The Actuarial Profession
making financial sense of the future

Financial Guarantee Business
Time for a Reality Check

Chris Waites

Cormac Bradley

GIRO Conference 14-17 October 2003

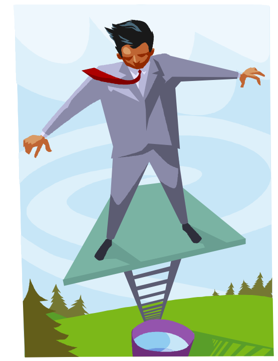
Last Year – State of the ART

- Securitisation
- Modelling the asset
- Structural issues
- The rating process
- Case study – private equity
- Modelling a new asset class
- Developing the business model

Some Questions:

- Economic effects?
- Market origins?
- What does financial guarantee mean?
- Who are the key players?
- Impact of regulation and credit ratings?
- Impact of the downturn in credit performance?
- Has this market got legs?

Contents

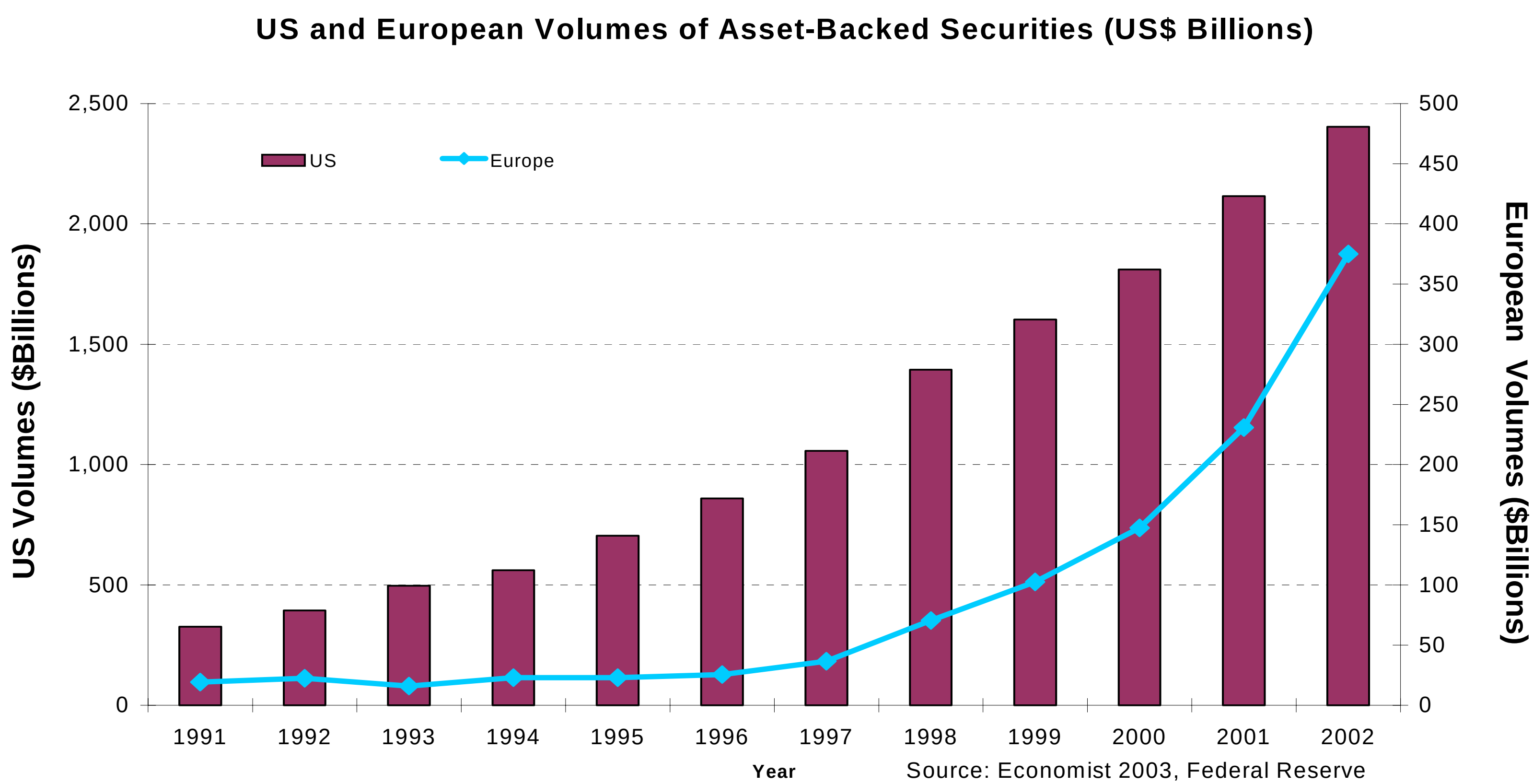


- Economic Effects
- Increasing Stability

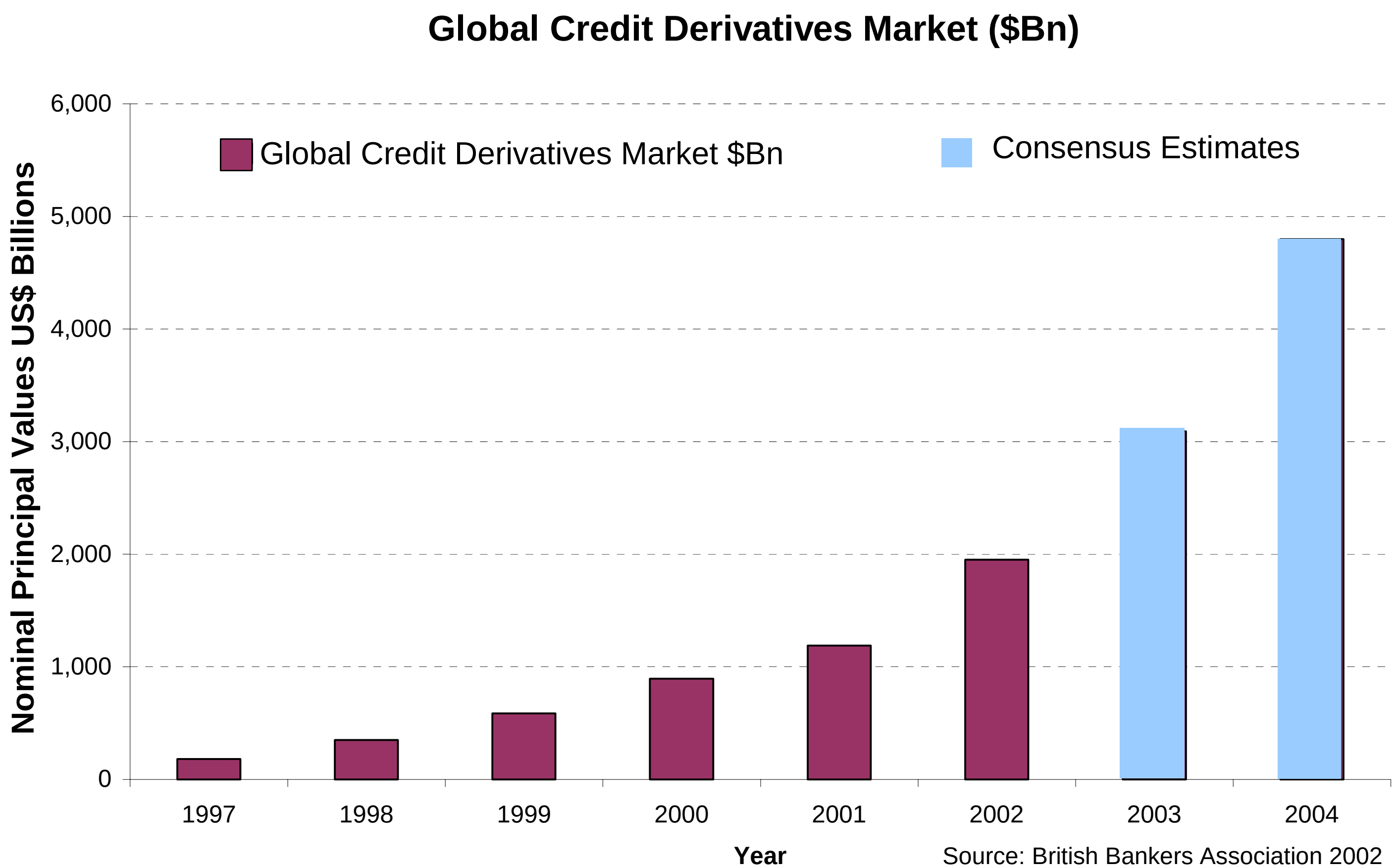
- Focus on Credit
- Products
- Banking vs Insurance
- Recent Market Conditions

- Where Next for this Market?

