

# CSFI

## CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

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**The changing shape of insurance capital: Barbarians at the gate or Darwinian Survival? A round-table discussion on insurance risk securitisation and its consequences for the industry. With Luca Albertini (Amlin Capital Markets), Henry Kus (ABN AMRO), Toby Ducker (Brit Insurance Ltd), Alan Punter (Aon Capital Markets), held Thursday, July 3, 2008, at the City Club, 19 Old Broad Street, London, EC2N 1DS, from 12:30-2:15pm.**

### CSFI/Generali Programme in Insurance

Insurance linked securitisation (ILS) is the new kid on the capital markets block. But it's still quite a small kid. Total ILS issuance outstanding now amounts to \$38bn since it was born in 1996 compared with \$1 trillion of insurance capital...and \$63 trillion in credit default swaps. The first speaker said a vanilla ILS was a catastrophe (CAT) bond where an insurer offloads a risk by setting up a special purpose vehicle (SPV) that issues bonds for investors to buy. If the event the CAT is designed to insure against does not happen, investors earn a healthy yield; if it does occur they lose their money, which is used by the insurance company to pay policyholders.

SPVs tend to be domiciled in the Cayman Islands, Bermuda, or Ireland. However the European Reinsurance Directive has removed some regulatory hurdles that might help the UK become a home for SPVs. More complex products include swaps around different insurance risks and industry loss warranties. ILWs allow someone to buy protection based on the total loss arising from an event to the entire industry rather than their own losses. The trigger point for those derivatives is measured against PCS indices that track estimated insured industry losses for catastrophes over a specified period.

This is all a new market for investors too, the second speaker said. Hurricane Katrina was the turning point. Before it was a niche area but after that new investors and new money flocked to the sector. Investment banks used structures familiar to the capital markets that helped attract investors. Since then a lack of major insurance events has seen the market soften and spreads narrow at a time when spreads elsewhere have blown out. The big issue is what would happen if a major event occurred during a bear market, such as this year's hurricane season. One member said the worry would be that capital markets would be unwilling to recapitalise the sector in the case of heavy losses.

One important issue is the type of trigger used to activate the policy. There has been a shift from indemnity - triggered by an issuer's actual loss - to parametric - where the trigger is the occurrence of a particular event, such as an earthquake or particular wind speed. Indemnity triggers, which tend to be more complex and take longer to deliver payouts, were popular during a soft market. One speaker said there was a real danger of moral hazard with indemnity triggers as insurer may be inclined to adjust losses. This led to fears of a repeat of the subprime crisis given the power of the sponsor to set the trigger terms.

The third speaker said while a sponsor might get away with that once they would never

want to risk jeopardising future deals. The first speaker said Camp Re was an example of a bond that did exactly what it said it would, paying out on Katrina albeit after a period of time. The third speaker described the market as akin to the Wild West, where an initial land grab had led to exponential growth in choice, whether indemnity vs. parametric, single peril vs. multi-peril or on- or off-balance sheet. He cited Brit Insurance's multi-year, multi-peril three-year catastrophe swap contract with Fremantle that would pay up to \$200m in the event of four to nine qualifying natural catastrophes. He said issuers could often achieve more at a competitive price compared with reinsurance. However the first speaker said securitisation was still young and there was no reason not to split a risk between the two.

The fourth speaker said he hoped greater use of parametric risk would enable the industry to develop new innovative contracts that would benefit the ultimate buyers of insurance, such as households and companies. He cited the first corporate bond issued by Oriental Land, operator of Tokyo Disneyland. The trigger was not damage to its property, but an earthquake that measured 6.5 or more on the Richter scale. In effect, the bond hedged less against specific losses and more to protect against income lost due to fewer tourists visiting in the aftermath.

One member asked whether these innovations would impact upfront insurance charges. The third speaker said it would change the reinsurance pricing cycle that would impact on the rest of the industry. The fourth speaker disagreed, saying it would mitigate rises in reinsurance costs but would not affect primary providers. One member said that it was the growing use of modelling that would affect prices and consumers' costs but not much was known about the model-makers. Another said models were constantly readjusted. A third warned of the danger of model convergence that would insure that if there were a problem "we would all go over the cliff together". The fourth perhaps eased some concern saying the different models often produced results from the same facts that were wildly different.

Where does the market go from here? The fourth speaker said ILS was here to say, adding that the challenge was to use innovation to deliver new products to the front end of the market. The third speaker said the Barbarians in the title of the roundtable invitation – the new investors – would come in and out of the market over time. The first speaker said that as an investor he wanted the insurance industry to keep learning and keep improving the products.