

The winds of change: Global capital markets take on insurance and reinsurance risk

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In 2005, there were 28 named storms in the Atlantic, of which 15 became hurricanes, seven of them major, four of which hit the US and one of which ruined the city of New Orleans. Total insured damage is estimated at US\$58bn. This followed a severe Atlantic hurricane season in 2004, winter storms in Europe, earthquakes and tsunamis in Asia and tornados in mid-west America, which collectively added tens of billions of dollars more to the total insured damage. According to reports from scientists speaking at this year's Catastrophe Modeling Conference, sponsored by the Reinsurance Association of America, atmospheric and geological conditions suggest that the earth faces an extended period of comparable natural catastrophes, though none could predict with any degree of certainty exactly when or where they would occur.



While these events and predictions have led some insurers and reinsurers to exit the market, creating somewhat of a capacity crunch, they have also opened wide the door for hedge funds and other savvy providers of capital to enter it. Recognising the leverage they possess as the only sources of capital sufficient to meet the demand for catastrophe risk transfer and management products, and that the available pricing for such products is, or at least can be, extremely attractive, the global capital markets have taken an earnest interest in, and shown a growing appetite for, insurance and reinsurance risk. This capital market capacity in turn holds the promise of enabling reinsurers to transform, in part, their businesses from being just accumulators of risk to also being distributors of risk, using their origination, warehousing, pricing and claim handling expertise to provide their shareholders with a better risk-adjusted return on equity. This new dynamic holds great promise for mutually profitable relationships between reinsurers and the capital markets, provided that they are aware of and deal properly with the critical practical and legal issues involved for each of them.

Factors driving capital markets activity

For several years, a tiny sliver of reinsurance risk was distributed into the capital markets. Only about US\$1bn of risk was transferred to capital market investors each year from 1997 through 2003, by means of securitisations, swaps and other mechanisms. The past three years, however, have seen a significant upswing in these types of transactions. In 2005, more than US\$2bn was transferred, and it appears that 2006 will set a record in both the number and the aggregate value

of capital market transactions involving reinsurance risk. Our practice has grown from a couple of lawyers working on the occasional deal to having teams working pretty much around the clock on cat bond, side car and similar transactions.

Some commentators have opined that the reason for the current level of activity is the post-Katrina double whammy of rich catastrophe pricing and shrinking catastrophe capacity. We think that the explanation is more complex. Historically, hard markets have led to the formation of new reinsurers, with fresh capital entering the industry through straightforward equity investment. Ace and XL were born from the hard market in D&O lines in 1985-1986. Hurricane Andrew led to the creation of reinsurers such as Tempest Re and Renaissance Re. The events of 9/11 led to the creation of Axis, Endurance, and others. What is happening now appears to be fundamentally different. Instead of major new start-ups, there have been a host of new cat bonds, side cars, cat swaps, and several variations on the theme. Why?

One possibility is that potential equity investors keenly understand that this year's 'pristine new balance sheet' can quickly become next year's struggling run-off, burdened by the 'legacy' liabilities of one or more hurricane seasons. Thus, taking long-term risk through equity investment in reinsurance start-ups does not seem as appealing as it once did.

Another critical fact may be that the 'traditional non-traditional' solution (or partial solution) to high risk, high loss cycles – finite and financial reinsurance – has virtually evaporated (at least in its 'traditional' form). Once upon a time (just a few years ago, actually), the insurance and reinsurance industries had finite reinsurance and other alternative risk transfer products which they could (and did, with

regulatory knowledge and approval) employ as tools to manage (at least in part) situations like the one we are now experiencing. Now, of course, countless companies are spending millions of dollars responding to subpoenas and conducting independent investigations of their finite transactions; some have changed the accounting of such contracts, restated their earnings and surplus and, as a result, been sued for securities fraud; and some honest and honourable people from the industry are facing criminal charges. As a result, finite transactions have lost much if not all of their utility. The combination of finite's disappearance, increases in property values and the magnitude of recent disasters seems to have caused a paradigm shift at insurers and reinsurers, many of whom now recognise that only the global capital markets can provide sufficient capacity to manage catastrophe risks.

On the capital markets side, the demand for capacity and the increased pricing resulting from it have led to an overall increase in risk appetite, some of which has been fueled by the emergence of hedge funds with expertise in reinsurance. In the 1990s, hedge funds were devoted principally to various technical arbitrages and proprietary trading strategies generally involving highly liquid securities. By some estimates, there are now more than 200 hedge funds that are either dedicated to reinsurance transactions or have set aside defined pools of capital to invest in them. Apart from the potential for profit, both property catastrophe and mortality/longevity risk have the added benefit to the capital markets of low correlation with the rest of their investment portfolios. Unlike bonds, equities or commodities, the risk of a hurricane or most other natural catastrophes bears little correlation to macro-economic events (although a bird flu or similar pandemic might well have a severe impact on stock and bond markets).

