

## PRACTITIONER'S POINT



Diego Wauters has extensive experience in the field of insurance/ reinsurance - specialised exotic products, cat bonds, weather derivatives

Investing in Catastrophe Bonds, post Hurricane Katrina ...

Prior to Hurricane Katrina, cat bond investor demand far outstripped supply, but the occurrence of the storm reversed this trend.

What is the status quo now?

And how do you see the cat bond market evolving in the future?

The cat bond market is mainly influenced by two factors - the price of traditional reinsurance and the credit worthiness of the reinsurance industry. Everytime a major event affects the reinsurance industry (such as September 11th, the hurricanes of 2005, the asbestos crisis of the late 90's, etc.) it tries to recoup its losses by raising the reinsurance rates over the ensuing two or three years.

The cat bond market reflects this by offering a higher coupon on the new issues that follow such a major disaster.

Cat bonds are structured such that, the insurance company seeking protection is not exposed to any credit risk borne by the investors. This is achieved by creating trust holding treasuries or high quality corporate bonds.

Rating agencies have systematically downgraded a number of reinsurers following the occurrence of major catastrophe event - such as Katrina. At this stage there is only one AAA reinsurer left in the market, Berkshire Hathaway. As a consequence more cat bonds tend to be issued, as they eliminate

credit risk.

The cat bond market is still recovering from the three hurricanes that hit the US east coast in 2005. Reinsurance rates are still high and insurance companies still like the protection offered by a cat bond as opposed to buying reinsurance from less credit worthy reinsurance companies. In 2006, growth in cat bonds for peril risk outweighed supply. Coupons being paid out currently continue to be attractive.

"It came as a surprise to many that Hurricane Katrina, which was only a marginal category 3, category 4 storm, could result in such an extremely large loss to the reinsurance industry, although there were special factors involved." What caused the risk models to "collapse"?

The major flood associated with hurricane Katrina created significantly higher losses than the hurricane itself. Hence insurance claims were much larger than would have been for a hurricane of that magnitude.

What were the revisions made by major insurance rating agencies and risk modelling firms in their respective methodologies? What impact has this had on the cat bond market and for players such as yourself?

The major rating agencies have modified their methodology to reflect the recent increase in hurricane frequency in the Atlantic. Also, they have developed new models to take into account floods associated with a hurricane.

Has the cat bond market witnessed changes since the occurrence of Hurricane Katrina? Elaborate.

The cat bond market has grown significantly since Hurricane Katrina - with a volume of issuance largely superior to previous years. Also, the cat option market has now developed into a multiple of the size of the cat bond market itself.

A variety of new structures have been introduced in both markets to better reflect the needs of the (re)insurance companies seeking protection. This has led to the creation of "second event", "multiple perils" etc structures.

Finally, a number of new bonds have been issued that cover non-natural catastrophe events, i.e. those linked to human activity (such as mortality, longevity, car accidents etc).

In your opinion, are cat bonds still a lucrative asset class? For whom?

Investors are still attracted by this asset class for various reasons. First, it offers low correlation to traditional financial assets. Second, it provides the investor with a return which is a multiple of the expected loss associated with the risk borne. Investors can now diversify their cat bond portfolio by adding non-natural catastrophe bonds or weather derivatives - as these are based on weather phenomena that are "local".

Given the frequency, severity, wide-spread nature of naturally occurring catastrophes - isn't it going to get increasingly challenging to deliver cat bond returns?

So far, we have not seen an increase in the frequency of earthquakes and the (re)insurance industry has already experienced periods, during which multiple hurricanes have occurred. One may remember that forecasters predicted a busy hurricane season for 2006, when hardly any occurred.

In other words, it is difficult to predict, on a short-term basis, the frequency of natural catastrophes. As long as the return remains a multiple of the long-term expected loss and provided one can build a diversified portfolio, it remains an attractive asset class that is broadly uncorrelated with financial markets.