



In our regular comment page, **Laurent Dignat**, Guy Carpenter's head of Capital Markets for UK and Europe addresses CDO technology

How CDOs can make excess capital productive

The reinsurance market ended 2007 flush with capital, but with few compelling ways to deploy it effectively. Three methods are dominating reinsurers' strategic capital management. They can continue to write cheaper business, return capital to investors or pursue market share and earnings growth through investments in external initiatives (e.g. mergers and acquisitions or green field market entry).

Accepting lower rates for higher volume might seem preferable. It facilitates competition for market share and affords some financial flexibility. But putting the focus on premium rather than the bottom line can lead to future losses. Returning excess capital to investors obviates the need to make it productive, but sacrifices flexibility. If funds are needed later, the reinsurer may need to turn to capital markets for an infusion - and pay the price. While growth initiatives have the potential to drive high returns, they tend to keep capital occupied for years. M&A activity and new business lines take time to develop, as opportunities are currently scarce and operational risks often significant.

Following Katrina, affected companies raised large amounts of money to buffer losses and support normal operations. In a matter of weeks, more than \$37bn entered the market, according to Lane Financial. This influx, bolstered by record profits for reinsurers in 2006 and 2007, has left companies with excess capital, a softening market and few "traditional" business avenues for deploying it.

For reinsurers, financial markets are not a new alternative. ILS, such as cat bonds, have become ubiquitous, fostering liquidity and market efficiency. The tools have also matured; structured products are the next step in risk transfer - and opportunity hunting - for reinsurers with excess capital. Now, instead of relying solely on cat bonds and other insurance linked securities, reinsurers can package them into collateralised debt obligation (CDO) structures. The CDOs can be customised to address specific market needs, while leveraging the yield of single ILS up to ad hoc levels.

Of course, CDOs are under a considerable

amount of scrutiny. The collapse of the sub-prime mortgage market has caused investors to approach Residential Mortgage Backed Securities (RMBS), the most prominent CDO type, with caution. Despite the current volatility in the RMBS market - and later CDO markets in general - this method of securitisation has been adopted widely and implemented with considerable success. Using CDO techniques, reinsurers can structure new classes of risk that are largely uncorrelated. The modelling of the underlying perils remains transparent, and CDO underwriters can use tranching practices to design specific securities that

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will appeal to the risk appetites of different investor classes.

The easiest way to bring a CDO to market is to customise it based on a static pool of multi-year Industry Loss Warranties (ILWs). The second is a bit more complex, involving CDOs with actively managed portfolios of catastrophe risks (eg cat bonds or ILWs). The need for a collateral manager to replenish the CDO's collateral according to strict rules can also add to the complexity.

The purpose of the static CDO of ILWs is to reach the market as quickly as possible. The ILWs in the CDO are customised parametric insurance contracts with digital or pro-rata risk exposure based on a broad variety of perils. They are customised when the security is designed, but they do not change once issued. Static CDOs typically contain ILWs with maturities of three years, ensuring that capital is not tied up for too long. What results is a diversified portfolio of multi-year, first-loss ILW contracts funded by rated notes, with different loss profiles. An equity/income tranche will suffer first losses, and senior tranches are triggered only if a specific number of losses occur.

Structured equity can deliver new opportunities beyond the securitisation of insurance risks. They embed positions in equity correlation, forward dividend yield, equity volatility and return dispersion (how the returns of stocks in a basket position themselves around the average). Structured products are based on "second order" risk, making them non-directional and uncorrelated to other asset classes, including equity.

Premiums tend to be high and may offer above market payouts, the price paid for relative illiquidity. But, underwriters usually embed sufficient bid/ask spreads to facilitate an exit, even though they are designed to be bought and held. Thus, these strategies are likely to appeal to investors interested in diversification, particularly through high yield products designed to be held to maturity.

A broader range of possibilities, such as structured equity derivatives, can be written from structured products. Underwriters can customise securities even further in order to target the profiles of a specific reinsurer or institutional investor. It is even possible to design securities to perform as contra-cyclical investments, over-performing if insurance perils occur.

Opportunities to generate potentially outsized returns using structured products are beginning to materialise. In a soft market, trading or investment gains may be needed in place of underwriting profits. If the goal is to make capital productive and available, static and managed CDOs may offer effective solutions that are close to the traditional reinsurance business.

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He joined the firm from Societe Generale where he was head of alternative risk transfer for global equity derivatives.

Prior to joining SG, Laurent served as managing director of Centre Re in Paris and in Zurich. He also spent four years with French insurer Mutuelles du Mans Assurances.