MEDILL REPORTS CHICAGO

Cat bond sales hitting record high in 2007

***by* CAROLINE KIM**
Nov 28, 2007

Designed to spread the risk of horrendous natural disasters like Hurricane Katrina, catastrophe bonds have grown to a $5 billion business this year, with Chicago's Aon Corp. helping to seal several large deals.

A sale of cat bonds, as the insurance industry calls them, enables the issuer, usually an insurance or reinsurance company, to raise funds against a described catastrophe, like a Gulf hurricane. The bonds' investors obtain an attractive interest rate, 7 to 10 points above U.S. Treasurys depending on the degree of risk, because there's a catch. If a catastrophe occurs, the issuer's obligation to pay the interest or principal is deferred or forgiven completely.

Sales of catastrophe bonds this year already have hit an annual record of $5.38 billion in 21 transactions worldwide, surpassing last year's $4.7 billion in 20 transactions.

Cat bond deals can be quite complicated, with several parties involved. For instance, on Oct. 17, Aon, as a broker, helped complete a private placement of $260 million of principal at-risk variable rate notes for Midori Ltd., a special purpose vehicle in the Cayman Islands.

This private placement provided Munich Re AG, a global reinsurance company, with fully collateralized catastrophe protection for Japanese earthquake risk. The beneficiary of the securitization was East Japan Railway Co., a Japanese railway company.

The year's cat bonds total so far is nearly nine times the amount of 10 years ago, which totalled only $633 million in five transactions, according to research by Guy Carpenter and Co. LLC, a New York-based global reinsurance company.

Investors view the bonds as an attractive investment because, on top of the high yields, cat bonds are not linked to the stock market or current economic conditions.

"The cat bond market is growing rapidly and probably for good reason," said Bill Bergman, equity analyst for Morningstar Inc. "It provides another alternative for risk management and insurance services."

Cat bonds originated about 10 years ago, said Rodrigo Araya, senior vice president at Moody's Investors Services of Moody's Corp., a New York-based research company. But now the sales have been expanding to create a much wider investor base.

"The market is somewhat standardized in what cat bonds cover," Araya said. "The usual are earthquakes in the U.S., Japanese earthquakes, and European windstorms."

Other coverages include typhoons, hurricanes and windstorms.

Especially in the last three years, issuances of cat bonds have increased significantly, said Christopher McGhee, managing director of Guy Carpenter.

The number of cat bonds has more than tripled from six transactions in 2004. The average deal size that year was $190.5 million; it jumped last year to $234.7 million, according to a report by Guy Carpenter and MMC Securities Corp.

"The principal driver was hurricane activity of 2004 and 2005, that basically caused an increase in reinsurance costs dramatically," McGhee said.

He said the record numbers this year are a continuation of the demand created post-Hurricane Katrina, with more insurance companies entering the cat bonds market and offering a good source of stable, multi-year investments.

Institutions are the main investors in cat bonds, while the main issuers are Bloomington, Ill.-based State Farm Insurance Cos., Northbrook-based Allstate Corp., Travelers Cos. and Hartford Insurance Cos.

Aon, the no. 2 insurance broker, handles cat bond deals worldwide. It was the first to bring an insurance-linked securitization deal to market, in 1994.

"I think it's a strong positive on balance for Aon," Morningstar's Bergman said.

Aon Capital Markets, Aon Corp.'s investment bank, raised more than $2 billion in capital for clients in 2006, said Aon spokesperson Rahsaan Johnson. That included $190 million for Lakeside Re Ltd., sponsored by Zurich Financial Services and $300 million for Cascadia II Ltd., sponsored by Johnston, R.I.-based FM Global. Lakeside and Cascadia II are special purpose vehicles based in the Cayman Islands.

“Capital markets provide for our clients for an alternative form of reinsurance,” Johnson said. “We are, in effect, helping our clients find lower cost alternatives, and they’re often finding alternatives for harder-to-place risks.”

With an increasing number of deals and invested capital overe the past 10 years and the instability of the markets right now, cat bonds are attracting more investors. In the past two years, investors have done very well with U.S. hurricane cat bonds because there were no major hurricanes.

“There’s a potential to be a very large market,” said Araya, of Moody's. “The expectation is that it’s going to grow.”

But McGhee disagrees.

“I suspect it will stabilize,” McGhee, of Guy Carpenter, said. “I wouldn’t expect very rapid growth" next year.

Whether it stabilizes or not, Bergman said, Aon is in a “very good position to benefit” from the increasing popularity of cat bonds.

“They see themselves as a risk management services provider and are trying to find solutions for consumers that way,” he remarked.