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Sub debt "better than reinsurance" for capital management

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Insurers looking to better manage their capital requirements should in most cases issue subordinated (sub) debt rather than buying quota share reinsurance, according to a paper from Twelve Capital.

The Swiss investment manager, which operates both collateralised reinsurance and insurance debt funds, argues that insurers operating under the Solvency II standard formula would make larger profits and have better solvency coverage in a variety of scenarios, if they used debt rather than reinsurance to meet capital requirements.

The firm engaged actuarial consultancy Towers Watson to build a model of a mid-sized European property and casualty insurer - a type of company that traditionally uses quota share reinsurance as a capital management tool.

The model projects the balance sheet and profit & loss over four years, and uses the standard formula to estimate the solvency capital requirement (SCR) at the end of each period. Twelve Capital ran four scenarios where the firm had a large underwriting profit, a small underwriting profit, a soft period when there are underwriting losses each year and a single-event loss. In all these cases, the debt-issuing firm had a better SCR coverage than the reinsurance-buying firm, and only in the case of persistent losses did the firm make more profit from reinsurance. The model assumed current market conditions for reinsurance commissions and debt interest.


Markus Stricker

"Purchasing quota share reinsurance is an efficient way to limit losses, but it is not a very efficient way to manage the SCR coverage ratio," the report notes.

Markus Stricker, a partner responsible for risk management at Twelve Capital, said the report's conclusion - that debt is more of a capital management tool and reinsurance is more of a risk management tool - might have been obvious to some, but it has not stopped many insurers from using reinsurance in this manner.

He acknowledged that issuing debt was more complex than arranging reinsurance, but on the other hand the debt tends to last for 10 years while reinsurance contracts are usually renegotiated each year. Reinsurance is more flexible but its pricing tends to be more volatile than debt markets, "and when you need it most, the price of reinsurance will go up," Stricker said.

The tendency for insurers to use reinsurance to manage capital might be partly explained by the lack of appetite among investment banks to get involved in sub-$100m deals that mid-sized firms would need, according to Stricker. This is a segment of the market that Twelve Capital is trying to tap with its debt funds.

Stricker said Twelve Capital had considered a similar study for life insurers, but found too much variation between each country to be able to present a "typical" case study.

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