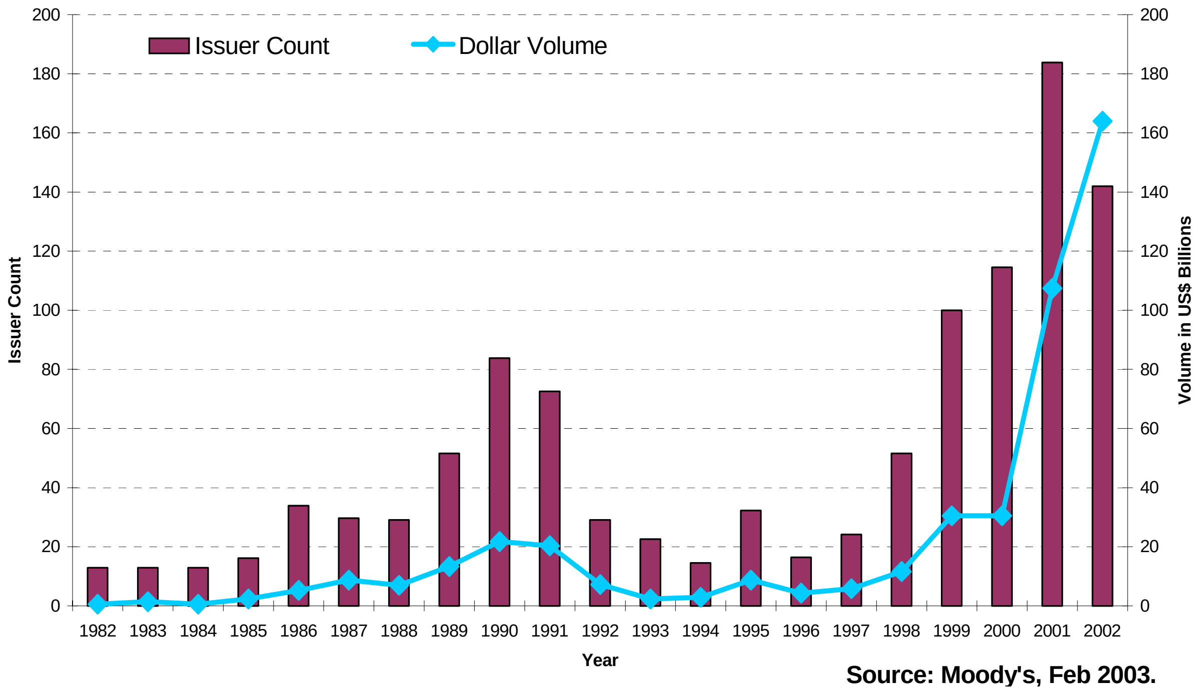
The Growth in Credit Risk Transfer - Asset-Backed Securities



The Growth in Credit Risk Transfer - Credit Derivatives



Turbulent Times for Corporate Debt Globally



Source: Moody's, Feb 2003.

- Defaults in 2002 (US$ Billions)
  - Total 163
  - Worldcom 23
  - Qwest CF 13
  - Marconi 3
- > GDPs of Greece, Finland, Denmark

A growing concern for the stability of the financial system

The growth in credit risk transfer is a “good thing” because:

- Less risk of banking meltdown – banks routinely mismatch assets and liabilities
- Risk is less concentrated
- Liquidity in the secondary markets
- Originators can concentrate on origination
- Insurers can diversify
- The financial system has withstood record levels of defaults and downgrades
- Increasing emphasis over time on genuine risk transfer for economic reasons

………But

“The most toxic element of the financial markets today” (Howard Davies):

- Specifically referring to synthetic CDOs
- More generally:
  - Losses may be borne by policyholders and pensioners
  - Insurance less well regulated than banking
  - Clear evidence of some regulatory arbitrage/accounting obfuscation
  - Insurance is less well capitalised
  - Sharp bankers are dumping unwanted risks on naïve insurers
  - Remoteness increases risk of moral hazard/adverse selection
  - Information asymmetries
  - Heavy reliance on portfolio manager
- Bank exposure to small number of insurance names

