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***Statement of
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***Testimony before
The Committee on Financial Services
Subcommittee on Oversight and Investigations***

U.S. House of Representatives

The Risk-Linked Securities Market

On behalf of The Bond Market Association,¹ I would like to thank the Committee for holding this hearing on risk-linked securities, an important and growing segment of the fixed-income and reinsurance markets. My name is Christopher McGhee. I am a managing director at Marsh & McLennan Securities Corporation. I currently serve as chairman of the Risk-Linked Securities Committee of The Bond Market Association. The Risk-Linked Securities Committee includes representatives of securities firms that are active in the primary distribution and secondary market trading of risk-linked securities. I should note that my firm is an affiliate of Marsh & McLennan Companies, Inc., a global professional services firm whose operating companies include the world's leading insurance and reinsurance broker.

Overview

Over the past two decades, participants in the financial markets have developed sophisticated products designed to manage and transfer risk. Instruments such as structured debt and over-the-counter derivatives allow securities issuers and investors to price and manage risk efficiently. The capital markets have applied the same financial principles that have allowed market participants to manage credit and interest-rate risk to the catastrophe risk posed by hurricanes, earthquakes, and other natural perils borne by public entities, consumers and commercial enterprises.

Risk-linked securities (RLS) are a capital market innovation that developed in the wake

¹ The Association represents securities firms and banks that underwrite, distribute and trade debt securities, both domestically and internationally. Among other roles, the Association's members act as issuers, underwriters and dealers of risk-linked securities. More information about the Association, its members and activities may be obtained from the Association's website at www.bondmarkets.com.

of major catastrophes in the 1990s. Following the market-altering losses from Hurricane Andrew in 1992 and the Northridge Earthquake in 1994, catastrophe reinsurance capacity severely contracted and premiums rose significantly. Risk securitization, or the repackaging of insurance risks for capital market investors, was an idea that had been discussed in the years preceding the natural disasters of the early 90's. This idea, however, had never been seriously considered until the capacity crunch and price spike caused by Hurricane Andrew, the Northridge Earthquake and other disasters. As a result of these circumstances, the potential buyers of catastrophic risk protection began to seek alternative ways of transferring risk. The exploration of risk securitization by the capital markets began in earnest.

Risk securitization has the potential to generate substantial new sources of catastrophe risk-taking capacity on the part of insurers and reinsurers. This would, in turn, enable insurers and reinsurers to assume greater amounts of catastrophe risk from their policyholders. As such, there is a hope that, much as the secondary mortgage market brought the cost of home finance down significantly, insurance securitization could make catastrophe protection more broadly and cheaply available to policyholders than is currently the case. An increase in coverage could, in turn, reduce the potentially substantial burden on the federal government to provide emergency disaster relief to uninsured homeowners following a natural catastrophe. At the end of 2001, for example, only 17 percent of Californians had earthquake insurance.

As in all securitizations, repackaging risk requires the use of a special purpose entity, or SPE (also sometimes referred to as a special purpose vehicle, or SPV). Establishing the SPE in the jurisdiction of the U.S. tax code would expose the RLS transaction to two layers of tax, making the transaction more costly for issuers and less attractive to investors. As a result, the bulk of RLS transactions take place offshore in jurisdictions with no entity-level tax.

To fix this problem, Congress could permit reinsurance SPEs to be treated as "flow-through" vehicles that would not be taxable at the entity level. The change would streamline the RLS industry in the United States. Onshore risk securitizations would be less costly and less complicated to transact allowing insurers and reinsurers to manage risk more efficiently. As noted above, policyholders would be the ultimate beneficiaries of this new capacity for risk taking. This issue is, of course, a matter involving the tax code. As such, we recognize it is not subject to the jurisdiction of this committee, but rather the Committee on Ways and Means.

The RLS market faces another obstacle in the near term in the form of a pending accounting standard the Financial Accounting Standards Board (FASB) is planning to issue by the end of the year. The rule as presently contemplated would require an SPE in which a third party does not own at least a 10 percent equity stake to be consolidated on the balance sheet of the SPE's chief beneficiary. Depending on how the new standard is finalized, it could inhibit future growth of the RLS market.

Risk-Linked Securities

Insurance underwriters use a variety of tools to make sure they will remain solvent following a major insured loss. These tools include raising equity capital, limiting risk concentrations via the underwriting process and hedging risks in the reinsurance market. Traditionally, insurers hedge risk through the purchase of reinsurance contracts. In turn, reinsurers often elect to reinsure some of the risks they have assumed from insurance companies, primarily as a means of creating a more balanced portfolio of insurance risk. The reinsurance of risk by reinsurance companies is referred to as “retrocession.” Beginning in 1994, insurers and reinsurers were able to use securitization to complement reinsurance and retrocession to accomplish their risk diversification goals.

