23 July,2010

Insurance Day

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P/c sector must consider moving beyond cat bonds

KEN PIERCE, ELANA HAHN and GONYI AJAWIN consider some opportunities to increase property/casualty capacity

THIS article explores the scope for property/casualty (p/c) insurers' and reinsurers' use of insurance-linked products other than catastrophe bonds to manage their exposure to catastrophe risk while diversifying away from the traditional reinsurance marketplace.

When the market next hardens, whether as the result of catastrophes to come or other market-moving events, we foresee the rapid expansion of instruments and transaction structures such as sidecar reinsurers, industry loss warranties (ILWs) and catastrophe risk swaps in lieu of cat bonds and start-up reinsurers. This is owing to a number of relative advantages of these products as compared to cat bonds and start-up companies.

Continuing growth in insurance-linked products

Over the past 20 years, investors have shown growing acceptance of insurance-linked products. There has been a steady increase in specialised funds focusing on insurance-linked products, and in recent years multi-strategy hedge funds and pension funds have recruited experts in insurance linked risk to add this asset class to their broader portfolios.

The financial crisis has served to increase this demand because insurance-linked products held up relatively well. With some exceptions (in particular, where investor proceeds were invested in poor-performing assets), the solid performance of insurance linked products demonstrated empirically the very limited correlation between insurance risk and the wider financial markets.

Sidecars' potential

Sidecars hold enormous potential for the market. We expect sidecars will drive the next wave of capital-raising for p/c insurers owing to present market fundamentals and the structural and trade execution advantages of the product.

From the insurer's perspective, sidecars provide quota-share reinsurance capacity and access to equity-type capital that is non-dilutive to shareholders. Indeed, because sidecar investors have a low cost structure and generally offer sponsoring insurers override and profit commission, they are an effective, potentially profitable and relatively low-risk method to leverage a insurer's franchise.

Because sidecars are typically fully collateralised up to the aggregate limit of reinsurance coverage, they do not expose the insurer to the credit risk of traditional reinsurers (which may be subject to the same catastrophe risks as the sponsoring insurer). Sidecars are flexible structures that can be adapted to suit the needs of both sponsor and investor on a case-by-case basis.

Investors have a long memory and sidecar reinsurers, as a class, outperformed the class of reinsurers that started up after hurricane Katrina (*pictured*) in 2005 and 2006. Start-up reinsurers, like any new standalone company, require the complete panoply of infrastructure and

management and their attendant costs, and lock up investors' capital in companies that may or may not ultimately be sold or trade in the public equity markets at a premium to book value.

By contrast, sidecars offer investors a focused "line of business" exposure at a very low cost because they are virtual companies with no full-time management, staff or infrastructure. Because sidecars are generally limited life

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vehicles, they offer investors a clear exit at book value, without the risk of a long-term capital investment that may be locked up without a clear exit strategy stock price volatility associated with investing in re/insurers or to asset and investment risk.

From a transaction execution perspective, sidecar structures are relatively uncomplicated but specialised; engaging an experienced insurance-securitisation law firm will ensure an efficient completion.

ILWs and cat swaps

There is also great potential for p/c insurers to expand their use of ILWs as capacity-management tools. These meet investor demands for tradable insurance-linked products and can be executed quickly.

In consultation with savvy insurance securitisation counsel, ILWs can be documented using a range of approaches customised to specific investor demands.

The full potential for over-the counter (OTC) derivatives trading in cat swaps remains unrealised. Cat swaps are relatively easy to execute and require less documentation than other insurance-linked products such as cat bonds. The International Swaps and Derivatives Association (ISDA) forms and practices are well developed and, as described below, continue to be developed for the p/c-linked sector.

Cat swaps and ILWs provide seasoned investors with familiar products that can be customised to meet their demands. As such, these products provide p/c insurers with new avenues for transferring risk that complement the traditional reinsurance market.

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Improving infrastructure

At inception, the insurance-linked market presented the creation of a complex product without a common language.

The products have in part become increasingly attractive to a wider investor base owing to improved rating agency methodologies (including recent 2009/10 releases).

The products have also benefited from document standardisation. For example, ISDA formulation reflects the maturing of the market and a continuing move towards transparency and liquidity.

Furthermore, the recent growth in the number of exchanges trading insurancelinked products provide the liquidity and transparency demanded by investors. This is expected to be further enhanced by regulatory changes in a number of jurisdictions, including those that will flow out of the OTC derivatives regulation under the US Dodd-Frank Act and its international coordination.

With these improvements in insurance-linked trade execution "infrastructure", a limited number of law firms have also developed specialised teams that have a true understanding of the insurance industry and the legal issues and are able effectively manage the multidisciplinary (and in some cases multi-jurisdictional) aspect of the trades.

These resources mean the transactional, time and operational cost for a p/c insurer conducting a trade can now be minimised.

Harnessing the potential

The insurance-linked securities and derivatives market has matured and it has demonstrated resilience in the economic downturn. As a result, the product infrastructure exists and is growing. The p/c insurance and wider-market fundamentals appear to be driving sidecars to the forefront. These fundamentals and regulatory changes are also driving traditional and new pools of investors' interest in other flexible insurance-linked products.

P/c insurers, assisted by specialist advisers with the relevant experience, are able quickly to execute trades leading to increased capacity and greater market efficiency at a reasonable cost.