

Class Report

INSURANCE-LINKED SECURITIES

DAY 1



RISK TRANSFER

A new product era

As the line blurs between the capital and reinsurance markets, a new product era is upon us and reinsurers are becoming increasingly flexible in the way that they assume risk for their cedants. **Albert Benchimol** and **Brian Tobben** look at what will influence how the new markets will shape up medium term

Insurance-linked securities (ILS) issuance took off in 2006, driven by the then narrow spread in credit risks and hard catastrophe risk reinsurance market following hurricanes Katrina, Rita and Wilma.

For investors, insurance risk is an attractive proposition as it is an asset class with low correlation to other capital market segments. ILS is now a \$35bn market that has overcome earlier issuance and pricing difficulties, increasing the choice of products available for risk transfer across a spectrum of classes, but in particular for life and catastrophe risk.

The integration of the capital

and reinsurance markets has marked benefits in terms of capacity and pricing – but this is still a relatively young market with a lot of uncertainty surrounding it. It is unclear at this stage, for example, how the capital markets will respond to a sustained period of either lower rates or higher losses, and there are of course pros and cons for cedants associated with all risk transfer options.

If risk is not assumed and priced effectively and/or if the products fail to deliver following a loss, the products will not meet issuer or investor expectations, and supply of risk capital in the form of ILS will be viewed as fickle.

These influential factors are valid for all forms of re/insurance and capital market risk transfer solutions, and that is because there are a lot of similarities between risk transfer solutions in the capital and reinsurance markets. This perhaps becomes clearer when we consider, for example, how both markets are susceptible to supply and demand driven pricing cyclicality, and to shock losses (reinsurers refer to ‘catastrophes’ or ‘casualty reserve developments’, while the capital markets talk of ‘credit crunches’ or ‘bear markets’).

Pricing cyclicality represents an uncontrolled cost deviation for cedants and investors that introduces asset volatility and complicates portfolio management. Shock losses lead to fluctuations in the level of available capital and insolvencies. Both features can be significantly detrimental to investors and cedants, and must be appropriately managed to ensure market durability.

Given the parallels, over the page, we now examine in more detail how reinsurance maximises its efficacy and certainty for clients in order to highlight the important considerations for capital market risk transfer.



Large loss events such as Hurricane Katrina will impact the development of market convergence in the medium term

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MARKET CONVERGENCE 1
The impact on capacity and pricing.

RISK TRANSFER STRUCTURES 2
Differences between traditional/capital markets products.

RISK MANAGEMENT 3
Strategy in the new marketplace.



IN BRIEF

How convergence of the capital and re/insurance markets shapes up over the medium term will depend on four principal factors:

- The way in which the capital markets assume, price and manage risk
- The characteristics of the products themselves
- Future large loss events and loss development trends
- External influences; for example, economic growth, interest rates.

RISK MANAGEMENT

Capital markets methods

IN BRIEF

The successful players in the reinsurance industry have made risk assumption through risk evaluation, valuation and management of their core skill, rather than relying on third parties for risk evaluation and pricing. This allows them to better withstand market 'shocks' and to offer continuity of capacity throughout the cycle.

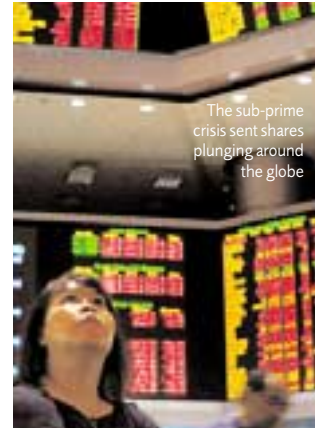
The sub-prime credit crisis in the capital markets highlights a number of market behaviours that the re/insurance industry has learned from experience to avoid.

First, growth became more important than profitability. Inevitably, underwriting standards slipped and inappropriate risk got into the system.

Second, there was an over-reliance on third parties, in that case the rating agencies, for the

evaluation and modelling of the risk. In-house capabilities for this are essential when dealing with complex, new or dangerous risks. Third, the markets failed to take broader systemic issues adequately into consideration; in that case a lack of liquidity leading to a market 'freeze'.

Unrecognised risks and aggregations of risk assets tend to become visible only after a shock loss event, but can be minimised given disciplined and effective risk and limits management.



The sub-prime crisis sent shares plunging around the globe

CAT BONDS

Characteristics of new products

It's early days for ILS and whether the products fully meet all cedants' expectations is yet to be tested. To judge efficacy at this early stage, cedants should consider the following product characteristics (as one of the main ILS products, we use cat bonds as the example):

Some cat bonds are indemnity based (similar to reinsurance where contracts are based on a cedant's own loss experience) but the vast majority are parametric. This means that payouts are based on an index rather than the actual losses of the cedant. As such, there is a potential that a contract may

be exposed to basis risk whereby the cedant suffers a financial loss, but receives insufficient recoveries from the cat bond. Reinsurance has the significant appeal of being an indemnity product and has no basis risk.

Ratings agencies generally do not give full capital credit for parametric or modelled cat bonds because of the basis risk, recognising that there is a potential for a cedant to take a loss but not to receive a corresponding payment on the bond.

