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'Mad scramble' for capital fuels cat bond market

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Though it's been slow developing, and some believed other alternative sources of reinsurance such as sidecars might supplant it, the risk-linked securities market is showing renewed vigor and increased interest in using bond structures to transfer risk to the capital markets.

Meeting last month in New York at the Bond Market Assn.'s Insurance & Risk-Linked Securities Conference, various parties involved in the market suggested activity in catastrophe bonds and other risk-linked securities has picked up due to last year's hurricane losses, a hardening catastrophe reinsurance market and, in general, more experience with the risk-linked security structures.

"The convergence of banking and insurance has started to happen," said Mark Azzopardi, chairman of the New York-based BMA's Risk-Linked Securities Committee and head of insurance and pensions within the global risk solutions team at BNP Paribas in London.

Alex Krutov, president of Navigation Advisors L.L.C. in New York and co-chairman of the conference, noted that while the BMA's last risk-linked securities conference 18 months ago focused almost exclusively on catastrophe bonds, this year-despite significant growth in that area of the market since last year's Hurricane Katrina-the 2006 conference also devoted considerable time to securitization of life insurance risks.

With regard to growth in the cat bond area, Christopher McGhee, managing director at Marsh & McLennan Cos. Inc.'s broker-dealer unit MMC Securities Corp. in New York, noted that when the group met in 2004, catastrophe bond volume was just over $1.14 billion. "Issuance was down, both in the number and in volume," Mr. McGhee said. At the 2004 conference, he said, "There was an informal theme from investors. It was, 'Please bring us the deals.' There weren't enough."

In 2005 though, cat bond issuance rose to more than $1.19 billion, a record volume. And thus far this year, cat bond volume has already topped last year's record at nearly $2.10 billion.

The number of deals is up as well and more deals are in the pipeline, Mr. McGhee said. "I would guess we're surely at $3 billion in volume (in 2006), and we're more likely at the $4 billion level," he said.

Katrina effect

While there was just over $4.04 billion in cat bond principal outstanding at the end of 2004, by mid-June of this year, principal in the market stood at more than $6.1 billion.

"Why the sudden change? Obviously, it's Katrina," Mr. McGhee said. "But it's really the related effects from Katrina."

Changes in the way rating agencies are viewing insurer and reinsurer capital, changes in catastrophe models increasing the loss potential from hurricanes during the next decade and reinsurers reducing property catastrophe capacity while increasing price-with a particularly tight market for peak U.S. exposures-have all had an impact on ceding companies' search for cat capacity, Mr. McGhee said.

"We've seen the result that there has been a mad scramble for capacity," he said. "There has been this dramatic hunt and that has very much benefited the development of the cat bond market."

"There is a very large imbalance currently...in the supply and demand" for U.S. hurricane reinsurance, said Kevin Stokes, managing director at Guy Carpenter & Co. Inc. in New York. "The supply is going down by 25% and the demand is going up by a similar amount."

"The situation is that there is a huge need for additional capital, and everything is being explored: sidecars, (industry loss warranties), swaps," Mr. Stokes said.

"The capacity shortage is there and there's a need for more capacity to satisfy clients' needs," Mr. Stokes said. In that environment, cat bonds are "certainly part of our conversation. It's building louder and louder," he said.

Transaction costs and complexity and basis risk-the risk that the coverage provided by the bond structure might not accurately match the issuer's loss experience-remain key stumbling blocks for many ceding companies considering the cat bond market, Mr. Stokes said. Still, for some, benefits such as access to new sources of capacity, the ability to obtain capacity for peak risk zones and the ability to lock in capacity and price over a multiyear period hold considerable appeal.

Offering the perspective he sees from small and regional insurers, Paul Little, executive vp and chief brokerage officer of Holborn Corp. in New York, said, "As we're sitting with a customer we'll certainly talk about the fact that there is basis risk involved that there isn't in traditional reinsurance."

"Obviously, traditional reinsurance is much more familiar to our clients," Mr. Little said. "But with so much that has been written about cat bonds, there is greater familiarity."

