

# Alternative risk strategies

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# European ART joins the big picture

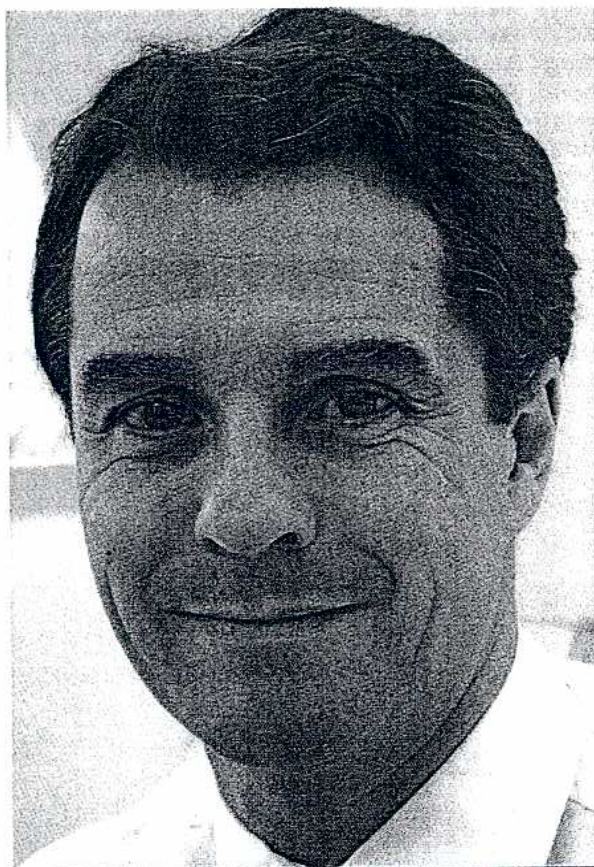
**There is increasing demand for alternative risk transfer solutions in Europe, in particular from insurers and reinsurers. Carola Schenk asks why the time is so ripe for ART**

**A**lternative risk transfer (ART) deals – dealing in products that transfer financial risks to the reinsurance industry and non-financial insurance risks to the capital markets – are catching on in Europe. Companies are starting to use them as alternatives or supplements to traditional hedging and insurance methods. Banks are increasingly eager to offload some of their credit risks on to the capital and insurance markets, to put their capital to use more efficiently. And insurers and reinsurers are keen to take on new types of risk. So, is the tide in Europe turning in favour of ART?

If you ask Denis Autier and Andreas Hanft, who head the new alternative risk solutions units of BNP Paribas and Westdeutsche Landesbank (WestLB), respectively, the answer is yes. Both banks have set up dedicated divisions this year to position themselves in the growing market for alternative risk solutions – the traditional playing field of reinsurers and insurers.

These traditional players are also optimistic. Julian Roberts, a director at Aon Capital Markets in London, says: "The tide is turning." He points to signs that the region's soft insurance and reinsurance markets are beginning to harden. "We are at the beginning of a period of an increase in [insurance] prices, and this makes people look at the alternatives available," he says. In addition, the concept of enterprise risk management and the idea of packaging multiple risks into a single product to cut costs are gaining ground, he says. Traditional reinsurance and insurance contracts do not cater to such demands – hence the need for alternative solutions.

Recent European transactions also suggest that not only is ART activity picking up in the region, but it is also breaking new ground. For example, earlier this year, Deutsche Bank placed the first cred-



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Aon Capital Markets**

it default swap insurance cover, while Société Générale and Swiss Re New Markets (SRNM) jointly structured the first banking and insurance capital facility. WestLB plans to launch the first flood catastrophe bond issue in spring. Aon Capital Markets is structuring an innovative transaction that would provide coverage for risks associated with satellite launches, involving a swap structure.

So, who are today's and tomorrow's end-users of ART and alternative risk financing techniques in Europe, and for what type of risks are they resorting to such methods?

To date, among the most active end-users of ART and risk financing tools have been Europe's insurance and reinsurance sectors. These firms typically use ART to create extra underwriting capacity, including for new types of risk, says Chris Mundy, practice leader, alternative risk transfer at Marsh in London. Securitisation of risk is particularly used in the region's more sophisticated insurance markets, such as Switzerland, France and Germany, notes Aon's Roberts. He expects the level of such transactions to rise. Italy, for now, is among the more backward markets in this respect.

