INSURANCE CAPITAL – PART 1

Investing in the (re)insurance space

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In this series of three articles Twelve Capital initiates readers to the different ways capital markets' participants can invest in the (re)insurance sector – namely via equity, debt and Insurance-Linked Securities (ILS). The first one will delve into the distinctive features of each form of investment. The series will then focus on secular trends such as climate change and population dynamics, exploring their implication for the insurance sector and investors. Finally, the focus will be on the so-called insurance cycle, with an outlook for investors in insurance equity, debt and reinsurance in the form of ILS.

Executive summary

- (Re)insurance companies operate under regulations that mandate the continuous maintenance of capital in excess of certain specified minimum levels.

- Capital markets participants can invest in the (re)insurance sector in forms such as equity or debt of (re)insurance companies or Insurance-Linked Securities (liquid Cat Bonds, or illiquid Private ILS). These investment opportunities present different levels of permanence and loss absorbency. Hence, they show different levels of risks and expected returns.

- Investments in the (re)insurance sector historically offered attractive returns.[1]

- Twelve Capital provides investors access to the entire spectrum of possible investments in the insurance space, in a standalone or multi asset format.

Investment opportunity in the (re)insurance sector

We identify three main ways for investors to allocate to the (re)insurance sector: equity, debt and ILS. These three types of financial instruments offer different risk return profiles for investors and have varying levels of permanence and ability to absorb losses in various stress scenarios. (Re)insurers typically issue these instruments to either build their regulatory capital (e.g., under Solvency II), under capital models from rating agencies (such as S&P or Moody's), or essentially as risk management tools.

- **Equity**: It is the most permanent form of capital and it bears the highest form of loss absorbency. Regulatory requirements often demand a significant portion of capital to be in the form of equity. Simplistically, and from an accounting standpoint, the equity of the company is the paid-in capital and the accumulated retained profits. In most geographies, regulators need to approve the return of equity to shareholders, via dividends or share buybacks, and typically only permit this when there is more capital than the minimum required.

- **Debt**: Usually comes in the form of Subordinated Debt in the EU or Surplus Notes in the US. To count as regulatory capital, it must have features that allow for loss absorbency such as mandatory coupon deferability in case of solvency not being met. It should also have a minimum residual maturity (typically more than 5 years). Short-term bank debt or senior debt typically does not qualify as capital; they can at times be used to finance liquidity needs or acquisitions.

- **Insurance-Linked Securities (ILS)**: Involve the transfer of underwriting risk from a so-called cedant entity to capital markets. For cedants, ILS serves as a form of capital and/or a risk management tool to reduce volatility in underwriting results. Typically, ILS represent an integral element of a cedant's reinsurance or retrocession program and forms a core part of a company's strategy. However, it is less

[1] Past performance is not indicative of future returns.

permanent than Equity or Debt as it is often renewed annually. It focuses on underwriting losses, is less exposed to corporate risk, and not exposed to asset-side risks. There are two main formats of ILS: proportional and non-proportional. Investors can access underwriting risks in two ways:

- ***Proportional***: A pre-determined share of losses (and profits) on specific business is transferred to investors. These are structures such as reinsurance sidecars, and are often used to protect against losses with high occurrence frequency, providing more coverage, but being rather expensive. For the cedant, these can act as a form of capital by reducing the capital strain of new business, as a portion of the risk is passed onto a third-party.

- ***Non-Proportional***: This type of reinsurance is essentially a limit over an excess amount, providing more specific coverage such as covering only hurricane losses, and requires more catastrophic levels of loss before paying out. As such, Cat Bonds are a form of Non-Proportional reinsurance. The most common structures are "occurrence" or "aggregate". This means that the financial terms are either applied to a single event or the total losses within a specific period.

ILS can focus on so called peak perils or non-peak perils. Twelve Capital focuses on peak perils, that are those where the concentration of insured values is high and the affected areas are exposed to low frequency and high severity natural catastrophes. Examples of peak perils are US hurricanes and earthquake risks. While peak perils tend to be the most researched, modelled and understood catastrophic risks, they are also those showing the most attractive returns. In fact, (re)insurers are required by regulators and rating agencies to hold significant capital to cover these potentially large tail risks. In contrast, non-peak peril risks such as convective storms and wildfires, have low capital requirements as (re)insurers can benefit from diversification credit. Low capital charges translate into lower returns achievable for investors.

Twelve Capital provides investors with access to each of these asset classes, on a standalone or combined format. The latter is via Twelve Capital's Multi Asset offering where two or more of these asset classes are combined in a way to leverage on distinct sectoral themes, cycles and seasonality patterns.

Capital providers to the sector are exposed to potential losses

As in all other sectors, any form of investment in the insurance sector can experience a partial or a full loss. Capital erosion can result from underwriting losses – for example when claims are higher than forecasted due to higher frequency or severity – or non-underwriting losses such as a write-down on investments, or operational losses. A key part of Twelve Capital's investment approach is to assess and model the potential loss associated to each form of capital.

