

Swap out risk?

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As the dust settles on the cat bond landscape after the Lehman bankruptcy, cat bond sponsors and investors are starting to see the way forward for the total return swap structure. GC Securities, a division of MMC Corp, looks to the horizon...

The far-reaching effects of the ongoing global financial catastrophe have led investors and catastrophe bond sponsors to question the status quo. While the (re)insurance industry has persevered (particularly relative to the banking industry) it is evaluating the true extent of the risk that it has assumed.

For sponsors of catastrophe bonds, this includes the reliability of the total return swap counterparty used to guarantee the collateral backing the risk transfer protection and the catastrophe bonds, as well as the quality of the collateral itself.

While four catastrophe bond issuances have been affected by the bankruptcy of its swap provider, there are several areas on which sponsors and investors can focus to bolster the strength of their collateralisation.

When a sponsor obtains risk transfer protection via a catastrophe bond, it pays its risk transfer premiums into a special purpose vehicle (SPV). In return, it receives a predetermined amount of coverage, based on the triggers defined in the risk transfer documents.

Investors who purchase the catastrophe bonds receive periodic interest payments and, if the protection is not triggered fully, the return of all or a portion of the catastrophe bond's principal at maturity. The sponsor's risk transfer premiums are used to fund the periodic interest payments on the catastrophe bonds to investors.

Catastrophe bonds typically provide protection for several years, resulting in the exposure of the collateral to interest, credit, and market risk. In order to protect the availability of the full limit of the risk transfer protection, as well as any outstanding principal not reduced by payments under the protection at maturity, the catastrophe bond structure typically uses a total return swap. To this end, the collateral held in the catastrophe bond's trust account consists of highly rated investments, which is an approach that generally provides a sufficient degree of safety.

The key player in the total return swap is the swap counterparty, whose role is to ensure that any collateral shortfalls can be

remedied. In the event that the collateral is deficient – because of a default, sale, or revaluation of any of the securities held as collateral – it falls to the swap counterparty to replenish it.

Additionally, the swap counterparty converts the investment earnings on the collateral into a LIBOR-based rate that is consistent with the catastrophe bond's accrual of interest.

A salient concern among participants in the catastrophe bond market at present is the implication of the loss of the swap counterparty as was experienced in September 2008 by the default of a swap provider as a result of the financial catastrophe.

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Many fear that the loss of the swap counterparty puts the stability of the catastrophe bond at risk.

While this would lead to a loss of security, the catastrophe bond's ability to provide risk transfer protection is not necessarily damaged – depending on the quality of the collateral.

If the swap counterparty is unable to continue normal business operations, but the collateral does not suffer any deficiency and the investment earnings can meet the expected LIBOR-based rate promised by the swap counterparty, there is no impact to the catastrophe bond's sponsor or investors – aside from ongoing exposure to interest, credit, and market risk.

While this is not ideal, it is certainly not commensurate with a total loss of collateral if the sponsor and investors were reliant only on the swap counterparty. Likewise, a 100 percent default rate (in theory) of the catastrophe bond's collateral alone would not result in a loss

of the sponsor's risk transfer protection or the investors' outstanding principal or portion of interest paid on the catastrophe bonds, as the swap counterparty would be obligated to pay any deficiency.

A problem would occur, however, if (1) the default of the swap counterparty occurred in conjunction with a deficiency of the collateral, or (2) the default of the swap counterparty in conjunction with the investment earnings being unable to meet the LIBOR-based rate promised by the swap counterparty. These potential scenarios in light of the financial catastrophe have led to a discussion of how the protection of collateral can be improved.

Sponsors may want to consider implementing a stricter minimum rating requirement for the swap counterparty. Additionally, stricter conditions under which the swap counterparty should be replaced – or under which the underlying obligations should be collateralised – should be considered and integrated into swap documents.

Further, tightening the investment guidelines for the eligible collateral within the catastrophe bond structure would mitigate sponsor and investor contingent exposure to the interest, credit and market risk on the collateral. Such additional requirements may include mark-to-market asset valuation triggers, limits on eligible collateral maturity terms, minimum ratings, and issuer concentration limits. If mark-to-market asset valuation triggers are used, critical considerations include the level of impairment at which a deficiency payment from the swap counterparty would be triggered and the frequency of asset valuation.

The catastrophe bond space benefits continually from innovative thinking. Refinements have been introduced regularly since these structures were issued more than a decade ago, and the future is likely to bring continued improvements in the collateral structures to protect sponsors from a gap in their risk transfer protection as well as investors with respect to their outstanding bond principal in the event of financial market dislocation.

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