



In our regular comment page, Laurent Dignat, managing director, GC Securities Ltd, predicts the next stage in ILS development

Cat bonds persevere

Credit markets tighten from time to time. It is a fact of life to which investors have grown accustomed. To prepare for this eventuality, they create well-balanced portfolios with the specific aim of insulating overall returns from disproportionate losses in specific asset classes.

For more than a decade, ILS have been considered non-correlative with other asset classes, making them likely counterbalances to other credit securities. The perseverance of ILS during the 2007 credit market meltdown has led to increased interest in this asset class, as well as an innovation path that can continue to attract new investors in the future.

Non-correlation is among the major advantages of ILS. Since ILS defaults are linked to physical events, they tend not to move with other credit securities.

The unique conditions created by the 2007 credit crunch demonstrated this, as spreads for BB rated corporate debt, the approximate cat bond equivalent, increased by 150 basis points (bps) – source GC Securities Ltd – while cat bond spreads actually tightened.

Thus, while credit markets spent the year reacting to aftershocks from the sub-prime mortgage market, cat bonds and the broader class of ILS remained relatively unscathed.

The effects of the 2007 credit tightening were four-fold; Equities dropped precipitously, and government-issued bonds soared in the resulting “flight to quality”; Stock market volatility peaked at 30 percent, as measured by the implied volatility on 1-month S&P 500 Index options. Credit spreads widened, particularly on 5-year credit default swaps, which soared from around 20 bps in March 2007 to 140 bps in mid-November, according to Bloomberg (banks tend to be highly rated; such spread widening is unusual); “Bulge Bracket” bank debt was downgraded, making capital more expensive and forcing higher rates of return for internal investment.

Despite the ongoing challenges characterising corporate credit markets, ILS have maintained tight spreads throughout

the credit crisis.

When credit markets take turns for the worse, ILS tend to hold their ground. This has led to an expanded audience for these once exotic investment vehicles.

Money managers, pension funds and even private bankers are being drawn to a highly complex asset class that used to be quite confidential. As cat bonds and other ILS become increasingly mainstream, adoption is likely to continue.

While non-correlation is frequently credited with the relative ILS prosperity of 2007, low betas – which measure the correlation between an asset and its relevant index, helping to measure the sensitivity of an asset to market movements – are only

“When credit markets take turns for the worse, ILS tend to hold their ground”

part of the reason for ILS resistance to tough credit market conditions. Modelling and transparency facilitate investor judgment, ultimately leading to more effective portfolio management. Savvy investors are able to learn about the assumptions in cat bonds and the underlying securities in structured ILS notes – luxuries not afforded by asset-backed securities (ABS).

Even with the judgments necessary to determine default risk and “loss given default” (i.e., the portfolio losses that would occur if a loan goes into default), ILS are usually more transparent than other structured products. Investors can understand the nature of the perils in which they are investing, further mitigating risk by allocating portfolio assets in a more informed manner.

The next stage in ILS innovation is the development of structured products using cat bonds, ILWs and derivatives written on both.

Investors may be wary in light of the

events of 2007, but structured ILS offer three advantages absent in ABS. The modelling, transparency and non-correlation advantages that characterise the ILS market as a whole will be carried into structured ILS products.

The only relationship to MBS is the structure used to create securities. The collateralised debt obligation (CDO) structure is agnostic; risk comes from the securities that comprise the CDO. Thus, investors exercising proper due diligence and portfolio analysis will be able to take advantage of structured ILS product transparency to make prudent investment decisions.

An ILS CDO consists of a diversified pool of insurance that can be carved into tranches with different risk profiles. The tranches can be customised to the needs of investors with varying appetites for risk. For example, AAA tranches with large subordination on a pool of uncorrelated perils would appeal to investors and money managers seeking to anchor portfolios with income-producing securities. The “first loss” tranches earn hefty premiums if no loss is triggered, though at the expense of suffering the first losses.

By customising securities via the CDO structure, decisions can be made on the alpha (measuring the absolute performance of an asset, in excess of the expected yield) and beta of a single contract, allowing investors to assess the impact of an inherently diversified portfolio.

Customised CDOs can be selected for specific characteristics, alleviating the pressure on institutional and individual investors to find individual cat bonds, ILWs or non-ILS that may not meet a portfolio manager’s particular needs.

Structured product innovation is just beginning, but hopes are high. With the ILS resilience of 2007, capital markets are ready for a new wave of innovation. Structured products – and structured product derivatives – are appearing in investor portfolios now. Risk management is changing from transfer to profit opportunity.

