How small mutual and cooperative insurers can access regulatory capital

Raising the additional solvency capital required for Solvency II compliance or financing growth is especially difficult for smaller insurers with limited access to capital markets. Private debt placements have recently become an attractive solution to that problem.

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The long awaited implementation of Solvency II in 2016 will bring new capital requirements for European insurers. The new regulation will generally result into higher capital charges than those currently applied under the Solvency I regime. Most companies started re-thinking their product strategy and asset allocation well ahead of the implementation of Solvency II, in order to successfully enter the new environment in 2016. Still, many players will need to increase their capital base if they want to operate with a sustainable buffer that will protect the interests of policyholders in strong and soft periods of the cycle alike.

In the US, although the overall insurance sector restored its capital position to aggregated levels higher than the 2007 pre-crisis peak, we believe that mutual and cooperative insurers will need to continue building up buffers in order to withstand financial markets' volatility and natural catastrophes occurrence, and to maintain their underwriting capacity in a concentrated and competitive market.

The options that mutuals and cooperatives have in order to strengthen their capital base are typically either an increase in own funds through additional policyholders' contributions, an equity capital increase (at their joint stock company subsidiaries or sister companies, if any), or an issuance of subordinated debt. Quota-share reinsurance, albeit not directly increasing available capital, would help reducing risk-based charges as underwriting and reserving risks would partly be transferred to reinsurance undertakings.

However, increasing capital is not always a viable option, while quota-share reinsurance supply and cost depend on capacity and cycles and might not be suitable for all lines of business.

A new market for subordinated debt?

Subordinated debt issuances could be the solution both for strengthening capitalization and also for improving capital management by diversifying capital sources, enhancing financial flexibility, and possibly reducing the overall cost of capital. That said, the

Reinsurance and private debt – a complementary solution

	Reinsurance	*Subordinated Debt (Tier 2 example)*	*Equity*
Term	Annually renewable	Min. 10 years (Calls at 5 years allowed with no step-up)	Perpetual
Payments	Fixed or pro rata	Floating, quarterly in arrears	Variable, annual in arrears
Voting rights	No	No	Yes
Taxability	Deductible	Deductible	Not deductible
Dilution to existing shareholders	No	No	Yes
Use of profits/losses	Ceded to reinsurers -> P&L smoothing effect	Remains within the firm ->No P&L smoothing effect	Remains within the firm ->No P&L smoothing effect
Effect on solvency margin	Progressive	Immediate	Immediate
Administrative burden involved in entering/exiting	Low	Medium	High

Source: Twelve Capital

European market for insurance subordinated debt is fairly small. At the end of 2014, there were 228 debt issuances with an outstanding amount above EUR 100 million (USD108m), issued by a total of 67 companies, mostly large international groups. Interestingly, the size of debt issuances was, on average, above EUR 500 million (USD 540m). Similar findings could be seen for the North American market. But what about the thousands of smaller players that just require say EUR 20-70 million (USD 22-75m)?

No place to go?

Often paying the penalty for a lack of diversification across insurance segments and geographies, smaller insurance companies typically find it difficult to access hybrid capital. The process of issuing debt in public markets can be burdensome and costly. It typically involves discussions with local regulators, investment bank(s), and rating agencies. It also typically takes around three months, although the timing of an issuance primarily depends on market conditions and investors' appetite. In addition, what was once a viable way for raising solvency capital, namely bilateral funding from banks to insurance companies, has dried up in recent years with the new banking regulatory regime (Basel III), which imposes hefty charges to banks' investments in insurance capital instruments, which are deducted from their core Tier I ratio.

Conscious of the limited access to funding for smaller companies and mutuals, regulators and policymakers across Europe are trying to facilitate their access to capital. However, the insurance sector's specificities, as well as the loss absorbency and persistency features of Solvency-II instruments in Europe, make them suitable only for a sophisticated investor base. Even instruments like mutual certificates, in our opinion, would carry a number of challenges, one of them being the question how to distribute them to potential investors such as policyholders.

So, where can mutual and cooperative insurers turn to? Capital market participants are starting to provide alternative solutions, as for example our own company Twelve Capital (an investment management company specialising in insurance-related investment opportunities) which has launched a private debt initiative that provides small and medium-sized insurance companies with regulatory compliant hybrid debt. Private debt placements would typically not require high level of third party disclosures nor the presence of an arranging and syndicating bank or a rating agency. Their bilateral nature also ensures stability in the relationship between investors and issuers.

Win-win situation

With institutional investors struggling to find potential alternative asset classes to low-yielding government bonds, offering subordinated debt capital to insurance companies while being compensated for the inherent illiquidity of such investments could prove to be a win-win situation for institutional investors and insurance companies alike. The table above shows how a combination of increased reinsurance and private debt may offer the best way forward.

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