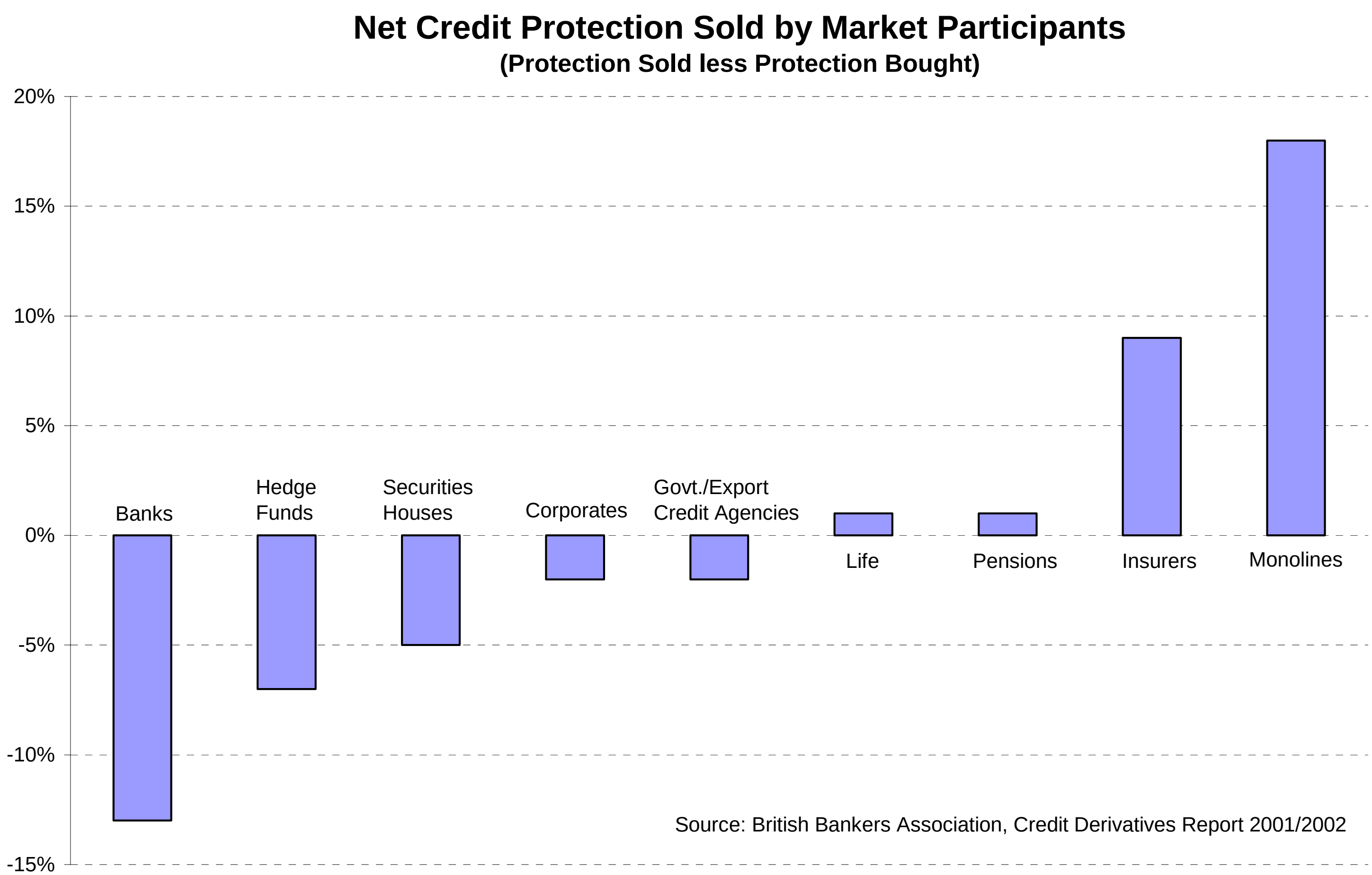
Increasing Financial Stability?

- Differing opinions

- Worldcom case-study:
  - At $23 Billion default in 2002
  - Largest corporate credit event experienced
  - 50 cash CDOs identified
  - 20 synthetic CDOs identified (Average exposure per portfolio 0.8%)
  - Highlighted correlations between CDOs – demand for more granularity / hybrid pools

Source: FitchRatings 2003

The Flow of Credit Risk from Banks to Insurers



Products

- A mixture of insurance, banking and capital markets solutions for asset risks

Insurance

- Credit Insurance
- Surety Bonds
- Residual Value Guarantees

Banking

- Letters of credit

Capital Markets

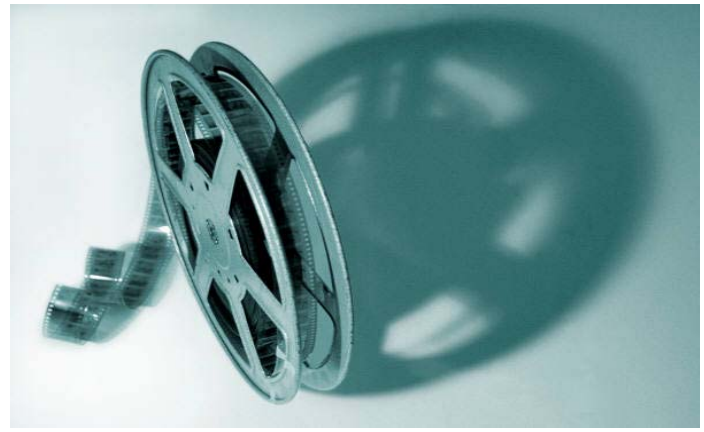
- Financial Guarantees
- Derivatives
- Credit Linked Notes
- ABS/CDOs