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Cat bond issuers have upper hand

A “surge” in insurance linked securities (ILS) investor capital and service providers offering structuring and placement advice has given (re)insurers “enhanced bargaining power” to drive favourable terms and conditions, according to Guy Carpenter & Co LLC and GC Securities Ltd recent research.

The rise in indemnity triggers – five bonds, representing \$2.3bn of issuance, were issued on an indemnity basis in 2007 – is evidence of the “imbalance between supply and demand”, according to Guy Carpenter’s sixth annual report.

The report continues, however, by noting that while sponsors generally prefer indemnity protection if all else is equal, the “practical utility of this position is waning”.

“The differences between each type of protection represent important cost-benefit decisions that sponsors are making in an increasingly sophisticated fashion,” it continued.

The report also noted that 21 of the 27 public cat bond transactions in 2007, representing more than 70 percent of the total \$7bn issuance for the year, were issued under shelf programmes.

The ability for (re)insurers to access the capital markets as a risk transfer mechanism became a “strategic priority” in 2007, Guy Carpenter said.

“Shelf offerings support both long-term planning and near-term manoeuvring.”

“Committed catastrophe risk investors tend to reward repeat issuers with progressively tighter execution pricing, provided that the issuer has a strong track record,” it continued.

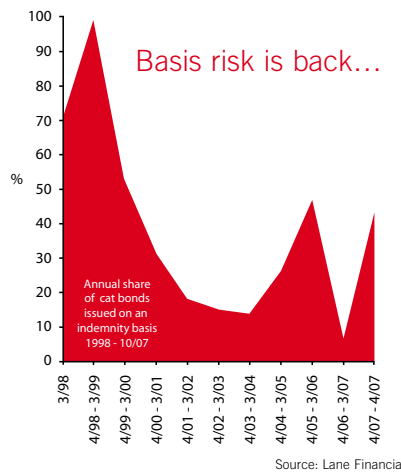
Predictably, the dramatic surge in issuance activity has prompted a corresponding rise in the number of service providers touting cat bond expertise, it noted.

Whereas, at the beginning of 2006, there were approximately 15 bankers active in the ILS space, at the end of 2007, between 20 and 25 firms “claimed to have cat bond structuring and placement capabilities”. “The impact of an increasingly crowded competitive field, in conjunction with the reduction in resources needed to complete an engagement, is pushing investment banking fees lower,” the report noted.

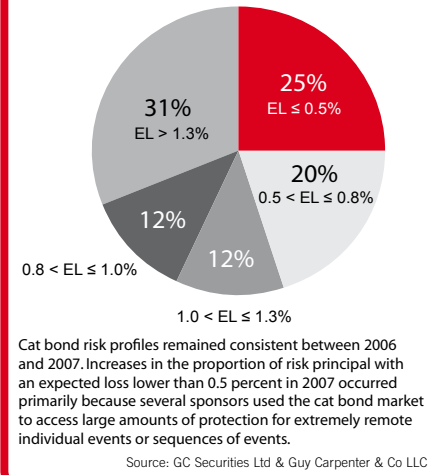
As a consequence, innovation is emerging as a competitive advantage offered by advisors.

“Rather than a race to the bottom, with service providers competing exclusively on fees, there is evidence of additional idea generation. As a result, this really may be a race to the top,” the report said.

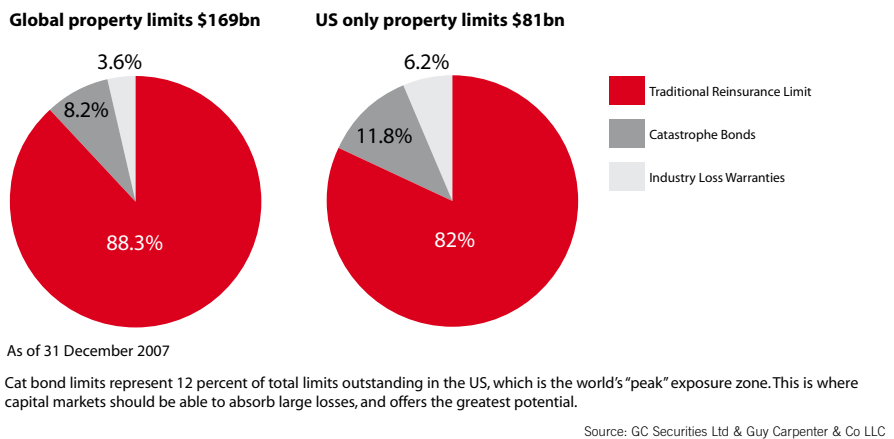
Indemnity cat bonds



Cat bonds: expected loss



Cat bond share of total property limits outstanding



Annual number of cat bond transactions and issue size