Relationships solid

While saying he sees a role for the risk-linked securities market to provide capacity for his clients to cover peak zone exposures, Mr. Little said he does not see it replacing the relationships his clients have developed with reinsurers that cover their many exposures besides property catastrophe. The loss experience of the next few years will determine how large that role will be, he said.

"The demand for capital markets participation in the insurance business is going to be directly tied, I think, to the events of the next 36 months," Mr. Little said.

MMC's Mr. McGhee noted that, in addition to increased volume in the risk-linked securities market, the market is broadening. While before this year it primarily consisted of U.S., Japanese and European exposures, this year there have been deals addressing Australian windstorm and earthquake and Mexican earthquake risks.

The market also has increased in sophistication, Mr. McGhee said, with increased use of shelf registrations and continued evolution of the indices that trigger bond payouts. "It's not all about cat bonds," he said in adding that other risks being securitized include third-party liability exposures, trade credit risks and auto insurance exposures.

Among the various risk-linked securitizations gaining interest on the life side are embedded value deals, according to Dan Ozizmir, managing director of Swiss Re Capital Management and Advisory in New York.

While the embedded value deals are a small percentage of life securitizations to date, they are gaining momentum in Europe due to solvency capital rules, Mr. Ozizmir said, and are seeing increased interest in the United States.

"You're talking about transactions that really go to the heart of the business model of the life insurance company," Mr. Ozizmir said. The market will develop because of investor interest in the securities and the long-term benefits for a life insurance company, he said.

Those securities essentially involve determining the present value of a book of business, then structuring it in tranches and selling it to investors, explained John Kiernan, managing director and head of life securitization at Swiss Re Capital Markets in New York.

For life insurers, the transactions convert intangible assets to cash, improve capital adequacy and transfer risk to investors, Mr. Kiernan said.

A key benefit for insurers, Mr. Ozizmir said, is the ability to hedge excess mortality exposures, but "the market for the excess mortality right now is in a state of flux." Concern over an avian flu epidemic has increased the interest in the area, Mr. Ozizmir said. "I think what we're seeing in the extreme mortality market right now is we will see a very busy 2006," he said.

Investors speaking at the conference indicated that they'd like to see diversity in the types of risk-linked securities brought to the market continue to broaden.

"I think what we'd like to see now are second- or subsequent-event securities," said John C. DeCaro, portfolio manager at St. Francis, Wis.-based Stark Investments L.P.

Niraj Patel, a portfolio manager and investment leader at Genworth Financial Inc. in Stamford, Conn., agreed. "We'd like to see a more diversified slate of bonds," he said.

Nelson Seo, managing member and senior portfolio manager at Fermat Capital Management L.L.C. in Westport, Conn., said that while his firm doesn't focus on "pure diversification" in its risk-linked securities investments, he still thinks the market could benefit from more diversity in its offerings.

"Overall, the market, just for the health of the market, needs to see more non-U.S. wind right now," Mr. Seo said.

Asked if there are any risks he wouldn't take, Mr. Seo said, "We're pretty much open to any type risk."

"I don't know if the market is exactly ready for terrorism or things like that right now," he said. "It might take another year or two."

Regarding current cat bond pricing, which seems to be moving in step with catastrophe reinsurance pricing, Mr. Seo said, "Investors are profit-driven. A lot of the capacity now just moves between cat bonds and reinsurance."

While current cat bond yields are attractive vs. other comparably rated corporate debt, Mr. Patel said the market's still not large enough for investors to say "let's get out of corporate bonds and get into cat bonds."

Mr. Seo said he expects the risk-linked securities market to continue to see steady growth during the next five years, adding that it takes time to attract participants on both sides of the transaction to a new market.

Mr. Patel said he thinks that while it's difficult to predict the market's future, "I think one thing we can be sure of...is there's going to be innovative structures and structural improvements."

Stark Investment's Mr. DeCaro said he thinks Hurricane Katrina was a significant moment in the market's

development. "Now we've reached the point where we've had a big property cat loss and I think the insurance and reinsurance markets have accepted the hedge funds and capital markets investors," he said.