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Reinsurance: GreyCastle shows different approach for new capital
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A recent deal between XL and GreyCastle is made possible by the long-term objectives of the buyer's backers. Rob Mannix spoke to GreyCastle's chief executive Raymond Brooks about how this approach is different from that of other similar investments.


Raymond Brooks at GreyCastle

A recent deal whereby global insurer XL retroceded part of its life reinsurance business to a Bermudan vehicle represents an interesting twist in the trend for new money to come into the insurance and reinsurance space.

In June, XL sold its subsidiary XL Life Reinsurance (XLLR) to GreyCastle Holdings, a startup reinsurance business, for $570 million (£335 million) in cash, with XLLR then reinsuring $4.4 billion of reserves relating to XL's life operations. The reserves relate to XL's European-facing reinsurance risk, primarily single premium annuities and term life policies.

By completing the transaction, XL was able to relieve itself of a business that, in the words of chief executive Michael McGavick, had distracted and detracted from the firm's core mission of property and casualty insurance and reinsurance. McGavick was ebullient about the deal in XL's Q1 earnings call and shareholders have responded positively, with the company's stock trading at highs for the past 12 months following completion of the deal.

A number of new types of investors have sought to access the insurance and reinsurance market over the past year, but GreyCastle has been keen to emphasise the different nature of its model. In particular, chief executive Raymond Brooks is at pains to highlight the long-term nature of his backers. With regulators having imposed tough controls on previous deals where private equity and hedge funds bought books of insurance business, it seems possible that such long-term investors might have a further role to play in the market going forward.

"We took really long-term capital and matched it with long-term liabilities," says Brooks. The family offices and endowments that make up the end-investors in GreyCastle have a multi-generational investment horizon, he explains. At the same time, GreyCastle agreed to stringent controls on how it will manage the reinsurance book, including terms that would see the entire portfolio recaptured by XL should GreyCastle trip specific requirements on capital levels, fail in its regulatory compliance or fall short on collateral requirements.

In XL's earnings call McGavick underlines this point: "The most important thing to note is that the counterparty is a collection of family offices and university endowments," he said. "While we had a number of interested parties to choose from – from traditional reinsurers to private equity and also some new life reinsurance startups – we view GreyCastle as exactly the kind of counterparty that should want these risks because its main focus is preserving capital. We did not want a counterparty that was going to do this as a leverage play or juice the assets. We wanted someone that was going to run it off and take the ordinary benefits of the run-off."

The XL transaction is the first deal from GreyCastle since its foundation by Brooks, who is looking to put to work his experience in leading ACA Financial Guaranty Corporation during the financial crisis. ACA was an insurance business in run-off worth $7.5 billion that Brooks managed between 2008 and 2012. Lord James Blyth, previously chairman of Diageo and the Boots Company, is GreyCastle's chairman. And the firm includes among its backers TRB Advisors and Equity Group Investments, as well as others who remain confidential.

"If you think about private equity or hedge funds, they have natural horizons," says Brooks. "They are five-year or seven-year funds. We purposefully went with family offices and endowments so our horizons are multigenerational. Since we don't have a fund or similar vehicles, we have an indefinite – that is, infinite – lockup, which is really compelling to the seller. They know we are going to be around for a long time. This is also important from policyholders' perspective."

This long-term view is particularly important given the close regulatory attention paid to other similar deals recently, where supervisors have been sceptical about the alignment of interests between buyers and policyholders. Last year, for example, US firm Guggenheim Partners bought the US life and annuity business of Sun Life Financial, while Athene Holdings, a Bermuda-based life insurer, sponsored by Apollo Global Management, bought Aviva US. In response, the New York Department of Financial Services (DFS), the state regulator for banking and insurance, launched action in mid-2013 that led to Guggenheim and Apollo agreeing to strengthen policyholder safeguards.

Superintendent Benjamin Lawsky of the DFS said at the time: "We have worked to build a new model for policyholder protections that will help address the emerging trend of private equity firms and other investment companies entering the annuity business. When it comes to these sorts of deals we need to ensure we are putting retirees who depend on these annuities first. We are pleased Apollo worked with us to reach a resolution that provides enhanced safeguards for policyholders so that this transaction can proceed."

