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Converging Capital and Reinsurance Markets

Will the alternative risk financing options for today's catastrophes become the mainstream financing options of tomorrow?

By Vanessa Mariga

Most of the 2005 cat season claims have been settled and 2006 proved to be a calm hurricane season, but reinsurers are never-theless looking for ways to bolster capacity so as not to be swept away when the next tidal wave of claims hits.

Guy Carpenter presented a half-day seminar in January 2006 on the specialty property market at Toronto's Hilton Hotel. Christopher McGhee, managing director of Guy Carpenter's investment banking specialty practice in New York, offered insights into the new ways that reinsurance companies are expanding capacity - in particular, cat bonds and sidecars.

"The critical point here," McGhee told his audience, is that "the convergence that we're talking about between the capital market and the reinsurance market, in my view, has actually happened or is in the process of happening."

McGhee acknowledged there has already been plenty of industry murmuring about the merging of the markets. But given the recent use of cat bonds and sidecars as alternative financing options for catastrophes, it has become crucial for those in the reinsurance market to develop an understanding of just what these mechanisms are, how they work, and whether or not they are here to stay.

"The important distinction between traditional and non-traditional alternative markets is becoming less relevant," McGhee suggests. "All of this is important to pay attention to because the non-traditional markets of today are, I think, going to become the traditional markets of tomorrow."

CAT BOND AND SIDE CAR 101

"Cat bonds are, very simply put, securitized reinsurance policies," McGhee explains. The reinsurance company sponsors the creation of a special purpose vehicle, usually in an offshore location like Bermuda, for example, and sells the reinsurance contract to the insurance company.

McGhee offers the example of a US\$100 million insurance contract. To raise capital for the contract, the reinsurer issues bonds to investors. Investors receive a paper saying: 'We will pay you principle when the bond turns over.' The US\$100 million collected from the investors for the bonds is then put into a trust account.

Assuming a multi-year term for the bonds, investors will receive two things. First, they will receive premium from the reinsurance contract. Second, investors will receive interest on the US\$100 million put into a trust account, since the trust income money will be invested in high-return, short-term

assets.

"We want these bonds to be insulated from interest rate risk as much as possible, so what we do is make these bonds floating rate notes," McGhee says. "We do that by contracting with a swap counterparty from a large financial institution, which says: 'I will take the returns from the assets invested in the trust, but I'll also take the default risks on the assets in the trust. I'll take all of that interest income; in return, I will give you the LIBOR (London Interbank Offered Rate), which is the floating rate.'"

LIBOR is then passed through to investors so the coupon is fixed with respect to the reinsurance premium, effectively making the bond a floating rate and insulating investors from interest rates.

"So if, after the term, there are no losses under the reinsurance contract, the US\$100 million is returned to the investors," McGhee notes. "If, on the other hand, a natural disaster occurs that is a subject of the reinsurance contract, then the sponsor makes a claim, and the claim is paid off by withdrawing the money from the trust. In that case, the investors have lost some or all of their money."

Sidecars, on the other hand, are a little newer to the market - and a little more complex, McGhee comments. This mechanism essentially means buying a reinsurance contract from a special purpose reinsurance company, with a limited lifespan, that has been capitalized by investors. They are basically "a quota share of a portfolio business," he explains. "That's it, that's all, nothing magical about it."

Sidecars are different from cat bonds in that they are a much higher risk, so investors will require substantially higher financial returns, McGhee says.

Essentially in a sidecar arrangement, the investor buys the core shares of a sidecar entity that has capitalized itself through debt and equity insurance.

"Think of them as equity capital," McGhee says of sidecar arrangements. "It's really a way to move a lot of equity very rapidly. What's interesting is [that] this mechanism allows the use of substantially more debt - it's an off-balance sheet - but you're getting more leverage that you would be able to use in the reinsurance marketplace."

Diversification is key, he posits. "If you can show a diversified risk profile, in which a lot of the upper part of the capital structure is not exposed to loss, and you get that through diversification, then you can use more debt."

The odd time - about 1.5% of the time, McGhee estimates - sidecars and their investors will lose all of their capital. "And 77% of the time or better, you break even or do better than that," he says. "So a full quarter of the time, money is lost."

