

Cat bond market reflects on a difficult year, with dwindling issuance and structural problems emerging

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The cat bond market has had a tough year, with the wider financial meltdown affecting issuance and problems emerging with how bonds are structured. But investors and issuers are confident the market will recover in early 2009.

The cat bond market was discussed in several sessions at the Reactions Insurance Conference 2008, held in New York on November 11 and 12.

"The cat bond sector has really been a success story over the past few years. The past year, though, is really a standout and not for the best of reasons," said Judy Klugman, managing director of insurance-linked securities at Swiss Re. "If you look at the issuance levels, they are significantly less than last year, when they were around \$7bn. What we are finding is not that the investors aren't there or that the sponsors aren't willing to issue new bonds, but that there are a couple of fundamentals going on in the market that are inhibiting it."

Klugman elaborated: "There is a significant amount of secondary market overhang. What I mean by that is that there is a significant amount of bonds being held by certain classes of investors that are being forced to sell. Because of the massive deleveraging that is going on in the financial markets a lot of our investors are getting their financing lines pulled. They are being forced to sell bonds, and the bonds that actually have the best asset value, incredibly enough, are the cat bonds. There are very few markets where you can achieve the prices you can in the secondary markets in cat bonds so the investors that do have cash, and certainly there are investors that do have cash, are being bombarded by investors that are being forced to sell for various reasons."

Also this year, concerns have arisen about the structure of cat bonds. Four cat bonds issued by Lehman Brothers – Ajax Re, Carillon, Newton Re and Willow Re – were thrown into uncertainty when the investment bank filed for bankruptcy. Lehman Brothers was the swap counterparty in each of the cat bonds.

Speakers at the Reactions conference said the market learnt a painful lesson from this.

"If cat bonds are not underwritten properly, as happened with four bonds underwritten by Lehman Brothers, then investors are exposed to credit risk," said John Brynjolfsson, managing director and chief investment officer at hedge fund Armored Wolf. "It was a complete disaster, I think, of risk management going on. The representations that were made were not followed through."

Investors demanded that the collateral structures of cat bonds are tightened and made more transparent. They said they wanted to avoid credit risk in deals.

"We would rather have treasuries in the account than any credit risk," said Urs Ramseier, head of insurance-linked securities at Swiss investment manager Horizon 21.

Beat Holliger, managing director at Munich Re Capital Markets, said no more structured products should be included in the collateral. "We will not be happy with just an explanation of assets. We want to see the lot," he said.

Luca Albertini, chief executive officer of Leadenhall Capital Partners, an insurance-linked securities fund manager set up this year with backing from Lloyd's insurer Amlin, also would like some changes. "There have been some structural features we would like to see updated," he said. "First of all, we want a tight collateral structure with either no or limited credit risk. Secondly, with more and more indemnity deals we would like data more upfront along the lines of what reinsurers would see."

Investors said the continuing success of the cat bond market was reliant on deals being as easy to assess as possible. "If insurance companies want the capital markets to adopt cat bonds in large size, they have got to make it as easy as possible," said Brynjolfsson. "In the past a lot of collateral structures were opaque."

Brynjolfsson said there were a number of developments that are making investing in cat bonds unattractive at the moment, such as end users of insurance being more aggressive in their use of insurance, opportunities for double-digit returns in markets that compete with cat bonds and the fact that structures in most cat bonds trading in the secondary market pre-date Lehman Brothers' collapse so have collateral structures that are not as good as bonds being issued now.

"I would be wary of buying cat bonds. In mid-2009 it will improve. I'd buy short maturity ones and you need to be very cautious about looking at the structure," said Brynjolfsson.

Ramseier at Horizon 21 said investors wanted better returns from cat bonds. "We think the returns these days are far too low. We think the cost of capital will go up significantly, and investors will expect double-digit returns," he said.

From a cat bond buyers' perspective, Greg Richardson, chief underwriting officer at Harbor Point Re, questioned how much of a success cat bonds have been.

"I have a different spin," he said. "Insurance securitisation should be called a qualified success. The talk about sensational success tends to come from the investor side. It has done nothing to decrease prices of insurance for homeowners in Florida. It is a qualified success for buyers. It is an extraordinarily expensive way to shed risk. The other fundamental belief being challenged is that the capital market is infinitely deep. Well, go and try to find capital right now and it's not easy."

Richardson added, however, that he was not pessimistic about the market. He believes it has a strong long-term future in providing excess and retrocession capacity.

"The end game for securitisation is probably finding its home in taking risk that is not being taken on by traditional reinsurers, such as for Florida risk," he said. "It would be terrific if it could take excess of \$100bn of cat risk at about three online. Also it should

probably remain in the retro space. There wasn't a spiral pre-Katrina but [reinsurers insuring other reinsurers] was incestuous. Retro probably belongs in the capital market."

Richardson added that having a well-run, cat focused reinsurer with about 50 people is the most effective way of managing most cat risk. But traditional reinsurers cannot cover all of the excess risk.

"The ability for most reinsurers to take large slugs of capacity is very limited," he said. "Rating agencies are very focused on PML [probably maximum loss] exposure, and 90% of that is Florida. For most normal reinsurers the ability to fill the \$10bn and \$20bn hole [in cat cover] is limited. I think we are in for a huge crisis and it would be great if the capital markets could solve that."

Michael Millette, partner, managing director and co-head of structured finance at Goldman Sachs, said it might be good in the long term that issuance has slowed this year. "I'm thinking a slow-growing, cultivated sector is something we should be happy with rather than having explosive growth, and then getting wiped out by a catastrophe, while other reinsurers have also been taken down," he said.

And Klugman was bullish that the market will pick up soon. "We are very confident that in the first or second quarter some of the fundamentals we are seeing today will reverse themselves," she said.