The enhanced protections for Guggenheim and Apollo included agreeing to heightened capital standards equivalent to 450% of risk-based capital levels, and to a backstop trust account held separately from the acquisition's funds to replenish capital should it fall below the 450% requirement.

The DFS also imposed enhanced regulatory scrutiny of operations, dividends, investments and reinsurance so that any material changes must be agreed with the regulator before they go ahead. In addition, Guggenheim and Apollo committed to provide more frequent and detailed reports to the DFS than are usually required.

The XL-GreyCastle transaction includes a number of measures that should help avoid similar concerns (and the deal has completed without objection from supervisors). "Because the deal is a reinsurance transaction rather than an outright sale, XL is still on the hook if GreyCastle doesn't work out from a financial strength standpoint," says Brian Schneider, a senior director at rating agency Fitch Ratings in Chicago. "The provisions relating to recapture were put in place to help get this deal through. Recapture is unlikely to happen in a reasonable scenario, but it provides extra protection to policyholders."

Whereas the strategy of other new ventures in the insurance space might be to seek a higher return on assets than achieved by the selling insurance company, GreyCastle is relying only on the long-term nature of its investment to generate the returns it targets. The buyer has agreed an investment strategy with XL that is purposefully conservative. "We agreed to an investment guideline policy that we co-authored with XL that was conservative and satisfied the needs of XL and the regulators," says Brooks.

Thus, the firm has agreed to maintain a single-A investment grade asset policy on a weighted average basis and has confirmed with XL who the managers for the asset portfolio will be and what the allocations will look like. "The policyholder does not have to take any undue risk. We have matched the assets with the liabilities," explains Brooks.

GreyCastle also agreed to a number of measures whereby the reinsurance book of business would be recaptured in the event of the firm failing to meet regulatory compliance requirements or contractual capital and collateral requirements. “It is a pretty draconian penalty for us and is designed so our behaviour is such that we don’t ever get there,” says Brooks.

On the XL investor call, McGavick outlined what would happen in such a scenario: “While a retrocession is not novel, that we are doing it to an unrated vehicle is. First of all and most importantly, this is a funds-withheld reinsurance transaction. That means we keep these assets on our books and in our accounts. What we transfer to GreyCastle is the management of these assets and their economic benefits. But should the counterparty not perform we are able to easily (because they are still in our accounts) recapture these assets under a variety of scenarios. This protects XL’s shareholders. Not letting these assets go is the ultimate protection.”

Brooks further explains that GreyCastle has capitalised the business at a level equivalent to that required for a Standard & Poor’s AA rating (although GreyCastle is unrated). To draw a comparison, this is approximately equivalent to the 450% RBC coverage required of the buyers by the DFS on the Guggenheim and Apollo deals.

From XL’s point of view, the structuring of the deal as a reinsurance contract rather than a complete sale means the company is unable to release all the capital backing the assets. Rather it will be able to reduce its capital buffer to a less conservative level. This will enable XL to increase its planned buyback of shares by $300 million this year.

Looking ahead, GreyCastle says it is has the capacity for further deals, with an inclination to focus on the European market. “We are trying to be a UK and European player,” says Brooks. “We like the products. We are comfortable with the regulatory regime. We aren’t afraid of a multi-currency environment.”

For risk officers taking an interest in the growing supply of reinsurance opportunities, this addition to the existing trend of new capital entering the insurance market is positive. It may be less so for established reinsurers, for whom already the influx of new capital into the market has put pressure on reinsurance rates. The more capital chasing opportunities in reinsurance, the greater that pressure will be.

Says one UK-based consultant: “The entry of new capital into the markets may have one of two impacts for conventional reinsurers. It may stimulate the development of a new market or it may drive yields down. That will to a degree depend on the supply of portfolios coming to market. For insurance companies the new entrants will provide more potential buyers of their liabilities so, in terms of risk management, it might enable them to spread their counterparty risks wider or with more capitalised bodies than before.”