Asset managers turn to the reinsurance industry for uncorrelated investment returns

An increasing number of asset managers are setting up reinsurance companies as a way of increasing assets under management while giving investors exposure to a new asset class writes EY's FERGUS MCNALLY. Ireland is well positioned to benefit from this trend due to its strong position as a re/insurance centre and industry specific professional services expertise he writes.

Across the Atlantic a trend has started to emerge in the traditional hedge fund industry which could drive new business to Ireland. Asset managers have been establishing reinsurance vehicles as they seek to attract new investors and generate non-correlated and diversified returns.

The idea of asset managers creating insurance/reinsurance companies isn't new. Warren Buffett was a pioneer in this space and one of Berkshire Hathaway's first acquisitions after Buffett took control, was to purchase a number of insurance companies, wherein they used the 'float' provided by these entities (investible premiums) to finance Berkshire's investment activities.

It's no secret that for any asset manager, there are two key tenets for business success: i) an ability to increase and maintain assets under management; and (ii) an ability to generate market beating returns.

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In 2012, we began to see the emergence of start-up reinsurers backed by traditional hedge fund managers including Third Point, Greenlight Capital, SAC Capital, AQR and Paulson & Co. The reinsurance industry has been recognised as creating an additional option and vehicle for asset managers.

The key business rationale is to raise capital via private placement with a view to achieving a public exchange listing within a short period of time. The initial capital typically comes from the sponsoring asset manager, its' founders and outside investors. Since this is not a traditional fund vehicle where investors can subscribe and redeem at will, once established, this model also benefits the asset manager through establishing 'permanent capital'.

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Fergus McNally

So what are the benefits from an investors' perspective?

Returns

Fund vehicles are the traditional mechanism through which investors gain access to a particular asset manager's expertise. By investing directly in a reinsurer instead of into a hedge fund, the investor will generate the same return together with the potential of additional uncorrelated risk in the form of a return on reinsurance underwriting activities.

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Liquidity

Typically the intent 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 (i.e. they 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. Third Point listed their Reinsurance vehicle on the New York Stock Exchange in August of this year.

What are the benefits from the asset managers perspective?

Raising Assets Under Management (AUM)

This structure provides an offering for the asset manager and given the benefits from an investor's perspective, there is an increased ability to raise additional AUM. This in turn, will allow the asset manager to generate increased performance and management fees. Additionally, as exchange traded entities, they open the possibility that investors who might otherwise have been precluded from investing with the asset manager might now invest through this avenue.

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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 from a hedge fund into an investment in the reinsurer, converts a redeemable investment into permanent capital from the asset managers perspective. Once the reinsurer is public, the investors can sell their investment in the reinsurer on a real time basis without any reduction in the capital of the reinsurer, and thus AUM for the asset manager remains unchanged.

Free Money to Invest

The reinsurance entity will also have the benefit of using 'free money' (i.e. its 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, reinsurance entities have investable assets of 1.5 times their capital base.

Therefore, there are compelling reasons for both an investor and an asset manager to want to avail of the business rationale of a reinsurance company.

And the risks...

You are probably asking yourself, 'If it's so attractive why isn't everybody doing it?' Well, a reinsurance company does carry with it the possibility of unexpected payouts as a consequence of the premiums it writes. Therefore, in establishing such an entity, the people you have on the ground running the day to day operations will need to be experts in their field. The types of risk written will drive the risk profile of any investment.

As noted earlier, from an investor's point of view, there is a promise of liquidity, however depending on the entities performance and market sentiment; this may not always manifest itself. Additionally, investors expecting to compare returns of this entity against those of the fund they may otherwise have invested in need to remember that because of the underwriting exposures the re-insurance entity takes, the correlation between the two will differ.

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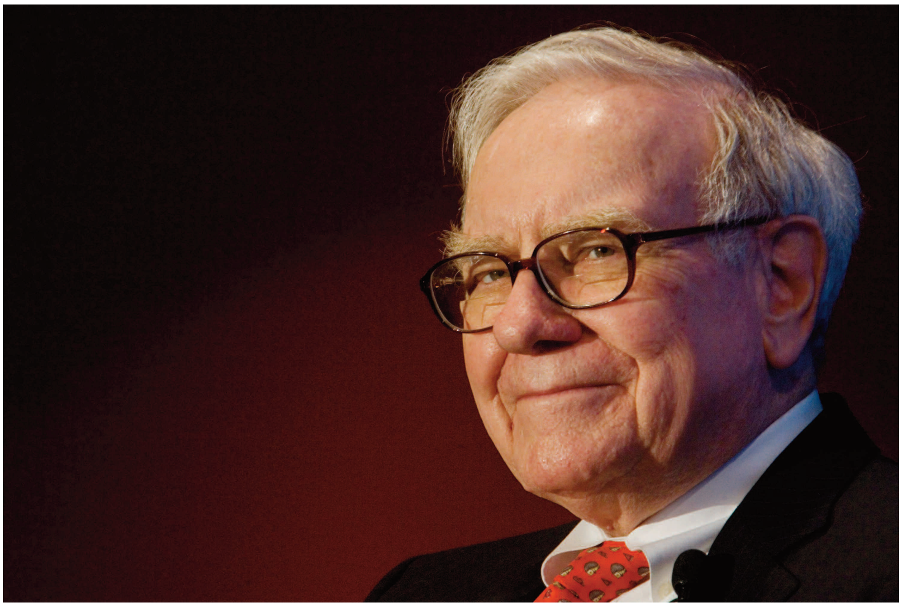
Why is this of interest to Ireland?

Asset managers and their investors looking to establish reinsurance entities will need to determine an appropriate domicile to establish the reinsurance vehicle, which will be impacted by the regulatory framework, tax regime and ability for the entity to find appropriate expertise on the ground.

Despite strong competition from other jurisdictions, Ireland is a well-established, highly regulated reinsurance location, which puts it in a strong position to attract these types of vehicles.

The international insurance industry in Ireland is approaching its 25th birthday and over those 25 years, Ireland has established itself as a global centre for insurance and reinsurance, with the result that today Ireland is globally recognised, as a well regulated, reputable (re) insurance location with more than half of the world's leading reinsurers with operations established here. This growth over 25 years, albeit we have seen a slight decline in the last few, has resulted in Ireland building up significant industry expertise in terms of workforce and industry specific professional services support. The needs of the market have resulted in the development of specialised service providers for outsourced services, which can assist in the set up and day to day running of entities. Running alongside all of this, Ireland is an onshore location with a transparent tax regime and extensive network of double taxation agreements.



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As has been demonstrated in the asset management industry, increased employment in the wider financial services sector is the key opportunity. This not only includes adding to the insurance expertise already here but also encompassing the traditional administration and custody providers who could partner with the reinsurance entities and the traditional insurance providers.

It would also revitalise the reinsurance industry here and attract additional asset management expertise

While there are obvious challenges in competing with other jurisdictions, Ireland has a very strong offering and is strategically well placed to attract new investment. In order to do so, it is important that we remain flexible by facilitating new business opportunities and responding to international developments. A highly regulated, business friendly environment is key to asset managers and their investors. This flexibility together with the solid foundations that have been built over the last 25 years should mean that Ireland is well placed to continue to win in this new business opportunity against other European locations such as Luxembourg and Switzerland and take advantage of international developments and the resulting opportunities that come our way.

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Fergus McNally is a partner at EY.