In the European catastrophe bond market, which has been thin so far, activity is picking up. The region's first large-scale cat risk bond issue took place last year: Allianz Risk Transfer, the Zurich-based ART arm of Germany's Allianz Group, structured and closed a \$150 million cat bond option linked to European windstorms and hail risk. However, Europe's ART experts are keen to break new ground, and cat bonds are part of their plans – in terms of the types of risks covered and their geographic location. WestLB, for example, is preparing the first flood cat bond issue (*Risk* November 2000, page 8).

Cat bonds are typically used where no traditional insurance cover is available or financially viable – that is, for

high-severity, low-frequency events such as certain forms of natural catastrophe. For a cat bond issue to be successful, as for any transfer of insurance risk to the capital markets, the risk being transferred must be objectively quantifiable. For now, cat bonds have been linked to earthquakes and hurricanes, primarily in North America and Japan – events for which objective risk measurement data are at hand.

Europe's life insurers are a particularly promising group of end-users of alternative risk financing and risk transfer. A particular reason is that the industry is facing increasingly pressing financial risks, which it is keen to offload. One such risk is the financial liabilities associated with the rising life expectancy of policyholders. Also, life insurers are beginning to consider hedging the financial risks associated with the upfront commission payments to agents who sell their policies, notes WestLB's Hanft. Such costs are priced into the premiums of a life insurance contract, and thus are only recovered over the lifespan of such a policy.

## Good data

Given the long-term nature of such liabilities, traditional hedging instruments often do not cater to life insurers' needs. And the industry generally has good, historical, quantitative risk data to hand – which lends itself to making more use of ART solutions. WestLB is in early talks with two European life insurers about providing financial reinsurance-style products to cover the risks associated with life insurance policies, says Hanft. He is keeping details of the prospective deals undisclosed for now.

Thomas Renggli, a director at SRNM, agrees that the entire sector of retirement provision across Europe will create more demand for ART solutions. Take Germany, for example, he says. The country, with around 82 million inhabitants, is about to introduce compulsory private pension provision, mainly via mutual funds but with a capital guarantee. As in other countries, such private pension savings will be invested mainly in capital markets – even if commonly via mutual funds. Given the long-term nature of the investment horizon, derivatives may not offer viable hedges against market risks, and ART solutions could step in.

Thus, says Renggli, demand for asset-risk hedging solutions will increase, as will demand for constant maturity swaps with very long maturities of at least 10 years and a maximum of 35 years. His firm is already working on several deals for German and other European life insurers offering principal protection for assets invested in capital markets. The deals,



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aimed at hedging against market risks such as movements in the stock, bond and currency markets, are based mainly on long-term option schemes with maturities of more than 10 years.

European insurers resort to ART to access new types of risk, but also for asset/liability management purposes. For example, insurers are keen to exploit tax and accounting arbitrage opportunities within Europe, notes SRNM's Renggli. His firm has structured several such transactions on behalf of European insurance companies, but details of such sensitive tax deals have not been disclosed. He hints that the transactions involved country combinations such as Switzerland, Germany and the UK, or France, Switzerland and Luxembourg.

European banks, including commercial banks, are increasingly eager to offload parts of their credit risk portfolios to the capital markets or the insurance industry. The general aim is to make better use of their capital. "[Commercial banks]

don't want to be merely risk takers [their traditional role], but also risk managers," notes Jürg Zeltner, head of portfolio management at UBS Schweiz in Zurich.

As soon as the regulatory capital adequacy requirements move towards a risk-adjusted assessment, banks will make more concerted efforts at transferring credit risks, he contends. For now, banks cannot free regulatory capital by transferring such risks and thus lack the financial incentive for doing so. He adds that a value-at-risk model for credit risks, which differentiates between the different qualities of the risks, is also needed. (For more on this, see our sister publication, *Credit*, September 2000, page 48.)

But even short of such regulatory carrots for banks, insurers can offer capital at cheaper prices given that their capital adequacy requirements are lower than those of the banking industry. They have already been very active in the field of credit insurance products, such as credit insurance and credit default swaps, which are targeted at banks, says Aon's Roberts. Underwriting a portfolio of credit risks enables them to utilise their capital relatively efficiently. He adds that they are gearing up to provide more enhanced credit facilities – in both the corporate and the sovereign bond markets.