The kind of deals that are getting done

Much has been written about catastrophe bonds, which need not be repeated here. The most intriguing development over the past few years has been the emergence of side car reinsurance structures. Not quite an equity investment in a reinsurer, and not quite a cat bond, side cars are a bit of both. Like a cat bond, in a side car transaction, a special purpose reinsurer is established. Proceeds are typically raised in private placements, and while some deals have been all-equity, most have involved a combination of debt and equity. Unlike a cat bond, coverage under the reinsurance agreement between

the special purpose reinsurer and the sponsoring reinsurer is not triggered by a single, modelable catastrophic event. Instead, the special purpose reinsurer provides coverage for an entire line of business, or several lines of business, which may include marine and other lines in addition to traditional property cat. The special purpose reinsurer essentially rides 'side car', with the sponsoring reinsurer in the driver's seat, controlling underwriting, pricing and claim handling decisions. The side car is designed to be a temporary source of capital and capacity for the sponsoring reinsurer, and the reinsurance agreement typically provides coverage only for a single year (or, at most, two years). When the year (or two) ends, the equity investors recoup their investment and profit through a mandatory share repurchase process while the noteholders are paid principal and accrued interest when the bonds mature, assuming, of course, that an underwriting profit was made. As with traditional reinsurance, if subject losses exceed subject premium, equity and debt investors can lose some or all of their investment.

Practical and legal issues

As should be evident, cat bonds, side cars and similar transactions involve a merging of reinsurance and securities concepts, which present practical and legal issues for those responsible for structuring and documenting the deals. For example, while strides have been made in improving the calibre of reinsurance contract wording over the years, the detail and specificity contained in such contracts still pales compared to that required in securities transactions. It is therefore essential that the reinsurance-capital markets transaction documents be prepared by those with both expertise in securities law and a full understanding of the nature of the reinsurance business, who can capture the precise components of the deal with the requisite clarity and specificity. Simply defining accurately and precisely what is and is not intended to be covered can be daunting for experts, impossible for others.

Similarly, while full disclosure of material information is required of those who buy reinsurance and those who sell securities, the definition of what constitutes 'material information' may well differ dramatically in the two settings. In particular, in side car deals, reinsurers often wish to retain flexibility in deciding what to put into the facility. With such flexibility, however, comes the obligation to make sure that investors are fully apprised of the risk characteristics of all potential exposures before they complete their pricing analysis. It is therefore necessary that all parties to

the deal have a common understanding of what must be and what has been disclosed, and that this is fully documented. Again, expertise in both securities law and reinsurance is essential for it to be done right.

For reinsurers, it is also essential that the deal be structured in such a way that they can take credit for reinsurance on their financials. With side car deals, this is typically accomplished by means of letters of credit or establishment of a Reg 114 trust. There is no logical reason why these should not be sufficient for the regulators, but, even if they are, that is no guarantee that they will not later be challenged by the politically motivated. Accordingly, any credit for reinsurance security device that is employed must be fully documented, and real, not illusory.

Another important issue for reinsurers has been to ensure that they retain control over claim handling, and that investors in the side car do not interfere with their long-term relationships with their cedents. Capital market investors, concerned with the short term only, might have a very different view of what qualifies as satisfactory claims handling and what claims should be paid. They may, for example, object to XPL or ECO coverage, or ex gratia payments. It is best to make sure that each party's rights and obligations as respects claims handling and loss settlements are unambiguously spelled out in the contract.

Given the fact that the sponsoring reinsurer and its side car are neither generally aligned (beyond the reinsurance agreement) nor necessarily expected to engage in future business dealings with each other, confidentiality may also be a significant consideration, particularly in transactions which may utilise the sponsoring reinsurer's proprietary data (such as catastrophe models). It is, therefore, important to define precisely what information is and is not confidential, and the universe of those to whom confidential information may be disclosed and the terms on which that can be done.

Countless other issues can and do arise and must be addressed. The important point to bear in mind, however, is that the hurricane winds of 2005 have seemingly triggered a sea change in the reinsurance industry. An industry with well-defined and

long-standing customs and mores is becoming, and likely will become much more, intertwined with another industry with equally well-defined, but quite different, customs and mores. It is not easy to meld different cultures, but it can be, indeed must be, and is being done. As long as each side understands the constraints and realities with which the other must live, and each has or employs the necessary expertise in both disciplines so as to anticipate and avoid the potential pitfalls, there is no reason why this relatively new amalgamation should not flourish.

Capitalism cannot thrive, or even exist, without insurance; the global insurance and reinsurance industries lack the capacity to meet the global demand for catastrophe coverage, but they have the infrastructure necessary to do so; the capital markets lack the infrastructure but have the capacity; together, they can provide the product and share the risk and the profit.

Notes:

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