

How state guaranteed bonds can help to free up capital in insurance companies

Robert Koller, CAIA¹

In this short article, I will explore the latest developments in the cat bond market and how such changes may help on the one hand troubled banks to sell their debt and insurance companies to free up capital.

1. Cat bond diversification benefits

During the financial crisis three important characteristics crystallised in the cat bond market:

1. Cat bonds proved resilient to the market turmoil (more details [here](#)).
2. Hedge funds sell-offs boosted the cat bond secondary market.
3. Cat bond structures still had some exposure to credit risk.

The first two points are positive for the cat bond markets however number three proved to be a problem. During the second half of 2008 there have been virtually no issues of cat bonds due to the fact that Lehman Brothers Special Financing Inc. went into bankruptcy and left several cat bond structures without a total return swap counterparty. This meant that the bonds had either a hard time to pay interest or even defaulted. However, in 2009 these problems seemed to be solved and in the first months of this year four new issuances of cat bonds have been successfully completed.

1.1. *The post-Lehman cat bond structures*

Three out of the four cat bonds issued this year still had a total return swap counterparty but also incorporated credit risk mitigation mechanisms into their structures.

- Atlas Reinsurance V Ltd, the first bond to be issued this year, sold a US\$ 200 million, three series cat bond. In this case the market value of the assets in the collateral account will be monitored monthly by the indenture trustee and will be made available to investors. Deutsche Bank as total return swap counterparty will be required to top-up the collateral account monthly if the collateral value in the applicable account drops below 97.5%. The collateral itself may only be invested in cash, US Treasury securities, US Treasury money market funds, FDIC-guaranteed bank debt and French and Australian government guaranteed debt (all with a maximum maturity of five years). Additionally, if the notes are extended the collateral will be invested in money market funds was the highest rating and the coupon on the notes will be reduced to yield what is generated by such funds plus the spread paid by the insurance cedant. Another

¹ Robert Koller is a Chartered Alternative Investment Analyst and is admitted as a lawyer in Spain, having trained in Austria and Spain. He specialises in hedge funds, debt capital markets and alternative investments. He currently practices as a lawyer in Frankfurt, Germany and has several years of experience in major law firms across Europe. Contact at: www.HedgeFund-Lawyer.com.

particularity is the fact that the Irish financial regulator declined the insurance licence for the special purpose vehicle Atlas V and therefore the deal is now based on a derivative agreement between Atlas V and Scor, the cedant, rather than a reinsurance contract. The spread offered lies between LIBOR + 12.5% and 14.5% depending on the relevant series. These spreads have been considered as competitive to a normal reinsurance contract for a three-year coverage.

- East Lane Re III Ltd issued a little later US\$ 150 million principal-at-risk notes. In this case the market value of the collateral will be monitored by the swap counterparty on a daily basis. Again, there are top-up provisions. The swap arrangement will remain in place for the full term of the transaction, including any extension period. In a further move to increase transparency, a third-party valuation agent will, on a monthly basis, provide a market valuation of the assets. The collateral may only be invested with the US government Temporary Liquidity Guarantee Programme not exceeding the expiration of such program or short-term commercial paper rated A-1, money market funds and securities issued or guaranteed by the US government or any of its agencies with a final maturity of three months or less. As has been seen in previous transactions, this cat bond also includes provisions regarding the downgrading of the total return swap counterparty.
- In March 2009 Mystic Re II Ltd sold another US\$ 200 million cat bond. The post-Lehman provisions are very similar to East Lane Re III. Collateral may be invested in FDIC funds, securities issued by the US Treasury and US\$-denominated fixed rate, and non-amortizing, non-mortgage-backed, senior debt securities of fixed maturity issued by any of the Federal Home Loan Banks.
- The most innovative bond issued this year coping with the problems shown by Lehman Brothers' insolvency has been Blue Fin Ltd, an SPV used by Allianz. Blue Fin has completely removed the need for a total return swap and the corresponding counterparty, therefore mitigating the credit risk to an absolute minimum. The proceeds from the sale of the notes will be invested by the issuer in floating-rate notes issued by *Kreditanstalt für Wiederaufbau* (KfW) with a final maturity of three years and nine months which are puttable quarterly after the first six months. The quarterly put options can be exercised at par. KfW is a German state-owned bank and, consequently, rated triple-A. The interest yield on the KfW-notes, which are held in a collateral account by an indenture trustee, is LIBOR minus a margin.

2. Cat bonds and state guaranteed bonds

The transactions mentioned above have shown that only high quality collateral may be used for new cat bond issuance that is acceptable to the markets. This opens a rare window of opportunity for the rest of this year. Governments all over the world have set-up guarantee schemes in order to guarantee debt issued by troubled banks.

These securities normally have a high-quality rating which is the same or very close to the rating of the relevant guaranteeing state. Also, most of the schemes have the maturity of guaranteed notes limited and allow for issuance of such guaranteed notes only up to a certain date.

Insurance companies could take advantage of these guarantee schemes by issuing cat bonds, transferring risks out of their balance sheets and have the bonds collateralised with state guaranteed bank bonds. The advantage of doing so is twofold:

- (a) cat bonds issued with state guaranteed bonds as collateral will probably easily find total return swap counterparty and
- (b) insurance companies could help to stabilise banks by buying state guaranteed bank debt which would also have a beneficial impact on their balance sheets due to their large holdings of bank debt.

This win/win situation allows, depending on the countries involved, for cat bonds with a maturity of up to 5 years. Especially German government guaranteed bonds might be very interesting due to the coupons they pay and due to a recent change in law which allows them to be issued with a maturity of up to 5 years (for more information see [here](#)). It is not necessary to mention that Germany is also home to some of the biggest players in the insurance sector. There are, however, drawbacks such as the possibility to issue state guaranteed bonds only up to the 31 December 2009 (in Germany) and that it may be impossible to issue puttable notes. Nevertheless, it seems that 2009 is a year with a lot of possibilities for cat bonds.

3. Cat bond outlook

The transparency initiatives taken this year in new cat bond structures are certainly a way to follow in other securitisation areas. The cat bond markets started strongly this year despite the increases in spreads with most issuances oversubscribed. Although pricing levels in standard reinsurance markets have not risen as much as in the cat bond market, insurers start to realise that cat bonds give protection for longer periods than reinsurance which has to be renewed annually and they use cat bonds as an alternative way to manage their balance sheets. Estimates are that this year's issuance activity will be around US\$ 3 billion, although volumes might be larger if the opportunities mentioned above are taken advantage of.

Also in the light of the new Solvency II regulation due to come in effect in 2012 which allows for a clearer accounting of cat bonds, this year and the following should be seen as a test run.