,000 globally. Dozens of other companies have offices of varying sizes, employing yet more professionals. Moreover, Bermuda also has high-quality service providers in administration, banking, brokerage, law, tax, actuarial, trust, and governance. The government recently overhauled immigration regulations to enable start-ups to bring talent to Bermuda easily, although recent start-ups have reported finding a robust market for local talent.

PROXIMITY TO MARKETS: The United States is the largest insurance and reinsurance market in the world, with roughly $71 billion of reinsurance premium ceded to non-affiliates by US insurers, just under half the world's total. With flights from New York as short as 90 minutes and daily non-stops to London, Bermuda is visited regularly by most of the world's major reinsurance buyers, brokers, investment bankers, and other professionals—far more than any other offshore jurisdiction.