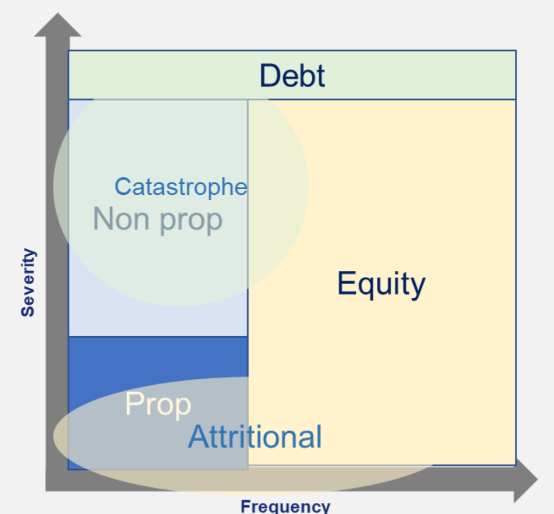
Underwriting losses

A (re)insurance company considers two broad types of underwriting losses; Attritional, and Catastrophe:

- **Attritional**: These losses are characterised by high frequency and often low severity. In the context of a portfolio of property risks, these events might include damage to contents or broken windows. Due to the numerous occurrences of such events, there exists a wealth of historical data, making it feasible to model and predict attritional claims effectively. Proportional reinsurance, which covers a portion of losses, often comes into play for managing attritional losses.

- **Catastrophe**: In contrast, catastrophe losses are generally low in frequency but involve high-severity events, such as those triggered by hurricanes, earthquakes, or significant man-made incidents. Non-proportional reinsurance structures are typically designed to handle these large-scale events. This could encompass tail events like catastrophic hurricanes or earthquakes, but it is also conceivable to safeguard against more frequently occurring events like floods, tornadoes, and hail storms.

Figure 1: Capital sensitivity



Source: Twelve Capital.

In Figure 1, we are looking at how different types of losses, whether attritional or catastrophe, can impact different parts of an insurance company's financial structure.

Starting with the horizontal axis: here smaller amounts of frequency losses can be covered by proportional types of ILS/reinsurance where the risk is offset and spread into the market. As the frequency of these losses increases, assuming they are not too severe, we see that there is a transition of losses into equity, as these claims reduce profits and in extreme scenarios retained equity and potentially debt.

Up to a certain degree, severity (vertical axis) can also have some protection from proportional ILS/reinsurance, but as the quantum of loss increases, we move into the territory of non-proportional coverages being used to protect the wider capital base and pay out claims. However, sometimes very large losses will exceed the protection provided by ILS/reinsurance and impact other components of the capital structure. Subordinated insurance debt would typically be absorbing losses in very remote liquidation scenarios.

Frequent underwriting losses can impact equity investors and, in remote cases, debt investors. Cat Bonds, categorised as Non-Proportional Reinsurance, are generally rarely impacted by smaller, more frequent events. Severity is more a concern for Cat Bonds, as they start to be impaired when losses reach a certain trigger. Equity and Debt are also impacted by severe events, although generally to a lesser extent compared to Cat Bonds.

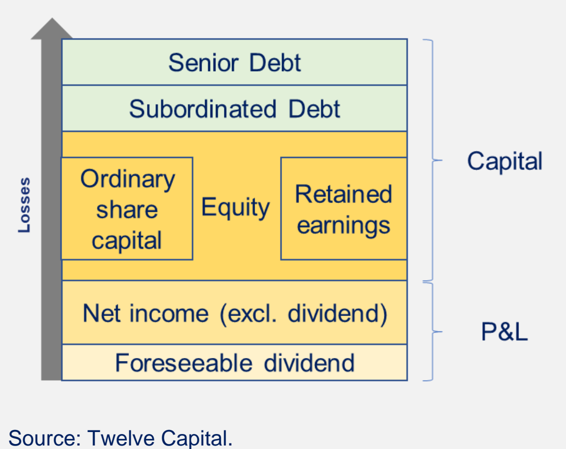
Non-Underwriting losses

One of ILS' main advantages is to offer investors an instrument that is not correlated to financial markets. The reason being the protection they offer to cedents does not extend to non-underwriting risks, such as those associated with market dynamics (e.g., interest rate risk, spread risk), nor asset impairments and operational losses.

When looking at the (re)insurance sector overall, we note that life insurance entities tend to have more asset leverage than non-life insurers that is a consequence of their need to manage and match long-term obligations (e.g., long-term savings, annuities) with suitable long-term and potentially higher-yielding investments. During periods of economic adversity, the valuation of these investments may undergo considerable oscillations, potentially resulting in financial losses upon divestiture.

Non-underwriting losses traditionally follow a systematic trajectory, commencing with an impact on the insurer's profit and loss (P&L) statement before potentially impacting its capital position. Losses should first impact the expected dividends that a company intends to distribute in the given year, followed by a secondary impact on retained earnings for the same period. Beyond this stage, excess losses can start to affect the equity of a company before potentially reaching the debt position. It is important to note that this theoretical order of payment may change based on various circumstances, including regulatory intervention or the company's decision to pay uncovered dividends.

