Optimism expressed on future of cat bond market

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The risk-linked securities market continues to grow gradually, driven by issuers seeking strengthened reinsurance capacity and by investors increasingly viewing catastrophe bonds as an attractive risk.

At the New York-based Bond Market Assn.'s fourth annual Risk-Linked Securities Conference, held last month in New York, industry experts told attendees that despite the market's slow progress, they remain optimistic about the future of risk securitization as an alternative to traditional property catastrophe reinsurance.

The conference did, after all, garner a record attendance of nearly 150 delegates, including representatives from law firms, modeling companies, banks and financial institutions, as well as a large turnout of investors.

This year is the 10th anniversary of the catastrophe bond-the first having been issued in 1994 by Germany's Hannover Reinsurance Co.-noted Christopher M. McGhee, managing director of New York-based MMC Securities Corp., a unit of Marsh & McLennan Cos. Inc.

As it enters its 10th year, the cat bond market is "still relatively small," Mr. McGhee acknowledged. Overall risk capital for the segment stands at $8.1 billion, with $3.4 billion in catastrophe bonds outstanding, according to Mr. McGhee.

But an encouraging trend is that bonds' issuing size is getting larger, Mr. McGhee noted. "Increasing transaction size suggests a maturing marketplace."

"Investor demand has been heavy and is growing," said James Doona, a director at Standard & Poor's Corp. in New York who rates insurance securitizations and other alternative risk transfer arrangements.

A panel of major institutional players in the risk-linked market shared with conference attendees several attractions of investing in cat bonds.

Martin Jones, chief investment officer and head of portfolio management at London-based Coriolis Capital Ltd., said, "The No. 1 attraction is the idea of low correlation," referring to cat bonds being an asset class not closely linked with the stock market or other economic conditions. Coriolis, a hedge fund management company created in July 2003, specializes in cat bond and weather derivatives.

Other advantages cited by investors were the low volatility of monthly returns, with losses resulting only from massive, once-in-a-century catastrophes, and the low credit risk.

Entering the risk-linked securities market is also attractive to investors because it provides portfolio diversification, the investors say.

The Teachers Insurance & Annuity Assn.-College Retirement Equities Fund of New York, was one of the earliest players in this niche market and has invested in 50 transactions since 1996. The fund now has over $300 million in total cat bond investments.

Speaking on the investor panel, Keith Ashton, an associate director in TIAA-CREF's asset-backed securities group, highlighted a unique aspect of the catastrophe bond market appreciated by his company-while the market is young, it is already "sophisticated," he said. Even during the especially active storm season this year, "dealers stayed involved," Mr. Ashton said.

With demand in this sector continuing to exceed the supply, experts cite this imbalance as the main impediment to the expansion of the risk securitization business.

On the fund management side, "everyone's concerned about the size of the market" for catastrophe bonds, said Andrew Sterge, chief executive officer of A.J. Sterge Investment Strategies L.L.C. in Berwyn, Pa. "A nascent market like this should double year after year," he said.

Coriolis' Mr. Jones said he is concerned about "the consistency of the supply" of cat bond deals, noting that investors may grow wary of the arrangements unless activity picks up. "We would like to see a more constant and reliable supply of deals to invest in," he said.

Still, industry experts showed their support of the use of the capital markets as a catastrophe risk transfer tool.

Conference keynote speaker Peggy Peterson, who is deputy staff director and head of communications for the House of Representatives' Financial Services Committee, offered encouragement to those involved in risk-linked securities and said that she "supports the kind of innovation (they) are doing in the marketplace."

Modeling firms EQECAT Inc. of Oakland, Calif., and Risk Management Solutions Inc. of Newark, Calif., both presented at the conference the scientific advancements they are making to catastrophe models for quantifying U.S. winter storms and floods, respectively.

The development of new cat models can expand the bond market's coverage of new perils beyond the current "big four" risks-U.S. and Caribbean hurricanes, European windstorms, Japanese typhoons and California and Japanese earthquakes-experts say.

"There is a real structural integrity in the cat bond market," MMC Securities' Mr. McGhee reminded issuers, as he pushed for insurers and reinsurers to consider using catastrophe bonds as a securitization technique and an alternative to traditional reinsurance.

Tony Rettino, managing director of Cochran, Caronia & Co. in Chicago, pointed out the cat bond's resilience over other types of risk management tools. The "cat bond universe to date appears to be unaffected" by natural disasters, he said, while "certain structured reinsurance transactions incurred losses."

"Overall, I think the market response is very positive for the future," Mr. Rettino said.

According to Niklaus Hilti, head of alternative investments for Zurich, Switzerland-based Bank Leu, "At the end, it comes to the question of how sustainable the reinsurance market" will be in the future.

"I'm actually very optimistic about the future of the cat bond market," said Mr. McGhee in the conference's closing remarks. "Don't worry, the sponsors are coming," he added.
