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Cat Bonds Survive Earthquakes, Decline After Lehman's Collapse

Catastrophe bonds, unshaken by a decade of hurricanes and earthquakes, are buckling in this year's financial tsunami.

The bonds promise investors as much as 10 percentage points more than benchmark interest rates unless insurers reclaim money to pay disaster claims. That happened only once before, and so- called cat bonds were posting annualized returns of as much as 8.3 percent as recently as August, even as the credit crunch left investors in bonds of companies with similar ratings nursing losses of 14.9 cents on the dollar.

All that changed with the Sept. 15 collapse of New York- based securities firm Lehman Brothers Holdings Inc., which sold contracts to protect returns on four cat bonds. Lehman's bankruptcy nullified the guarantees, and Standard & Poor's said a few weeks later that two cat bonds are holding assets with "significant impairments." S&P said in a report last month that it expects the four bonds to default "in the near future."

"Investors don't want to be caught by credit risks through the backdoor," said Karsten Bromann, chief risk officer at Solidum Partners AG, a Zurich-based hedge fund that invests in insurance-linked securities. "The biggest challenge going forward is the structuring of new cat bonds." Demand for the insurers' bonds dried up since September as investors retreated from all but the safest securities in the credit-market seizure caused by losses in the subprime mortgage market that started in 2007. Cat bond sales probably fell to $2.7 billion this year from a record $7 billion in 2007, according to estimates by Oldwick, New Jersey-based rating firm A.M. Best Co.

Hedge Fund Liquidations

Lehman's bankruptcy isn't the only drag. Hedge funds have been forced to liquidate holdings, including cat bonds, to meet investor redemptions. Cat bond prices are down as much as 5 percent since the start of October, Bromann said.

"For the first time, the catastrophe bond market has lost its independence from other financial markets," he said.

Cat bonds have declined 5.8 percent since the end of August, according to the Swiss Re Cat Bond Price Return Index. Similarly rated high-yield bonds fell 31 percent in the same period, according to Merrill Lynch & Co.'s Global High Yield Index.

While yields on junk bonds climbed to more than 20 percent, U.S. Treasury two-year notes dropped to a low of 0.81 percent, data compiled by Bloomberg and New York-based Merrill Lynch show.

Insurers and reinsurers sell cat bonds to reduce the risk of claims that could erase profits or threaten their solvency. The only cat-bond default occurred after Hurricane Katrina struck New Orleans in 2005. Property damages exceeded the threshold that entitled Zurich Financial Services AG to keep investor funds for the Kamp Re cat bond it sold earlier that year.

Greek Warrior

The worst-performing cat bond this year is Ajax Re Ltd., one of the four protected by Lehman with so-called total return swaps that guaranteed fixed returns for investors, Bromann said.

The $100 million Ajax Re bonds, sold last year by Bermuda- based Aspen Insurance Holdings Ltd., promise to pay back principal and interest of 625 basis points more than the Libor interbank rate unless an earthquake increases claims in California. A basis point is 0.01 percentage point.

While no earthquakes have occurred, the assets held by Ajax Re, named after the suicidal Greek warrior from Homer's Iliad, turned into dead money for investors because of an investment trail that ends with the same sort of subprime mortgages that led to $980 billion of writedowns and losses at the world's biggest financial institutions since the start of 2007.

The debt became "a significant issue" following Lehman's bankruptcy, S&P credit analyst Cameron Heath said in a Sept. 30 report. S&P cut its rating on Ajax Re by eight grades to CC, two steps above default.

Ajax to Ballantyne

Ajax Re's collateral, which was guaranteed by Lehman, was worth "substantially less" last month than $100 million, Aspen Insurance said in a Nov. 10 regulatory filing. Ajax invested in bonds sold by another insurance company, called Ballantyne Re Plc, which were offered by Bermuda-based Scottish Re Group Ltd.

Brandon Ashcraft, a New York-based spokesman at Barclays Plc, which bought Lehman's North American investment-banking business, declined to comment.

Ballantyne Re bonds have been cut to as low as C by Moody's Investors Service, the firm's lowest grade, because it invested in mortgage-backed securities, including subprime debt. Moody's said Aug. 25 there is a "high probability" that losses on the mortgage bonds will cause some Ballantyne Re bonds to default.

The Ballantyne Re bonds that Ajax Re holds are guaranteed by bond insurers Ambac Assurance UK Ltd. and Assured Guaranty (UK) Ltd., according to an Aspen Insurance investor presentation this month. They are rated Baa1 and Aa2 by New York-based Moody's.

'Sausage Factory'

Aspen Re expects a "zero or modest" recovery from the Ajax Re collateral if a disaster occurs and Ajax Re is forced to cover damages, according to the investor presentation.

"It's very clear that the sausage factory behind the scenes was running amok," said John Brynjolfsson, chief investment officer of Aliso Viejo, California-based Armored Wolf LLC, which plans to invest in cat bonds. "Investors have suffered. It will be a challenge to re-earn that trust."

Another of the cat bonds protected by Lehman swaps was $250 million from Willow Re Ltd., which covered Northbrook, Illinois-based Allstate Corp. against hurricane losses. It's "highly unlikely" investors will receive timely interest and principal payments on Willow Re's Class B 2007-1 notes, S&P said last month in a statement.

Goldman Sachs Group Inc., Wall Street’s most profitable firm, underwrote the Willow Re bonds and said changes such as finding a replacement for the Lehman guarantees will be decided by the bond’s managers, investors and Allstate.

“Lehman made decisions on the investments as the swap counterparty,” said Goldman spokesman Michael DuVally.

Allstate is “considering various actions to resolve the situation,” the company said in an e-mailed statement last month.

Bromann estimates the Ajax Re collateral may now be worth as little as 18 cents on the dollar. The assets backing Willow Re are trading at 80 cents to 90 cents, he said.

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