Figure 2: Non-underwriting loss stack



Source: Twelve Capital.

When looking at collateralised reinsurance, it often mirrors the format of a zero-coupon bond, where the total collateralised limit is comprised of the premium plus the collateral investment. In this case there is no credit risk because all of the premium is paid upfront. Cat Bonds are a collateralised instrument, but where there are coupon payments during the course of the year. There are mechanisms in place such that if a coupon is missed then the contract will become void and collateral is returned to investors. In both cases, credit risk is eliminated.

Returns Achievable

Different structures, risk profiles, loss absorbency mechanisms and tail risk of the various investments in the (re)insurance sector affect their expected long-term returns. These different features also contribute to varying levels of expected volatility. Insurance cycles and capital influx in the sector, topics that will be covered in the third article, also play an important role and influence achievable returns.

Figure 3: 10-year performance within Insurance

Source: Twelve Capital, Bloomberg. As at 29 December 2023. **Past performance is not indicative of future returns.**
Eurekahedge ILS: The index is ILS Advisers and Eurekahedge's collaborative equally weighted index of 25 constituent funds. The index is designed to provide a broad measure of the performance of underlying hedge fund managers who explicitly allocate to insurance linked investments and have at least 70% of their portfolio invested in non-life risk.
MSCI World Insurance: The index is an index focused at measuring the equity performance of the c.80 largest listed global insurance companies weighted by free-float of market capitalisation.
Pan European Insurance Debt: The index is a subset of the Bloomberg Pan-European Corporate Index and measures the market of bonds issued by insurance companies and denominated in different European currencies.
Swiss Re Cat Bond Index: The index calculated by Swiss Re Capital Markets, is a market value-weighted basket of natural cat bonds tracked by Swiss Re Capital Markets, calculated on a weekly basis.
MSCI World Index: The index is a market cap weighted stock market index of more than 1'550 companies throughout the world in USD.
Pan-European Corporate Debt BBB: The index is a subset of the Bloomberg Pan-European Corporate Index and measures the market of corporate bonds rated in the range [A+, A, A-] and denominated in different European currencies.

Over the past 10 years, stocks have outperformed other asset classes. Insurance Equity (MSCI World Insurance) has shown a defensive stance compared to General Equity (MSCI World), in particular in the recent rising rate environment. However, despite its positive performance, Equity has also unsurprisingly been the most volatile asset class, especially during major events such as the Covid-19 pandemic and the Ukraine conflict, contrasting with the relative stability of Cat Bonds and Insurance Debt.

Insurance Debt (Pan Europe Insurance Debt), akin to other fixed income classes, has been affected by the increase in interest rates. This, however, has led to attractive forward-looking yields for investors approaching the asset class today. It is worth mentioning that insurance debt has outperformed the corporate debt index (Pan-European Corporate Debt BBB) while presenting a higher credit quality. In the European blue-chip insurance space, there has only been one credit default in connection with the Greek debt crisis.[2]

The Cat Bond index, which can be used as an indicator for returns achievable in the ILS space, demonstrates a defensive profile during economic crises compared to debt and equity. This is because it is not correlated to financial markets, and losses stem from natural catastrophe events, such as Hurricane Ian in September 2022. It is worth noting that despite the fact that not all claims from Hurricane Ian have been resolved, the current market value of outstanding Cat Bonds already takes into account potential future losses.

Looking at the historical data, we can draw the following general statements on the key features of the asset classes:

- **Insurance Equity**: It offers the highest returns and highest liquidity among the insurance asset classes. However, investors need to be ready to experience higher volatility and drawdowns.

- **ILS**: Show lower historical returns than Equities but lower volatility and no correlation with financial markets. Different types of non-proportional reinsurance can be more or less liquid, with Cat Bonds funds available in UCITS format. However, the market is not as deep compared to Insurance Equity and Debt.

- **Insurance Debt**: Investors can expect solid creditworthiness as highlighted by the low default history. However, the asset class was not immune from recent interest rates' movements. It is a liquid investment that can be offered in UCITS format. Products with lower liquidity, higher credit risk as well as higher historical and prospective returns would also be available.

Twelve Capital, thanks to its domain knowledge and expertise in insurance-related investments, offers investors funds and mandate solutions adapted for various risk/return targets. Its active investment management approach integrates ESG and risk considerations and leverages on institutionalised, replicable processes.

[2] The French insurance group Groupama missed a coupon payment in October 2012 after suffering impairment losses on Greek debt and equity holdings.

Figure 4: Complementary strategies and genuine diversification opportunities

Source: Twelve Capital.

To be continued in part 2…

In the next article we will cover some of the secular trends that are re-shaping the insurance industry and the opportunities available to investors.

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(b) a trust (where the trustee is not an accredited investor) whose sole purpose is to hold investments and each beneficiary of the trust is an individual who is an accredited investor,

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(2) where no consideration is or will be given for the transfer;

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