Insurance and Financial Guarantees

- Culture
  - To an insurer a claim is just a claim
  - To a banker a default is a problem
- Essence of a financial guarantee
  - Pay first and ask questions later
  - Fixed income investors averse to indemnity type language
- Essence of an insurance contract
  - Investigation of claim precedes settlement
- Film finance saga
- Remedies sought by rating agencies
  - Willingness vs ability to pay
  - Introduction of FERs (“Financial Enhancement Ratings”) for insurers

Case Study: Film Finance

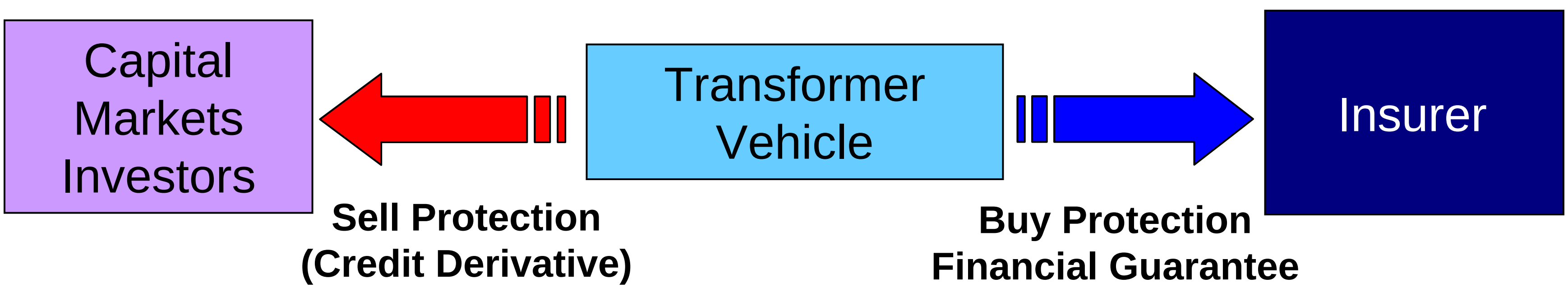
- Zero coupon bonds placed with European investors
- Funds invested in film projects with revenues to repay bonds
- Insurance policy to guarantee proceeds
- Bonds rated AAA
- Substantial claims
- Allegations of fraud, misrepresentation, non-disclosure, breach of warranty
- Shock downgrade to CCC- overnight (rating agency credibility?)



Insurers in the Dock

Insurance and Capital Market Distinctions

- Duty of disclosure and utmost good faith
- Warranties and remedies for breach
- Existence of insurable interest
- Indemnity principle
- Transformer vehicles a solution