The securitization of risk involves the transfer of insurance liability and premiums to investors in the capital markets through an SPE. Usually, but not always, this is structured as a special purpose reinsurance vehicle (SPRV). These SPRVs are similar in function to SPEs used in plain-vanilla asset securitizations, such as those underlying mortgage-backed securities. Risk-linked securities are issued by the SPRV to investors, and the proceeds from the sale of the securities are used to buy safe and liquid investments held in a separate trust until needed to pay claims (see Appendix). The SPRV then sells a reinsurance policy to the "sponsor" of the transaction, usually an insurance or reinsurance company. The policy limit is fully collateralized by the assets in the trust. RLS investors earn a return on the securities derived from the premiums associated with the underlying insurance risk and the interest earnings on the investments held in the trust. If the insured risk—such as an earthquake or a hurricane—occurs, the insurance company can collect under the reinsurance policy (subject to satisfying the terms of the reinsurance contract) and can use the proceeds to help satisfy insurance claims. The reinsurance policy pays out from the investments held in the trust.

The insurance company sponsoring the transaction has no control over the assets in the trust and can only access the assets if a pre-agreed natural disaster has occurred and the pre-agreed terms of the reinsurance contract are satisfied. Depending on how the securities are structured, RLS investors may have all or a part of their investment at risk. In no case, however, do RLS investors have liability beyond that investment. RLS investors also have no recourse against the insurance company's assets. The transaction represents a transfer of the risks and benefits of the catastrophe exposure to the RLS investors. In an economic sense, the RLS investors act as a reinsurer, with their exposure fully collateralized by the trust investments.

RLS are a relatively recent innovation that gained an initial foothold in the capital markets following Hurricane Andrew in 1992 and the Northridge Earthquake in 1994. The industry had paid claims of \$15.5 billion from damage caused by Andrew as well as \$12.5 billion in Southern California. This hit to reinsurers' financial resources caused catastrophe reinsurance capacity to be withdrawn and helped double the cost of catastrophe reinsurance by 1994. In that type of cost and limited capacity environment,

directly accessing the capital markets through the use of RLS became a more economically attractive alternative.

It is important to note that while many kinds of insurance risk have been considered for risk securitization, the securitization of natural catastrophe risk has dominated issuance to date. The need has been greatest in this area, essentially because the enormous concentration of risk to large catastrophe events is not easily absorbed on the balance sheet of the insurance and reinsurance industry.

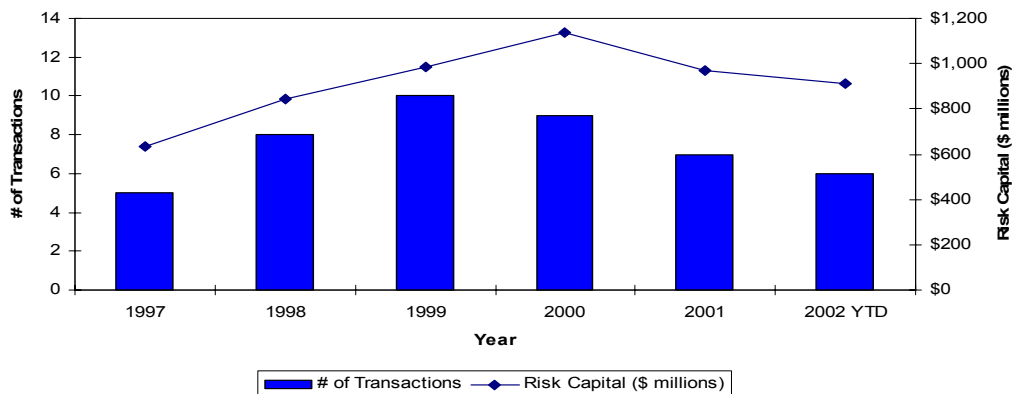
It is also worth noting that although terrorism risk to date has not been securitized, it may well happen in the future. Modeling firms have already done much work in this area. These efforts have yet to yield credible quantitative analysis of the probabilities of loss from terror events. With time, however, these models may be sufficiently accepted by issuers and investors so that securitization of terror risk will become a possibility.

Evolution of the RLS Market

In the eight years since the first RLS were issued, all aspects of the market—investors, issuers, RLS structures—have changed significantly. At the outset, the education required to understand the pricing of RLS limited the pool of investors. Sophisticated natural catastrophe modeling—which insurance industry participants spent years developing for use in managing their risk portfolios—began to be used to help investors assess the pricing and risks of catastrophe bonds. Investors had to grow comfortable with such techniques. Issuers, by the same token, were unsure of the new market and lacked an understanding of the best way to structure RLS. The various structures included different payout triggers, different maturities and both single and multiple peril bonds.

As the market grew accustomed to RLS, the number and size of transactions began to increase (see chart below). The first year of multiple issues was 1997 with five. While the number of issues per year and volume of deals has flattened out since its 1999 peak, the market has remained steady.

Risk-Linked Securities – Catastrophe Bonds Only



Since 1997, 45 catastrophe bond transactions have been completed with a total risk limit securitized of almost \$6 billion. Of this total market size there are approximately \$2.7 billion of catastrophe bonds outstanding in the capital markets as of September 2002.

