

The tipping point

Laurent Dignat and Frederic Morlaye look at development of capital market participation in the reinsurance sector



NYMEX has added natural cat-related futures and options for trading



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The market for insurance-linked securities (ILS) is still in its infancy and doubtlessly will be quite different in five years, thanks to new bursts of innovation and a progressive lift of the limiting factors. There are two axes of development that likely will help structure the market in the near future with the first being increasing investors' interest in insurance-linked products through 'tranching'.

In order to develop further, the ILS market must draw more investors beyond the hedge funds and private equity firms. The increasing popularity of securitisation among issuers will help increase the range of risks available in the market, but other solutions are needed.

Tranching is likely to help. Here, several distinct risks are pooled together, and the resulting portfolio is

COMING UP TOMORROW

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on data management.

divided into multiple tranches with varying expected return. Tranching allows structuring firms to transform low-rated bonds into investment-grade securities by concentrating the risks in lower quality tranches stemming from subordination and over-collateralisation. These higher risk tranches, called 'junior' or 'equity' tranches, are usually bought by alternative investors attracted by the potential waterfall profits they would receive if no triggering event occurs. Some groundbreaking deals have been placed, including recent transactions brought to market by ABN Amro (Bay Haven Re in 2006, Fremantle Re in June 2007). Guy Carpenter¹, through its affiliate MMC Securities, Ltd, advised the issuer in both deals.

So far, investors have been able to pick up the risks they were offered when issuers went to the market. In the future, investors could approach insurers and define the risks they seek. Structuring firms or risk transfer

hubs would emerge to find these risks or create them through tranching.

ADDRESSING THE BASIS RISK CHALLENGE

Secondly, as parametric or index-linked securities will always retain basis risk, solutions to address this point (other than indemnity triggers) will be found in other corners. Standardised products, such as Deutsche Bank-sponsored Event Loss Swaps and index-based derivatives, now present attractive features for investors. The first attempt to launch index-based products more than 10 years ago failed to attract attention and liquidity (cat index on the Chicago Board of Trade, or CBOT, in 1995). Many believe it may have been too early, however, capital markets have dramatically evolved and the investor base is deeper today.

As we look ahead, a very encouraging frontier was crossed recently with the New York Mercantile Exchange (NYMEX) and the Chicago

Mercantile Exchange (CME), which both added natural catastrophe-related futures and options for trading.² Derivatives will be written on these indexes, and the year to come will further illustrate the attraction of insurance risks to capital market investors.

It certainly appears that the convergence of insurance/reinsurance and financial markets about which many theorised during the past decade is gathering momentum, and the tipping point is now here.

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NOTES

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² This new initiative is very encouraging, almost 10 years after the CBOT stopped trading such options. The NYMEX product is based on the final aggregate annual ISO's PCS loss estimate for the contract year (three years available to trade). The CME product is settled on a parametric index for individual storms making landfall in the US (there are contracts for three subsequent hurricane landfalls in five US regions available to trade).