

Capital and Financing: Re Live Life

The life insurance industry, particularly in the USA, has just had a near death experience. Balance sheets remain under pressure, leading BRAVE Partners to believe that there will be strong demand for life reinsurance.

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Asset intensive balance sheets

The media has focussed on banks as the epicentre of the credit crisis. Certainly bank balance sheets became over bloated and over leveraged with large volumes of questionable assets. However, less attention has been paid to the life insurers. Annuity business is much like banking business. The returns are generated by leveraged spread of asset returns over liability costs. As asset returns turn to asset losses, that spread is placed under increasing pressure which is ultimately passed onto the capital of the business.

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- Hartford's business model 'Does not make sense,' Bernstein's Kamath says.
- MetLife credit rating lowered by Moody's on 'Elevated' investment losses.
- Insurers may lose \$10 billion on commercial property.

Variable annuities

Life insurer asset portfolios took a hit across the board. Many held bonds and preference shares in Lehman, AIG and Wachovia. As these financial institutions tumbled, the insurers took realised losses on their investments.

However, the real sting in the tail for US life insurers was their variable annuity books. Variable annuity business includes a number of guarantees in investment performance. These guarantees amount to some highly complex, long dated equity options. As equity markets became volatile and prices fell the value of these options sky rocketed, placing strains on the capital bases of the large life insurers.

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S&P 700

As the equity markets plunged in the third and fourth quarters of 2008, equity analysts started to take a keen interest in the solvency capital position of the large variable annuity writers. One particularly painful investor call ended with a Q&A session where analysts almost queued up to ask the same question: "What is your solvency capital position if the S&P drops to 700." The management continually avoided the issue, until finally making a comment which was something similar to: "We will be fine, but the question is irrelevant because the S&P will not drop to 700." Within weeks the S&P dropped through 700 and the life company's stock fell off a cliff.

No gain, just pain

Markets have stabilised and recovered to some extent. US Domestic life insurers are out of intensive care and perhaps their 150 year of history is not flashing before their eyes. However there is not much health to be found in the life sector. As noted above, the negative articles continue to pour out on Bloomberg. Moreover, the capital requirements for variable annuity business have been increased.

Capital needs

Primary insurers are left in a situation where they are in need of capital. It is almost a quadruple whammy (or a double, double whammy). The firms need capital to:

1. Replenish their capital following investment losses
2. Bolster their balance sheet at a time of increased risk
3. Fund some potentially interesting acquisitions as their competitors flounder
4. Provide regulatory capital to absorb the new business strain on increased demand for fixed annuities

The issue that life companies face is that the capital markets are not fully functioning, especially for large asset intensive balance sheets. Capital markets investors have been stung by large asset pools in banks and are nervous of life insurer balance sheets, especially as there have been losses from what were once considered highly secure bonds – AIG, Lehman, Freddie, Fannie, etc...

Large pools of illiquid, unknown assets are not proving popular in investor circles.

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The opportunity

BRAVE Partners likes to look for the opportunity in all market situations. The opportunity here is for private equity.

Private equity has the opportunity to provide capital to the US, and other, life insurance markets by capitalising a life reinsurance business. This opportunity makes sense above investing directly in a primary business for two reasons:

1. The reinsurer can benefit from the increased cost of capital in the market place.
2. The reinsurer, and therefore the investor, can have direct oversight and control over the invested assets.

Capital and expertise

This opportunity suits a fund that has both private equity and investment management expertise. For this investor it offers a cheap entry point to large pools of sticky investment funds. The investor will benefit from leveraged returns on their asset management.

BRAVE Partners services

BRAVE Partners is currently advising two highly experienced and credible entrepreneurs on entering the asset intensive life reinsurance market.

Interaction

If you enjoyed this commentary and would like to receive a weekly update by E-Mail, then please contact BRAVE Partners on commentary@bravepartners.com

If you would like to comment on the content of this piece, then please send an E-Mail to discussions@bravepartners.com

LinkedIn

BRAVE Partners has established a Life Reinsurance group on LinkedIn.

http://www.linkedin.com/groups?gid=2465264&trk=hb_side_g

• *BRAVE Partners believes that the state of the financial markets combined with the capital needs of life insurers, creates a significant opportunity in life reinsurance.*

• *BRAVE Partners LLP is advising two entrepreneurs on establishing a life reinsurance business.*

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