## Interest

Deutsche Bank this year structured a landmark credit risk transaction: the first credit default swap insurance cover, placed with Independent Insurance of the UK. As part of the deal, Deutsche Bank set up a Bermuda-based reinsurance arm, Global Credit Reinsurance, which took on the credit default swap. Graeme Sutton, group marketing director at Independent in Edenbridge, Kent, says the insurance company has "a small involvement in ART... and a genuine interest in ART" but is unlikely to extend its involvement in this area.

SRNM, for example, is preparing to roll-out an enhanced loan facility that will transfer the credit risk portfolio of medium-sized US firms via a bond issue to the European insurance industry. The insurers, whose risk portfolios tend to be local, are keen to take on such risks on diversification grounds, says SRNM's Renggli. The deal will comprise bonds and equity worth \$50 million–100 million relating to a credit portfolio of several hundred million dollars. Further details are under wraps for now. It is the firm's third enhanced loan facility.

However, it is not yet certain whether the run on regulatory arbitrage opportunities linked to the discrepancy in insurers' and banks' capital adequacy requirements is a long-term trend. Aon's Roberts cautions it may well be a short-

lived one. For now, such deals are profitable for insurers. This could, however, change if, for example, the industry's capital adequacy regulations are revised upwards or the relative pricing advantages are reversed. Furthermore, insurers may decide they have sufficiently diversified their portfolios for other reasons and thus lose their appetite for new types of risks or risks in other parts of the world.

### New ground

As far as credit risk transfer to capital markets is concerned, UBS Schweiz, for example, recently broke new ground in the Swiss domestic market: it was the first Swiss bank to transfer Swiss small- and middle-sized enterprise (SME) credit risks to the capital markets – via a synthetic securitisation transaction. The deal is part of UBS Schweiz's strategy to position itself in what it regards as a market with "massive growth potential", says Zeltner. It involved securitising part of the credit risks attached to a Sfr2.5 billion portfolio of loans to Swiss SMEs, and was executed via a special purpose vehicle dubbed Helvetic Asset Trust. The loan loss risks were converted into collateralised loan obligations (CLOs), ie, fixed-rate bonds with their repayment linked to the losses in the underlying portfolio. The CLOs were placed with the Swiss general public earlier this summer.

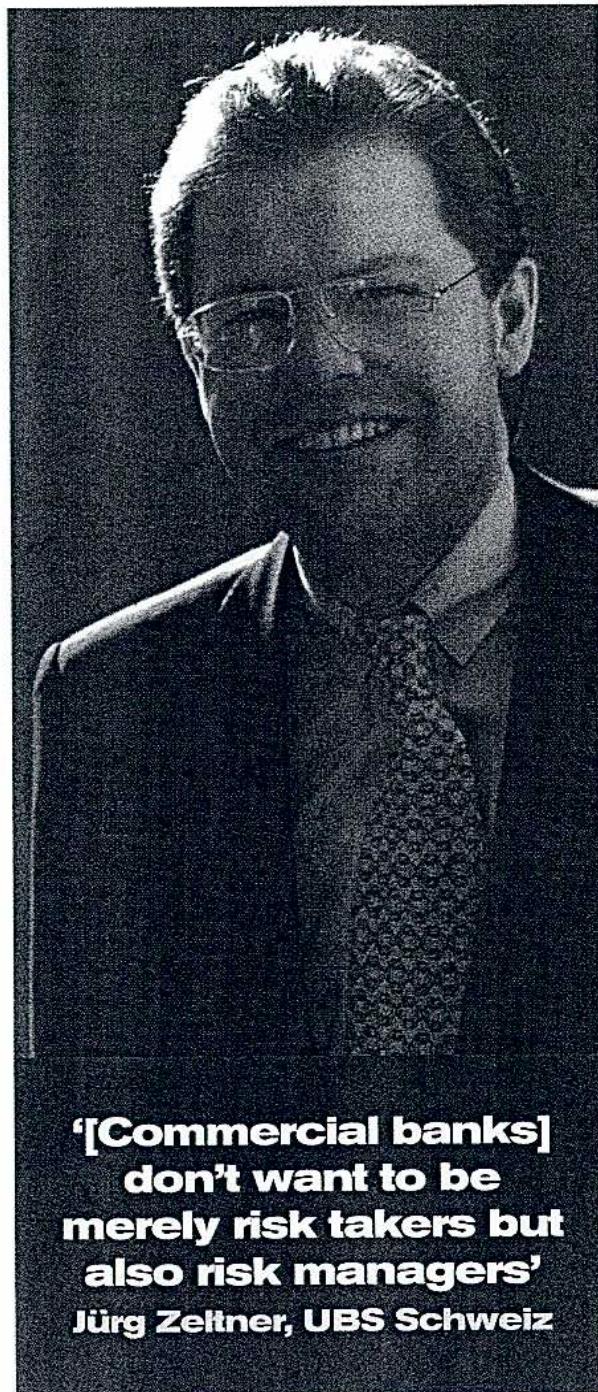
The main stumbling block for such a transaction is rating the risk inherent in credits to SMEs, which is necessary to make such risks tradeable and liquid. For over five years, UBS Schweiz has been working on a rating system for Swiss SMEs, says Zeltner. The majority of its clients are now rated based on its own historical data pool, the exceptions being a small group of non-conforming firms, which UBS Schweiz is now seeking to rate. UBS Schweiz is likely to come to the market with similar public and/or private placements, including possibly with insurers.