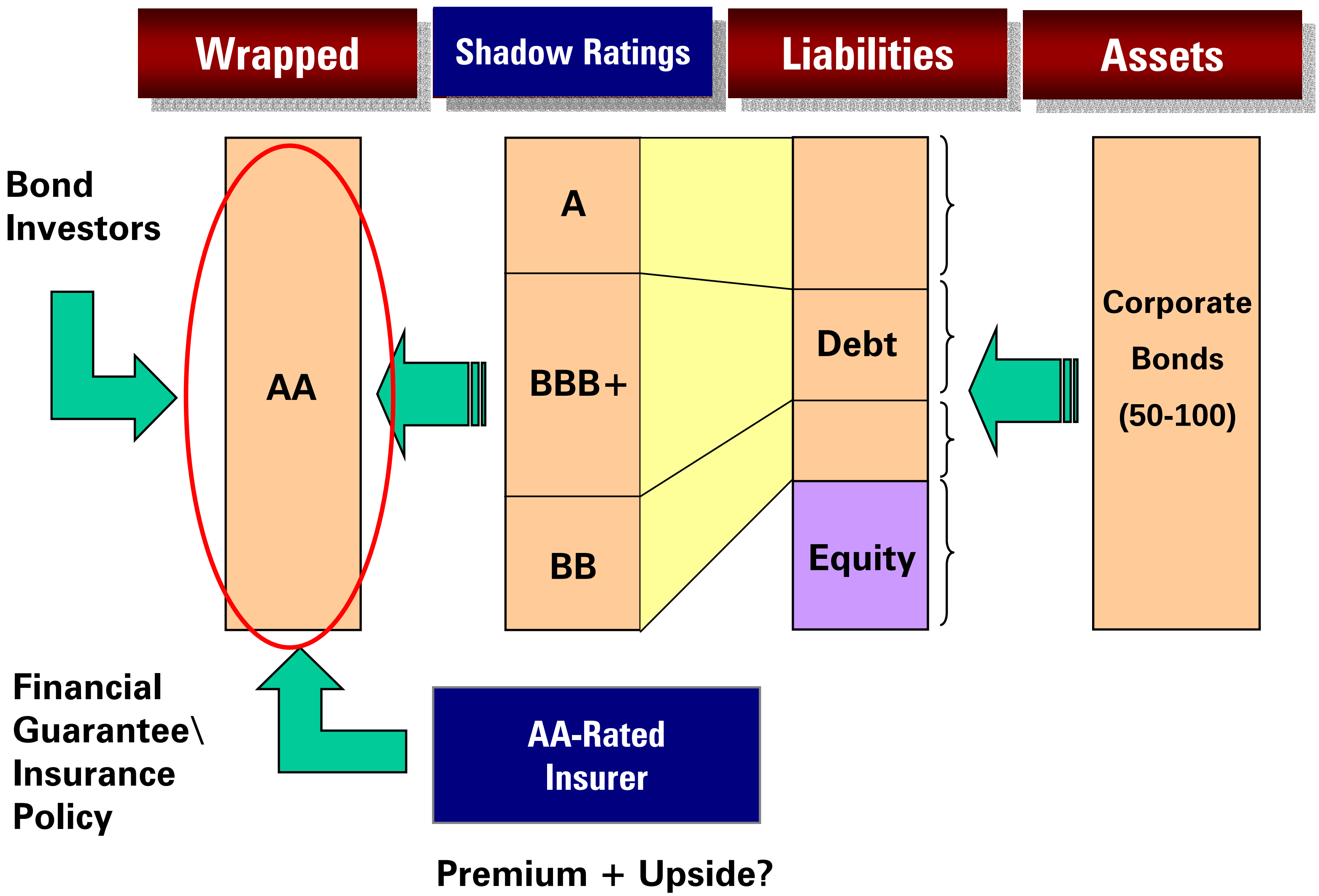
Market Participation by Insurers

- Impact of soft insurance markets driving insurers to innovate
- Exploiting core strengths
  - underwriting
  - risk management on a holistic basis (unlike banks)
  - actuarial
- Regulatory arbitrage
  - recognition for diversification (unlike banks)
- Credit ratings drive appetite for risk
- Economic capital savings through reduced concentrations

Focus on Credit

- Spectacular growth in exchange of credit risk through credit derivatives and CDOs
- Direction of flow a topic of interest to regulators
- Some insurers are large players
- Variety of instruments
  - Single name credit default swap
  - Total return swap
  - Credit linked notes
  - Portfolio credit default swap
  - Repackaging of credit risk through CDOs

