Leading the way

Hedge fund-backed reinsurers generate AUM and permanent capital for asset managers

Hedge funds are increasingly investing in the reinsurance business as a means for innovation and diversification in the rapidly growing convergence space. Hedge funds have typically invested in reinsurers through sidecars or buying equity in the companies. But more recently, managers are launching reinsurance businesses themselves.

In this new structure, the reinsurance entity focuses on its chosen lines of business from an underwriting perspective, while the investible assets are managed by the sponsoring asset manager. It's been a success.

Over the past couple of years, start-up reinsurers Third Point Reinsurance Ltd., S.A.C. Re Holdings, Ltd. and PaCRe, Ltd. were all formed with an underlying hedge fund sponsor playing a pivotal role in the formation. Third Point Re recently went public with a successful launch on the New York Stock Exchange.

There continues to be a tremendous amount of interest in this business model, and based on our market intelligence, we expect to see many more of these structures set up soon.

How does this structure benefit the investor?

Returns

These reinsurance vehicles are virtually certain to outperform funds managed by the same asset manager using the identical investment strategy. The reason for this is the embedded leverage within a reinsurer. The capital initially invested in the reinsurer is invested in the asset management strategy; however, the reinsurer also receives premiums on its underwriting activities, which in turn generates profits, and these cash flows are also invested into the asset manager's investment strategy. Accordingly, provided that the investment returns are positive over the long term, the reinsurer is virtually certain to outperform a fund with an identical investment strategy.

Liquidity

The intent with these structures typically is for the reinsurance entity to be taken public within a reasonably short period of time, which means that the investor will get daily liquidity (investors can sell their shares in the reinsurance entity any day the exchange is open) versus the typical redemption restrictions associated with investing in a hedge fund. In addition, once the reinsurer is public, the reinsurer typically trades at a premium to NAV.

Tax benefits

There are also compelling tax attributes if the reinsurer is structured properly. Unlike an investment in a fund, where the investor gets a K-1 each year and has to pay tax on their allocation of the capital gains/dividends/interest income, the investor would only have to pay tax on their investment in the reinsurance entity when their shares in that entity are sold. In addition, upon the sale, the tax would be at the capital gains rate rather than at the rate based on the character from the K-1 allocation. As such, there could be both a tax deferral and an attribute change if the reinsurer is structured properly.

How does this structure benefit the asset manager?

Raising assets under management (AUM)

This structure provides a new product offering for the asset manager, and given the compelling benefits from an investor's perspective, there is an increased ability to raise additional AUM. These structures have attracted pension funds and other investors that would not otherwise have invested in the asset manager's hedge funds. Thus, these structures provide a new source of AUM. This in turn allows the asset manager to generate increased performance and management fees.

While investors converting from funds to the reinsurer do not generate new AUM, the assets they convert become permanent capital and they increase the amount of investible assets that the asset manager can manage, through the sale of reinsurance premiums. For every $1 converted, the reinsurer may generate up to $2 of investible assets.

Permanent capital

The capital raised in the reinsurance entity is permanent capital, removing the ever-present threat for asset managers of unforeseen redemptions. Every investor who converts their direct investment in the asset manager's hedge fund into an investment in the reinsurer converts a redeemable investment into permanent capital from the asset manager's perspective. And once the reinsurer is public, investors can sell their investments in the reinsurer on a real-time basis without any reduction in the capital of the reinsurer. A win-win for both parties.

Free money to invest

The reinsurance entity will be levered using "free money" (i.e., the reinsurance premiums). Through the sale of reinsurance contracts, the reinsurance premiums collected by the reinsurer will be available to be invested by the asset manager. Thus, in

addition to the initial capital that is managed, the reinsurance company will generate additional assets to be managed, generating additional fees for the asset manager. Typically, these types of reinsurance structures have investable assets of 1.5–2 times their capital base.

Ability to monetize value from asset manager

The reinsurance entity will typically trade above the net book value once public, which is compelling both to the investor and asset manager. The founders of the asset manager can use this structure to monetize their significant personal investments in the asset manager, by taking a portion of the investment in the asset manager and investing directly in the reinsurer, which will provide the founder the investor benefits noted above in addition to the monetization of the investment once the reinsurer is taken public.

It is not easy to extract value out of an asset management complex. Asset managers that take themselves public sometimes trade at a discount to NAV, which is largely due to the many restrictions on holding publicly traded securities associated with the Investment Company Act of 1940. These restrictions limit the opportunities and thus valuation of the public investment manager. A reinsurer is exempt from the Investment Company Act, and thus, going public using a reinsurer is an excellent way to monetize one's investment in an asset manager.