The risk of loss for an investor in a sidecar arrangement, therefore, is much higher than the risk of losing money in a cat bond investment. In a cat bond situation, McGhee notes, "99% of the time you're going to make your money, and 1% of the time you're going to lose your money."

So, greater risks are rewarded with greater returns in sidecar arrangements, McGhee reminded the audience.

WHAT'S IN IT FOR EVERYONE?

In 2006, cat bond activity increased by approximately 136% - from a total value of US\$1.99 billion in 2005 to US\$4.6 billion in 2006. Not coincidentally, an increasing number of catastrophic natural disasters pounded the U.S. during that same timeframe.

As far as cat bond sponsors are concerned, cat bonds are fully-collateralized transactions. "As sponsors become increasingly concerned about credit quality, especially for the most extreme events, full collateral is an attractive feature," McGhee says. Cat bonds also "allow a lock-in capacity at a fixed cost over a multi-year period." Typically, he adds, a fixed capacity at a fixed cost is a rarity on the reinsurance market.

As far as cat bond investors are concerned, they're looking for assets to diversify their portfolios and hard returns. "Investors are looking for transactions that are clear and simple," McGhee says. "They want transparent triggers of loss."

Generally, investors like contracts where there is only one, or a very limited number of perils, McGhee notes. "Ceding companies like it the other way," he adds. "They want as many perils as possible covered. So, there is always a tension that we try to manage."

Increasingly, investors are finding ways to invest in insurance risk that is not in cat bond form, McGhee noted. "Most investors come to the risk transfer space first through this [cat bond] mechanism," he says. "Then they realize it is an interesting market and ask: 'We like this risk, how do we get more of it please?'" In other words, cat bonds represent the baby steps investors take before taking on reinsurance risk directly - enter the sidecar.

For a sidecar sponsor, if the portfolio makes money, fee income and profit-sharing is generated. "It gives the sponsor some intangible marketplace benefits, such as the ability to offer larger lines and maintain marketplace clout or relationships," McGhee says.

What is the upside for investors? They get to capitalize on market dislocations.

"It's a great way for an investor, who doesn't have underwriting benefits, to immediately take advantage of a reinsurance market dislocation," he notes. "Of all the sidecar transactions that have entered the marketplace in the past 15 months, all have expected pay-outs of 20% or greater."

As is the case with cat bonds, there is a tightrope between sponsor and investor needs in sidecar arrangements.

He gives the simplified example of a sidecar with a \$100 million capacity. If the ceding company puts in \$20 million, it is up to the investors to supply the remaining \$80 million. It is unlikely the \$100 million limit will ever be exceeded at once; therefore, investors will typically opt to supply only a portion of the \$80 million. From the investor's point of view, the smaller the amount of money invested, the greater the investment returns. The ceding company, on the other hand, wants the full

\$100 million as collateral; it would rather avoid using credit for any amount the investors don't provide. So there is a constant push-pull between the ceding company's credit quality and higher returns for investors, versus a ceding company's financial ability to pay claims.

"Investors want to make as much money on capital deployed as possible, so the smaller the actual level of collateralization, the better the potential return to the investor," McGhee notes. And on the flip side, for the sponsor, "the lower the level of collateralization, the more chance there is that they won't be able to collect fully on the ones that they have ceded."

LOOKING AHEAD

McGhee predicts 2007 will see a decrease in cat bond activity and a dramatic drop in sidecar transactions compared to 2006. "Sidecars are a great mechanism, but they are also an opportunistic mechanism," he says. "You can think of a sidecar as a great capital market mechanism for importing capital rapidly, pumping it like an accordion and then dropping it back down as the marketplace softens."


And there are "absolutely clients that like the cat bond market and [reinsurers that] will continue to issue them," he suggests, adding that these are most competitive around peak perils. But even though transaction numbers may take a dip, these mechanisms are here to stay and are already affecting the reinsurance marketplace.

McGhee asked rhetorically whether or not the rapid change in the pricing environment of the reinsurance marketplace is in no small part due to these mechanisms? "Capital came flying in, needed to be deployed, and drove prices down," he says. "So, we're talking about a hard market that evaporated in 15 months."

These capital mechanisms, he continues, probably have a more substantial impact on the overall risk transfer spectrum than their size demonstrates.

"The bad news is that it's more complex and everybody who's in the business has to spend a lot more time understanding these mechanisms so that they can either take advantage of them, or defend against them."

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