Insurer exposure to CDOs

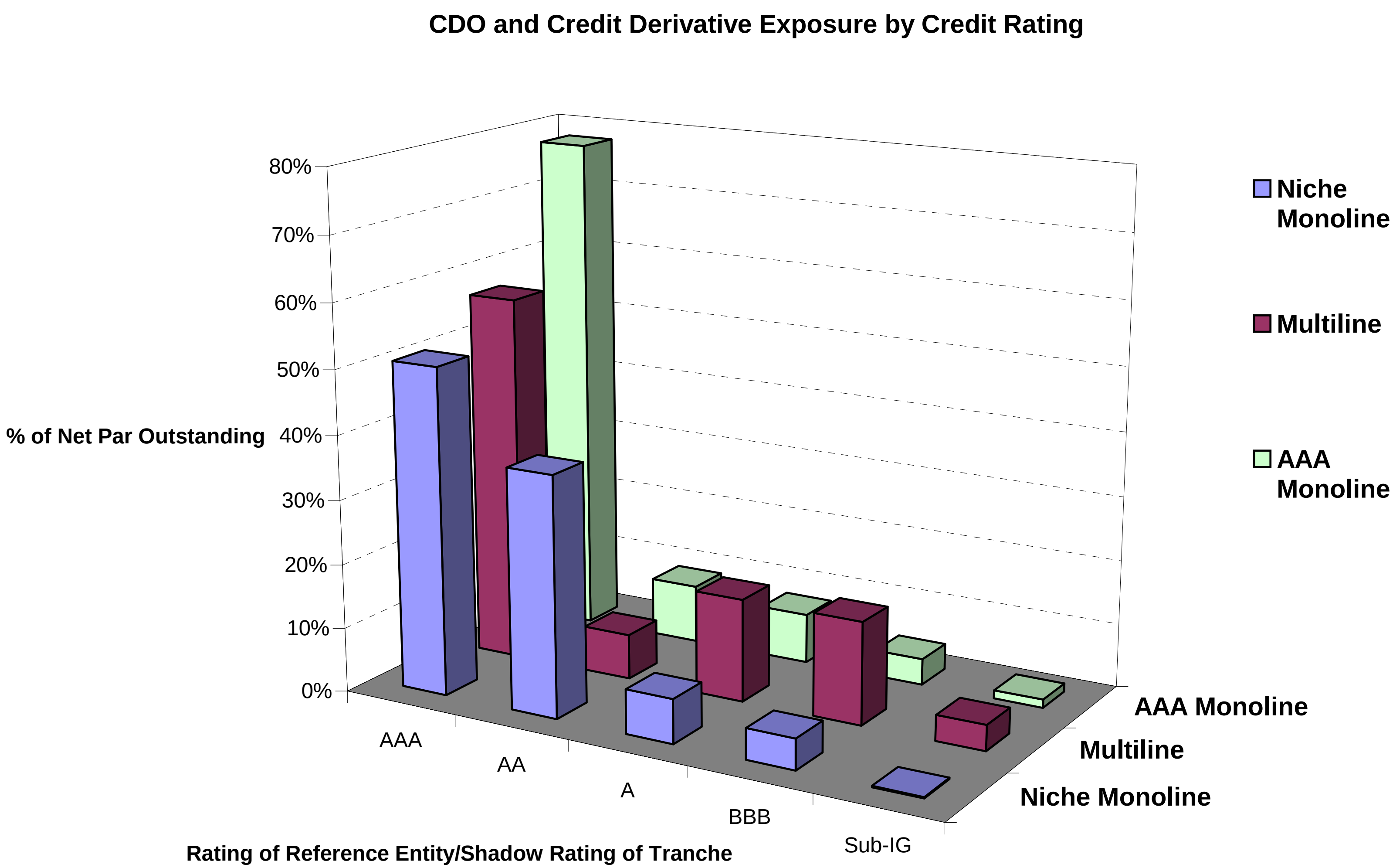


The Market Participants

- Monoline Primaries typically rated AAA
- Monoline Reinsurers AAA
- Niche Monolines AA
- Multilines Insurers/Reinsurers BBB-AAA
  - Often separately capitalised subsidiaries within a wider group
  - Capitalisation normally targets a required rating
  - Europeans – Swiss, Allianz, Scor
  - Bermudans – XL, Ace
  - US – Chubb, Berkshire Hathaway
  - Worldwide – QBE

- Competition between monolines and multilines not that common
- Ratings of participants determine their risk appetite

