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# Capital Restructuring in Reinsurance Groups

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## Capital Restructuring in Insurance Groups

- Why they are restructuring
- Influences on choice of capital structure
- Rating agency viewpoint
  - Importance of capital (rating methodology)
    - How we look at capital
  - Key Rating Agency Themes re : Capital Policy
    - Financial Leverage Targets
    - Capital Fungibility
    - The Importance of Risk and Capital Management
    - Benefits of Securitisation



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2

### Why Insurers are Restructuring Capital

Reason	Driver	Capital Solutions
Regulatory Capital Enhancement	Move towards Solvency II allows more eligible capital instruments, may require more capital	Issuance of bank-style Tier 1 / Tier 2 hybrid
	Changes to regulatory capital eligibility	Refinancing of old sub debt and senior into new UT2
Improved Shareholder Returns	Shareholders	More leverage (all forms)
Improve Rating Agency Leverage Tolerance	Rating Agencies / Shareholders	Refinance senior debt or sub debt into high equity content hybrids
Reduce (economic) capital requirements	Solvency II / Capital Modelling	Securitisation of insurance risk
Improve capital fungibility	Closed life funds	Securitisation of VIF, reinsurance, fund mergers
	Regulatory capital / dividend blocks	Reinsurance. Intra-Group arrangements to maximise available capital at Group level

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### Influences on Choice of Capital ReStructure – Finding the ‘Sweet Spot’

Stakeholders view	Equity Level	Debt Level	Debt Maturity	Dividend Level	Non-Cumulative Coupons (Debt)
Shareholders	Low	High	Short	High	High
Regulators	High	High	Long	Low	-
Rating Agencies	High	Low	Long	Low	High
Tax Authorities					Low

- Challenge 1 : Capitalisation Level and Mix (Debt vs Equity)
  - Shareholders vs Regulators vs Rating Agencies vs Policyholders / Distributors
- Challenge 2 : Nature of (debt) capital instruments
  - Tax Authorities vs Rating Agencies

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### Rating Agency View : The Importance of Capital

- Moody's published refined Insurance Rating Methodologies in September 2006
- Identifies the key factors that contribute to the level of an insurers' (Financial Strength) Rating. In addition
  - reasons why the factor is important
  - metrics that we use to look at the factor
  - the relevant importance of that factor within the overall rating
- Capitalisation (stand-alone) contributes 10-15% to our 'idealised' rating approach



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5

### Rating Agency View : The Importance of Capital

Factors for P&C Insurers	Weightings	Sub-factor Weightings
1 - Market Position and Brand	25%	
Market Share Ratio		25%
Relative Market Presence Ratio		50%
Distribution Efficiency		25%
2 - Product Risk and Diversification	10%	
Product Risk		40%
PC Product Diversification		40%
Regulatory Diversification		20%
3 - Asset Quality	5%	
High Risk Assets % Invested Assets		20%
Reinsurance Recoverables % Equity		60%
Goodwill % Equity		20%
4 - Capital Adequacy	15%	
Gross Underwriting Leverage		100%
5 - Profitability	15%	
Return on Equity		50%
Sharpe Ratio of Growth in Net Income		50%
6 - Reserve Adequacy	10%	
Loss Reserve Development % Reserves		60%
A&E Funding Ratio		40%
7 - Financial Flexibility	20%	
Financial Leverage		40%
Earnings Coverage		30%
Cash Flow Coverage		30%



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6

## Rating Agency View : The Importance of Capital

- What we need capital to do
  - Absorb unfavourable deviations in results
  - Satisfy regulatory requirements / avoid regulatory pressure or intervention
  - Be at a level sufficient to enable business expansions and / or enable business strategy (e.g. asset / reinsurance / liability policy)
- Simplified rating methodology metrics

	Aaa	Aa	A	Baa	Ba
Gross Underwriting Leverage	<2x	2x - 3x	3x - 5x	5x - 7x	>7x

	Aaa	Aa	A	Baa	Ba
Global — Capital as % of Total Assets	>12%	8% - 12%	6% - 8%	4% - 6%	<4%



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7

## Rating Agency View : How we Look at Capital

- Rating Methodologies stipulate simplified global metrics that we use currently
- We are also incorporating Groups' Internal Capital Models into our analysis (we will not develop our own internal stochastic model)
  - Results from internal capital modelling (security of policyholder claims)
  - Extent of use of model results within the business (pricing, asset strategy, reinsurance, capital management, risk management)
  - Robustness of capital models (assumptions, stress testing, covariances)?
  - No prescribed methodology by Moody's
  - Scenario / stress testing



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8

## Key Rating Agency Themes : Financial Leverage Targets

- We have set out our expectations for adjusted financial leverage by rating category (put table in)
- Adjustments relate to hybrid instruments / unfunded pension deficits / operating leases
- We allow deviation from our rating range expectations for a given rating level, and in some situations (e.g. bridge financing) for a certain time frame
- Key question : what is management's acceptable range of financial leverage?
- Contributes (overall) 20% of total rating



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9

## Key Rating Agency Themes : Capital Fungibility

- Capital is not always freely available throughout an insurance Group (regulatory traps, local tax laws / regulation)
- We are concerned that the right amount of capital is available at different levels of the organisation
- We haircut some elements of capital to allow for lack of fungibility (e.g. Unallocated Divisible Surplus (AKA FFA) in the UK)
- Regulatory developments will continue to have an impact on the real fungibility of capital



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10

## Key Rating Agency Themes : Risk and Capital Management

- Risk Management
  - Ability of companies to identify and mitigate risks is a key element of credit worthiness
  - We are incorporating Risk Management assessments into analysis
  - Risk Management Experts creating Risk Mgt Best Practice Framework, to allow analysts to evaluate Group's Risk Management capability
- We believe that Risk Management Capability (or lack thereof) will become a rating differentiator for Insurance Groups
  - Rating Methodologies give analysts the flexibility to move rating up/down for factors such as Risk Management



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11

## Key Rating Agency Themes : Benefits of Securitisation

- Various reasons for Insurance securitisation (cash management / capital recycling / capital extraction / risk reduction)
- We analyse each deal individually, due to substantial differences to date in terms of deal structure (deal rationale / materiality to issuer)
  - VIF securitisation : impact depends on use of proceeds
  - Cat risk transfer (mortality / nat cat) : generally positive, depending on cost versus other risk transfer mechanisms
- We will publish in early 2007 a 'guide' to our views on deals to date
- We expect securitisation to increase, heading towards usage levels in banking world (caveats : data / homogeneity / investors)
  - We would expect the ability to undertake such deals to not be uniform



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12