Traditional reinsurance allows for annual customisation of terms and conditions, whereas cat bonds are more standardised and require a

longer term commitment.

Issuing a cat bond has a different cost structure than reinsurance placements, including bank issuance cost, third party risk assessment cost, legal fees and credit rating fees.

Reinsurance creates a potential credit risk whereas ILS products are usually fully collateralised.

Future large loss events and loss development trends, as well as external influences such as economic growth and interest rates, will combine with the above described risk acceptance and product features to influence how the market develops.

CATASTROPHE BONDS IN FOCUS

Cat bonds are financial instruments that securitise natural hazard risk and sell it directly into the capital markets. Worldwide cat bond limits now exceed \$13bn (excluding sidecars). An insurer or reinsurer issues a cat bond and the capital markets invest in that bond. The investment (or 'principal') earns interest, usually quarterly. If there is no loss under the contract, the investor receives back their investment when the bond expires, plus the interest earned over the bond's duration.

However, if there is a loss, the investor loses all or part of the principal and associated future interest payments. Cat bond recoveries may be based on reported industry losses, modelled losses or an index based on event intensity and location.

Reinsurers are both investors and issuers of bonds. As an investor, a reinsurer will analyse a cedant's bond in terms of price and risk and if it fits their portfolio, may invest in the cedant's bond. As an issuer, the reinsurer is involved in the creation of the bond, using the bond as a form of retrocession.

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EDITOR: GREG DOBIE

+44 (0) 20 7017 4145

greg.dobie@informa.com

ART EDITOR: NICKI SITARAS

COMMERCIAL DIRECTOR:

ANDREA WARD +44 (0) 20 7017 4708

andrea.ward@informa.com

ADVERTISING MANAGER:

PAUL CLIFTON

+44 (0) 20 7017 5043

paul.clifton@informa.com

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STRATEGY

The takeaway for cedants and reinsurers

COMING UP TOMORROW

DAY 2: RESERVING

- Estimating and managing long-tail reserves
- Bodily injury claims trends
- Factors which impact on future loss development.

Class Report

Traditional reinsurance covers are based on an expertise in insured risk evaluation and assumption. These are tested products that offer cedants a wide coverage and continuity of capacity on offer. ILS bring an increased choice for cedants, and are for reinsurers also a means to transfer risk and access quality risks to maintain and grow a diversified portfolio.

The critical point is that the same disciplined and quality approach to risk assumption should be applied to ILS products as it is to traditional reinsurance covers. There is a very definite core strategy that works. Without this, expectations will not be met and gaps will appear following market 'shocks', involving withdrawal of capital, reduced diversification benefit and lower capital leverage opportunity.

As a risk assumer, PartnerRe recognises that the capital markets and traditional reinsurance are converging and that the reinsurance community needs to be fully equipped to offer cedants risk assumption solutions in whatever form

they choose.

Reinsurers have the modelling experience, underwriting capability and risk management skill, as well as the capital markets expertise, to work with and price alternative risk transfer products including cat bonds and complex reinsurance structures.

While our traditional product is

IN BRIEF

The same disciplined and quality approach to risk assumption should be applied to ILS products as it is to traditional reinsurance covers.

risk assumption via reinsurance contracts, the industry needs to be flexible with regards to the way in which we assume risk for our clients and build our balanced portfolio.

But it also has to be consistent when it comes to acting as a discussion partner for cedants for all forms of risk transfer and make sure it applies the same core strategy for all forms of risk acceptance.

Albert Benchimol is CFO at PartnerRe. Brian Tobben is SVP, weather risks at PartnerRe New Solutions.

CAT BONDS NOW COVER A VARIETY OF RISKS INCLUDING:



CAT BOND END-OF-YEAR ISSUANCE

The total value of catastrophe bond issuance in 2007 is expected to hit \$6bn by the end of this year, according to rating agency AM Best.

Speaking at last month's Monte Carlo Rendez-Vous AM Best said that this would represent a 28% growth on previous year's total issuance [approximately \$4.69bn].

Between 2005 and 2006, after the triple hurricane strike of Katrina, Rita and Wilma, the cat bond market grew tremendously, recording an estimated 136% increase in issuance.

However, AM Best said cat bond issuance has actually slowed during 2007, citing changes to the Florida Hurricane Catastrophe Fund as being an influential factor in this development.

The markets fluctuate. We remain constant.



In soft markets and hard, the way a reinsurer approaches risk is critical. Reinsurers must be able to offer high quality capacity, continuity of offer and the assured ability to pay claims. In short, provide value for their clients.

At PartnerRe, our balance sheet is the best place to find evidence of this value. There, through soft and hard markets, you'll see asset quality, strong reserving and financial strength – all evidence of long term stability.

We believe you can't provide value without transparency. Well managed reinsurers keep no secrets as to their approach to risk and their financial strength. By being transparent about both, we at PartnerRe give clients the information they need to make the most informed reinsurance buying decisions.

Markets fluctuate. When it comes to providing value for our clients we remain constant.

PartnerRe

For an opportunity to find out more
or share your viewpoint visit:
partnerre.com/pricingcycles

