NEWSLETTER
INSURANCE AND FINANCE

THE GENEVA ASSOCIATION

No. 15, February 2015

Views from Inside: Alternative Capital, Smart Modelling and Liquidity vs Capital

By Benjamin Meuli[+]

I look at the world from a slightly different perspective than some insurers, and one of the subjects where this may be the case is the debate regarding alternative capital in the insurance industry.

Of the two major classes of alternative capital—hedge funds and pension funds—I believe the pension funds are more likely here to stay. These are big institutions that are taking long-term, serious decisions to add diversification to their portfolios.

Many of the hedge funds, however, are being attracted to the insurance industry on the back of what I believe is essentially a tax arbitrage. If you can invest your money in the context of taking insurance risk, as a U.S. taxpayer, you do not pay taxes on the investment income in the same way. However, my personal experience suggests that building a business on the back of a tax arbitrage very rarely constitutes a successful long-term business plan. I wouldn't be surprised if this loophole is closed eventually and, if so, many of these hedge funds will likely disappear from the insurance industry.

I also think it is clear that not all alternative capital providers have understood the correlations involved in insurance. As a former banker who worked with insurance industry clients, I am well aware of some of the pitches that have been made to attract alternative capital into insurance. However, the reality is that there is almost certainly a significant "one-way correlation" between catastrophe risk and financial market risk.

We as an industry faced a series of major events during 2011, but none of these were anything like the potential 1-in-100-year events that we could conceivably face. For example, the Japanese earthquake/tsunami produced economic losses of approximately USD 200bn and insured losses on the order of approximately USD 30bn. If you think of a similar loss occurring off the coast of California, where a much greater portion of the economic risk would be insured, insurance and reinsurance companies around the world would be forced to sell assets to pay what could potentially be several hundred billion dollars of claims. You would also see uninsured property owners on the West Coast essentially giving back the keys to their properties to banks or lenders.

Such a scenario will have a major impact on the banking industry and might even lead the U.S. Federal Reserve to adjust monetary policy. In other words, a truly major insured event will have a big impact on financial markets, apart from the impact that will come from the financial sector's investment in the insurance industry. If we were to witness a so-called "tail event", some alternative capital providers will be surprised to see their insurance activities go south at the same time as they are having trouble with more conventional investments.

There are also questions over the ability or willingness of some of these alternative capital providers to pay claims. We are already seeing disputes arising from policies that have triggered losses. Hedge fund managers tend to have a relatively short-term perspective which may lead them to resist paying claims. On the other hand, as long-term

[+] CFO, Catlin Group Ltd.

participants in the industry, insurers understand the product they sell, and they know that you will be quickly out of business if you do not pay claims promptly and fairly.

But it's important to understand that my experience at Catlin[1] is to not see alternative capital as a type of "existential threat". On the contrary, at my current position, we want to work with it and we will be interested in seeing how much of it sticks around. I regard it a positive trend to attract a lot more capital in this industry in order to have the capacity to insure the risks of the future.

Another topic in which many of us are interested is the investment profile of property/casualty insurers. At my current position as a CFO, I cannot say, that we are going to beat the market, especially when you think of all the resources that the banks and hedge funds have. That would be a crazy thing to do.

However, I see a core competitive advantage which is the liquidity. Insurers have a lot more liquidity than many other investors. However, if we are to maximise the advantages that our liquidity provides, we must better explain to the regulators what we want to do with it.

There are differences between liquidity and capital, and for me, far too much of the current regulatory debate is still about capital. However, if you look back at the financial crisis, what got people into difficulty was not a lack of capital, but a lack of liquidity. You get in trouble when you are forced to sell assets and are therefore forced to take whatever price you can get.

As an industry, we must devise an approach for measuring and monitoring liquidity that is every bit as robust as the measures now being utilised to measure capital adequacy. We need to take this approach to the regulators, and we need to see whether they will buy into it.

At Catlin, when we examine liquidity, we look at all of the subsidiaries within our Group. We look at the worst type of 1-in-100-year event that could occur in relation to each of these subsidiaries, and then we look at how fast we expect to pay the resulting claims. We assume that, at the same time, we have a financial market crisis of the same magnitude as 2007 and 2008 so that we are forced to take a big haircut on the value of our assets. We also assume that our largest reinsurer and bank counterparty fails. We then model cash flows on a quarter-by-quarter scale to see if we have enough liquidity to survive in business. Even on this basis, we believe we have liquidity far in excess of what is required.

It seems to me that, with such a scenario in mind, regulators should not be concerned if we purchase fixed-income securities that are considered illiquid as long as we earn a spread that more than covers the cost of default and credit migration risk, and we hold them to maturity. However, we must prove this to the regulators, and we need to develop a language to do that. As an industry, this is an area where we have so far fallen short.

We must also continue to develop a much deeper dialogue with our regulators as I see "government risk" as the emerging risk that poses the greatest threat to our industry. We have seen several losses that have been inflated by government and regulatory actions far beyond what they should have been: the Costa Concordia accident and the redefinition of "hurricane" following Superstorm Sandy, to name two. Governments will continue to look to the deepest pockets to help pay when things go wrong, and, in a lot of cases, insurers will be those deep pockets. We constantly run the risk of our policies being reinterpreted by governments and regulators. Like any other form of risk, we can only price for this adequately if we understand it properly.

---

[1] At the time of writing this article, I am an employee of Catlin, which is merging with XL.