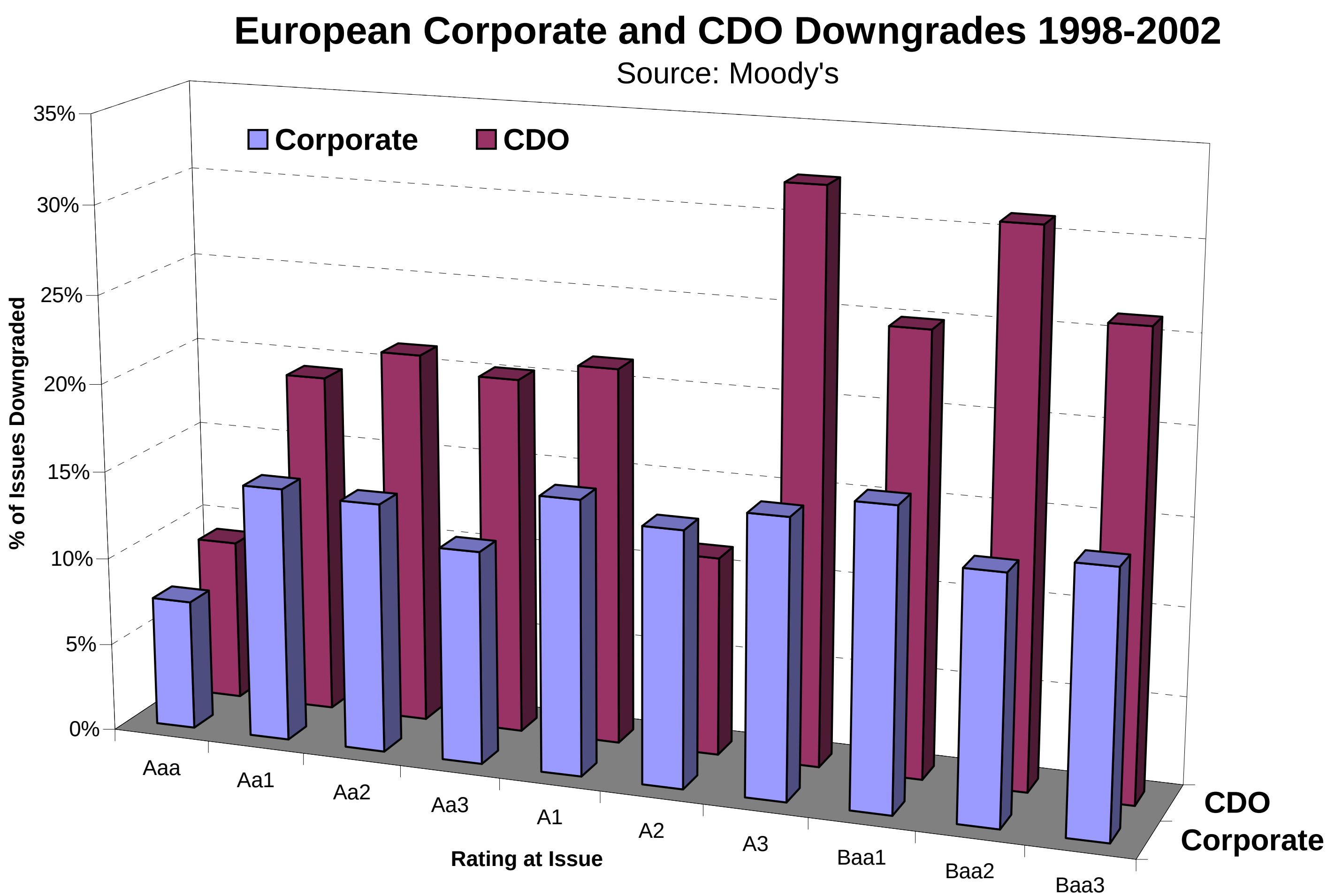
The Business Model is the Credit Rating



Experience so Far

- Some real pain:
  - Notably single name Credit Default Swaps ("CDS")
- Also CDO's
  - In particular equity and mezzanine tranches due to leverage
  - With cash flow CDOs - exposure to default
  - With market value CDOs - exposure to downgrades
  - Vintage year concentrations of name

Experience so Far: CDOs



The Market’s Reaction

Some Withdrawal of Capacity

- Some withdrawal of capacity / pulling back
- Limits being reached on credit risk
- Losses not the only reason
  - A risky business; credit is non-core to many insurers
  - Capital depletion and the need to redistribute capital within wider the insurance groups has caused some exits, eg. Zurich/Centre Solutions
  - Long term nature of the business which is capital intensive
  - Openly voiced regulator concerns
- Larger players showing a more long term commitment

Regulation and Credit Ratings

Impact of Basle II

Banks

- Lower capital charges for highly rated assets
- Higher capital charges for mezzanine layers of CDOs
- Potential reduction on volume of business for monolines?
- Greater role for niche monolines
- Greater role for multilines able to accept mezzanine

Insurance Regulation

- A lot of guarantee business is written offshore where regulation is less
- Rating agencies effectively become the regulators

Where next for this market?

- Much of the over-exuberance is gone
- Regulatory arbitrage appears to be giving way to economic arbitrage
- Premium rates on P&C lines are attractive so some insurers have decided to refocus on their core business

- Time for the real applications to develop
- Time for insurers to demonstrate commitment to capital markets
- Capacity for credit risk is filling up
- The search for new asset risks begins – other ABS
- Technical risks could be attractive ie. those without a systemic component – eg. Pharmaceutical development, Oil & Gas, Decommissioning

Assets of the Future

- Other asset backed securities including:
  - Life embedded value
  - Fund of funds
    - Private Equity
    - Mezzanine Loans
    - Hedge Funds
  - Residual Values

- Technical Risks
  - Pharma – first transaction in 2003
  - Oil and Gas
  - Litigation revenues
  - Other royalties

- More consumer-related, non-financial and alternative assets have the potential to truly increase diversification

Some tentative conclusions

- Credit – risk transfer has been demonstrably resilient and robust
- Insurers are following a disciplined approach and have a good understanding of the risks
- Impact of systemic risk has been reduced
  - Total capital in the financial system reduced
  - Risk of institutional and system failure also reduced through dispersion
- More work needed on reserving, capital and solvency implications
- Financial guarantees now mean what they say but caveat emptor

Sources

- **FitchRatings**: Global Credit Derivatives: A Qualified Success 24 September 2003
- **FitchRatings**: Bond Insurers 2002 Six-Month Review
- **Moody's Investors Service**: Global Credit Research: Default and Recovery Rates of Corporate Bond Issuers 1920-2002
- **Moody's Investors Service**: European Structured Finance Transition Study
- **British Bankers' Association**: BBA Credit Derivatives Report 2001/2002
- **The Economist**: Special report – Bank Lending, Who's carrying the can?
- **Alternative Risk Strategies**: Morton Lane

Contacts

- chris.waites@tillinghast.com
- cormac.bradley@tillinghast.com