Investor relations

As an asset manager, there is a significant time commitment in liaising with one's investor base. If the reinsurer becomes a public company, individual communications with investors will decrease dramatically because securities laws require that information for investors be provided to all investors.

Full steam ahead?

There are compelling reasons for both an investor and an asset manager to want to get involved in the formation of a hedge fund-sponsored reinsurance company. Given these compelling benefits, the obvious question is: why isn't every asset manager setting up these structures?

In fact, many are. Those who are not point to the following two concerns.

Distraction. To set up a reinsurer takes a significant amount of time and management attention. From the initial idea to the launch of the reinsurer takes between 18 months and 2 years. Someone needs to lead the project who otherwise would be focused on the core asset management operations. As reinsurance is outside the skill set of most asset managers, a significant amount of time is needed to understand the reinsurance industry and develop industry relationships.

A prudent approach to overcoming these obstacles is to hire an experienced reinsurance executive to advise the asset manager throughout the process. However, it is important to make sure the right advisor is engaged, one who has experience in the start-up phase of a reinsurer, without any conflicts.

Cost. The cost to launch a reinsurer is substantial. As a result, typically only asset managers with a certain scale would consider setting up a reinsurer. There are many variables that affect the cost, the most important of which is the source of capital. If the asset manager does not need to raise funds for the reinsurer, but rather the founder and executive management along with existing investors in the funds of the asset manager will provide the seed capital for the reinsurer, the overall cost of the project will decrease substantially. This eliminates the need to provide incentives to the lead investor, and the other costs associated with raising capital.

The other significant cost is the retention of the senior management team, most importantly, the CEO. It is critical that a credible and experienced CEO be retained to execute on the objectives of the structure. The reinsurer will require an A– rating from AM Best to allow for the leverage model to work, and a key factor in AM Best's analysis of a start-up reinsurer is the experience and credibility of the management team. An experienced and credible CEO will not sign on unless he or she receives guarantees and significant stock-based compensation (i.e., guaranteed payments irrespective of whether the reinsurer gets launched). The costs associated with the CEO and management team will be borne by the reinsurer and not the asset manager should the reinsurer be launched successfully. Accordingly, to minimize the cost to the asset manager, it is imperative that the probability of a successful launch be very high prior to signing on a CEO.

The hurdles noted above, while significant, certainly are not insurmountable with the right advisors and careful management to make sure that the expense load is not incurred before certain hurdles are met. As a decision to launch is made, it will be necessary to determine the type of reinsurance to offer to customers and the jurisdiction in which the reinsurer will domicile.

What type of reinsurance should you offer?

The type of reinsurance offered will be a focus area of the rating agency and the insurance regulators. Given that the business model of the reinsurer is to generate float for the asset manager to invest, the most suitable type of business to underwrite is long tail, low severity reinsurance. This means that the premiums will be held by the reinsurer for a long period of time before any claims are paid out, and as a result, the premiums can be invested by the investment manager for an extended period of time earning management and incentive fees. In addition, given that the reinsurer will be taking on more risk on the asset side of the balance sheet relative to traditional reinsurers, the rating agencies and regulators will expect the underwriting operations to have less risk than traditional reinsurers have. Accordingly, these reinsurers will not be as heavily involved in catastrophic reinsurance, and the underwriting operations will not be as heavily leveraged as those of traditional reinsurers.

Another option that hedge fund-backed reinsurers have been interested in is fixed annuity contracts. The risk associated with these contracts is investment risk — that is, the risk that the investment returns do not exceed the guarantee associated with the fixed annuity contracts. Many hedge fund managers are more comfortable with managing this risk, rather than insurance risk, as managing investment risk is in their sweet spot of core competencies. In addition, these annuities are typically very long tail, and accordingly, the reinsurer obtains the premiums to invest for an extended period of time prior to the reinsurer having to pay the annuity streams. Again, this business line aligns well with the overall strategy of these structures.

A model for growth

The benefits to an asset manager of setting up a reinsurer are compelling. While there are short-term costs and other hurdles in setting up this structure, with the right advisor and careful management, these can be overcome, allowing the investment manager a new source of AUM, permanent capital and an innovative product for its investors.

Contacts

Arthur Tully
Co-leader of Global Hedge Fund practice and Leader of Asset Management practice
Ernst & Young LLP

+1 212 773 2252
arthur.tully@ey.com

John Santosuosso
Americas Insurance Leader
Ernst & Young LLP

+1 617 585 1867
john.santosuosso@ey.com

Pete Cangany
Partner and Insurance Leader
Ernst & Young Ltd.

+1 441 294 5653
pete.cangany@bm.ey.com

Craig Redcliffe
Partner
Ernst & Young Ltd.

+1 441 294 5348
craig.redcliffe@bm.ey.com

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