

# The Road Not Taken

By Bruce Thomas

We tend to think of change as something that happens suddenly and conclusively, but most innovations take place incrementally while our attention is focused on other more pressing matters. Most people think, for example, that the automobile was conceived in the 19<sup>th</sup> century, when in fact the first steam powered cars were driven down the streets of Alexandria in religious processions in the first century AD. While these machines must have been impressive, people did not find them very practical. No doubt these cars didn't get good mileage and were not fast enough to capture the public's imagination.

In the last few years, insurers have witnessed a cumbersome risk management vehicle called securitization with similar mixed reactions. When focusing on all of the difficulties of placing insurance risk directly with investors, it is easy to see why some people feel that securitization is a "solution in search of a problem." On the other hand, the efficiency of the capital markets is unparalleled, providing sound rationale for those who believe that it is only a matter of time before the wizards of Wall Street completely transform the insurance industry.

A more balanced perspective is that securitization is just another group of risk management alternatives that may or may not be useful in a given situation. They are not magical solutions and they will not alleviate the need to pay premiums, but they may help stabilize insurance and reinsurance prices by providing the insurance industry with ready access to new sources of capital.

## So Far

Since 1992, a lot of reflection, research, restructuring and development have changed the landscape of the insurance industry. \$16 billion of insured losses from Hurricane Andrew made it clear that the insurance industry had much more catastrophe risk than previously recognized. Lacking the capacity to deal with such large events without causing severe disruptions in the price and supply of insurance and reinsurance, significant efforts were made to find other means of funding insurance risk.

Research by Guy Carpenter & Company demonstrated that insurance risk, despite popular impressions, is actually quite fetching as an asset class. Guy Carpenter showed that insurance risk has attractive rates of return and is uncorrelated with other investment types. Sighting the investment equivalent of the Holy Grail, many quests were undertaken. Although many of these endeavors will prove to be misadventures, they serve us well by exploring new opportunities for risk transfer, business, and investment.

A few years ago, many insurance professionals questioned why any investor would want insurance risk. Now, everyone recognizes that one person's risk is another person's investment opportunity. The character of the insurance and investment industries has changed just as dramatically. Demutualizations, mergers, and restructurings have combined with a booming stock market to cross-pollinate these industries with

professionals who understand both insurance and investments. Compensation practices have changed too, increasing the rewards for success and supplying managers with a reason to challenge the status quo. Grants of stock options are much more common today, making managers much more focused on the bottom line and more receptive to new risk management strategies.

### **A Range of Solutions**

Perhaps the greatest misconception about securitization is that it is a single means of transferring insured risk to investors. In fact, this term represents every conceivable form of debt, equity, swap, option, and futures contract that could be used to convey risk whether in the form of an exchange-traded instrument, a public offering, or an over-the-counter contract.

The deal structures that securitization encompasses are virtually unlimited, permitting a client's needs to be satisfied with endless variation. These solutions are so multifarious that they are often difficult to categorize without coining new terms. Thus, securitization is just a handy word for every form of risk transfer other than traditional insurance and reinsurance.

### **Bottlenecks**

With such a blistering array of financial options to choose from, one might well ask why more insurance risk has not been securitized and why this market is still so lightly trafficked. One answer is that current market conditions are not conducive to innovation. High stock values and declining interest rates have combined to make insurance and reinsurance companies over capitalized. This has given primary insurers a reason to retain more risk, and it has also led to soft insurance and reinsurance prices. With prices depressed and capacity plentiful, there is no need for substitutes.

Against these market conditions, new ways of securing risk continue to be developed. While these efforts are helpful in offering new directions and blazing trails, no roads have been paved. Most of the transactions that have been completed have been highly customized to the loss experience of individual companies, making it difficult to compare these transactions, establish a market price, or create a context for a liquid secondary market.

Essentially, these contracts look and feel like insurance and reinsurance but are not technically (re)insurance. This may provide a sense of comfort and familiarity for hedgers and investors, but it is not very efficient. Before these issues can offer any real pricing or liquidity advantages, they will need to be much more standardized.

### **Wanted: STANDARDIZATION**

To turn individual contracts into a steady stream of transactions, buyers and sellers need the ability to exchange information about the risk that is being transferred with only a few key terms. By standardizing risk, an index makes this possible. Using an index to determine settlement values eliminates the issuer's disclosure burden and gives investors

confidence about the quality of the risk assumed. It also provides assurance that contracts will be settled fairly, without regard to any unique aspects of the issuer's actual loss experience. Thus, indices help expedite transactions by containing negotiations to price, credit, and settlement terms. Since counterparties do not have to reference the original issuer, there is much more opportunity for transparent pricing and the growth of a secondary market.

Unfortunately, it is very difficult to create and maintain good insurance indices. An objective index methodology and copious amounts of supporting data are a good start, but ultimately people want more than this. To feel truly comfortable, they would like to review the Index and the supporting data over an extended period of time.

On the bright side, once a workable index has been developed, the on-going publication cost is fixed. This creates significant scale benefits for use of indexed-based contracts. Once the insurance industry fully understands these efficiencies, there will be a great push to develop indices for every line of insurance.

### **Down the Road**

Although a significant amount of infrastructure still is needed before securitization becomes a common form of risk transfer, it is clear that this transfer makes sense and that more work should be done to help facilitate it. Although the road ahead is uncertain, it is not a dead-end. Better yet, there are some favorable signs that key impediments to securitization are being removed.

As the underwriters point out, the cost and time necessary to place these issues is likely to decrease with repetition, as all of the parties to a transaction become more comfortable with their roles. It is very likely that new legislation may help make these structures more efficient (see Protected Cell Company Concept Gains Ground in United States by David W. Alberts in the June 1999 FRR). Moreover, accounting and regulatory treatment that more resembles insurance and reinsurance conventions seem just around the bend.

Despite all these reasons to be optimistic, it is easy to disparage the size and transaction volume of the market as it is today. However, any worthwhile assessment of securitization must consider its original objectives, i.e. providing the insurance industry with quick access to new capital. The securitization mechanism we have built so far may not be as efficient as we would like, but it does work and it is available to us if we need it. Many reinsurance professionals believe that despite its infancy, securitization has all but ended the price shocks associated with the reinsurance cycle. If this is true, the insurance industry must consider securitization an unqualified success even if it is not a commonly used risk management solution.

### ***Author's Note:***

***This article was published in Financing Risk & Reinsurance in September 1999.***