The market has succeeded to date because RLS provide a complement to traditional reinsurance, equity capital and prudent underwriting. RLS also offer investors an opportunity for risk diversification as catastrophe risk generally does not correlate with other risks in investor portfolios. While the initial investors were typically insurers and reinsurers familiar with catastrophe risk and its pricing, today a wide variety of investors including commercial banks, large institutional money managers, life insurance companies and dedicated catastrophe bond funds invest in these securities.

The sponsors of RLS have been almost exclusively insurers and reinsurers. This is true for many of the same reasons mortgage bankers dominate the mortgage-backed securities markets. Like mortgage bankers, insurers and reinsurers possess the ability to aggregate insurance risks and the expertise required to repackage those risks in a way that is appealing to the capital markets. Insurance securitization follows a classic financial intermediation model where financial intermediaries assume risk, then pass risk to various types of investors ranging from their own equity shareholders to fixed income investors with varying risk appetites.

The RLS Market Going Forward

Domesticating the SPE and Accounting Issues

For insurers and reinsurers, risk securitization is an increasingly efficient way to diversify catastrophe risk using the capital markets. Under the current U.S. tax code, however, conducting these transactions using SPEs established in the United States is cumbersome and economically inefficient. As a result, most RLS transactions take place offshore in jurisdictions that do not tax the SPE at the entity level. However, even offshore securitizations present added costs to the fundamental RLS transaction, including compliance with the legal requirements in a foreign jurisdiction, the use of foreign administration services and other factors. From a cost viewpoint, it would be most efficient to conduct RLS transactions onshore provided the SPE is not taxed at the entity level.

Under the U.S. tax code, the SPE used to effect the RLS transaction would likely be subject to entity-level tax on income—the premiums it collects from the primary insurer and the interest earned on the investments held in trust. Because investors already face a tax on the return they earn from RLS, the second level of tax at entity level represents double taxation. This would reduce the economic benefits of the transaction, and is the reason why virtually

all RLS transactions have used offshore entities. It is important to note that current U.S. tax treatment of RLS transactions does not prevent transactions from taking place. U.S. tax law simply creates unnecessary costs and burdens on RLS issuers, forcing issuers to use offshore vehicles. The transactions are nonetheless subject to regulatory oversight in the offshore jurisdiction. In addition, issuers must disclose the mechanics and risks associated with the transaction in offering documents prepared for investors.

Uncertainty over whether RLS would be classified as debt or equity compounds the problem, as a tax deduction can only be taken for interest payments, not dividends. Permitting the reinsurance SPE to be treated as a "flow-through" vehicle that is not taxable at the entity level and clarifying the debt status of RLS would allow the transactions to be done at a lower cost in the United States.

A pending ruling by the FASB on the consolidation of SPEs may also present an obstacle to the development of RLS. FASB is expected to increase the minimum level of equity interest a third party must hold in an SPE in order to prevent consolidation on another party's balance sheet. The current 3 percent level would rise to 10 percent, under FASB's proposal. In general, the proposal would result in cases where the consolidation of an SPE would not reflect the true economic risks and benefits entailed by a company's relationship to the SPE. Until the new accounting standard is final, it will not be clear whether the change would require the consolidation of certain reinsurance SPEs by either a sponsor or an investor. In this respect, it should be noted that RLS transactions involve the transfer of contingent risk liabilities—which are not on balance sheet in the first place—from an insurer or reinsurer to the reinsurance SPE. RLS transactions do not involve the transfer of assets from the balance sheets of sponsors to the SPE. In addition, the transfer of contingent risk liabilities creates no accounting "benefit" for the insurer or reinsurer. It is therefore not clear that the FASB proposal should apply at all to SPEs used in RLS transactions. If the FASB proposal were to apply to these SPEs, however, it would limit further growth of the RLS market and could even disrupt outstanding transactions.

A subcommittee of the National Association of Insurance Commissioners (NAIC) has produced a model law that would facilitate the issuance of RLS. This model law is intended to clarify the treatment of RLS transactions under state insurance regulations so that sponsors of RLS transactions get full reinsurance "credit" for the risk transferred to RLS investors. To date, a few states have adopted this law and several others are considering it. The model state law would not resolve the federal tax issues currently discouraging onshore RLS issuance.

Conclusion

Risk-linked securities have the potential to dramatically increase the amount of competitively priced catastrophe insurance available to consumers, public entities and commercial enterprises. Insurers and reinsurers will act as the principal risk-taking intermediaries between those looking to shed insurance risk on the one hand, and capital markets investors willing to assume risk for a return, on the other. By providing a new

source of capital to the insurance and reinsurance industry, it is hoped that some of the price and capacity volatility of the marketplace can be dampened.

In sum, I would make these final points on behalf of the Association:

- RLS are beneficial to policyholders (consumers) as they help expand the availability of competitively priced catastrophe insurance.
- The RLS market can relieve pressure on governments to insure catastrophe risk.
- Any FASB proposal that results in an increase in the third-party equity requirements for RLS SPEs or requires consolidation of the SPEs on the balance sheet of any other entity involved in the transaction would be severely detrimental to the market.

Appendix

Basic Catastrophe Bond Structure

