Financial Guarantee Business
Time for a Reality Check

Chris Waites
Cormac Bradley

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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
- Recent Market Conditions
- Banking vs Insurance
- Where Next for this Market?
The Growth in Credit Risk Transfer - Asset-Backed Securities

US and European Volumes of Asset-Backed Securities (US$ Billions)

Source: Economist 2003, Federal Reserve
The Growth in Credit Risk Transfer - Credit Derivatives

Global Credit Derivatives Market ($Bn)

Source: British Bankers Association 2002
Turbulent Times for Corporate Debt Globally

Global Corporate Bond Defaults - Counts and Volumes in US$ Billions

- 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

Source: Moody's, Feb 2003.
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

Net Credit Protection Sold by Market Participants
(Protection Sold less Protection Bought)

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?)
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

Diagram:
- Capital Markets
  - Investors
  - Sell Protection (Credit Derivative)
- Transformer Vehicle
- Insurer
  - Buy Protection Financial Guarantee
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

- **Wrapped**
  - **Shadow Ratings**
  - **Liabilities**
  - **Assets**

Bond Investors

- **AA**
  - **BBB+**
  - **BB**
  - **Equity**

Financial Guarantee
- **Insurance Policy**

AA-Rated Insurer

Premium + Upside?

Corporate Bonds (50-100)
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

CDO and Credit Derivative Exposure by Credit Rating

% of Net Par Outstanding

Rating of Reference Entity/Shadow Rating of Tranche

AAA Monoline
Multiline
AAA Monoline
Niche Monoline

Niche Monoline
Multiline
AAA Monoline
Niche Monoline
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

European Corporate and CDO Downgrades 1998-2002

Source: Moody's

% of Issues Downgraded

Corporate  CDO

Rating at Issue

Aaa  Aa1  Aa2  Aa3  A1  A2  A3  Baa1  Baa2  Baa3

CDO  Corporate
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

- 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

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Contacts

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