On the corporate side of the European ART market, there has been little activity as yet. The UK has been at the forefront, because of the strength of the corporate governance movement and the resultant stakeholder liabilities, says Mundy. Continental Europe, which has lagged, is focusing on operational risk control rather than on protecting against strategic liabilities, he notes.

Renggli attributes the low level of corporate ART activity in Europe to date partially to the inefficiency of the region's capital markets, which has implied that traditional insurance and hedging methods often offer cheaper solutions. Furthermore, European companies are reluctant to transfer business risk, which they consider an inherent part of any busi-

ness, he says. Many industries are subsidised and have not faced the tough competition and shareholder pressure that have been major drivers for US companies' use of ART techniques, he adds.

But here, too, things are changing. A recent ART survey by international law firm Denton Wilde Sapte, The ART survey 2000: risk finance for corporations – the new frontier, suggests companies are warming to such techniques. George Sanders, a partner at Denton Wilde Sapte in London and involved in the survey, says the most promising markets are those for credit and financial guarantee products, where there is already perceivable growth. The financial guarantee market sheds credit risk on debt portfolios to



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**Jürg Zeltner, UBS Schweiz**

reinsurers. Other areas attracting keen corporate interest in ART or risk financing include product-launch failure insurance. Demand for such insurance is emerging, in particular in the pharmaceutical industry. Weather derivatives, too, are a hot topic. Earlier this year, for example, the UK wine bar chain Corney & Barrow purchased a weather cover to hedge against lower sales caused by bad weather.

And more may come as the corporate environment changes. Since the European Commission launched its electronic tender database, more firms compete on a pan-European basis, which raises the cost of acquisition and triggers the need to boost their financial strength on competition grounds, notes Mundy. As a result, companies are keen for any "risk management product that gives you the slightest edge over competitors", he says. Also, the concept of corporate governance is gaining ground in Europe, as evidenced by increasing pressure on companies to be "very vocal" about their risk exposure, he adds.

### Novel concept

Companies will also seek solutions for more exotic forms of risk, for which no insurance product is yet available, says Aon's Roberts. Enterprise risk management, a novel concept in Europe, is becoming more common in corporate risk management thinking. The seeds of this approach are in the move towards a multi-product or business-line approach to risk management, he notes. The traditional barriers between a company's treasury and insurance buying operations are beginning to come down, he adds. A prominent recent example of a European company resorting to a combined insurance/capital markets solution is the deal structured jointly by Société Générale and SRNM for Compagnie Financière Michelin, the financial and holding arm of tyre group Michelin (see story on page S18).

Nevertheless, the industry consensus is that the European ART market-place will not take a sudden quantum leap from its low base. Rather, it will evolve gradually. Many firms remain inherently reluctant to embrace new solutions, and it may take years before they become comfortable with alternative risk management and financing techniques. And then, there is the cost factor. Alternative structures – whether for risk financing or risk transfer – compete on price with traditional solutions and even if they break new ground, they must do so in a financially viable way. Many ART deals to date are said to have been expensive, calling into question their economic rationale. ■