

Capital and finance: Avalon Pray

The Avalon Re cat bond was the first (and currently only) cat bond to transfer third party liability. Events in the Gulf of Mexico bring the risk assessment on that bond into sharp focus. The issues around Avalon Re aside, the oil leak in the Gulf of Mexico also highlights the need for large scale capital capacity to absorb some of these risks. BRAVE Partners believes that it is time to get back to the drawing board to look at capital markets solutions for liability risk.

May 7, 2010

“There’s no problem – even if a rig blows up”

Some of the BRAVE partners worked for an institution that bought the Avalon Re cat bond. Avalon Re was issued by OIL Casualty Insurance Limited (OCIL), which is the casualty lines sister insurance company to Oil Insurance Limited (OIL). Interestingly, a quick check of the OIL and OCIL websites would suggest that neither of BP, Transocean nor Haliburton is a member.

Cat bond

In 2005 OCIL sponsored a cat bond, Avalon Re. Losses accumulated on Avalon Re as “events” occurred. An “event” was defined as something like a claim of \$150m or more against OCIL. As OCIL is a casualty insurer, these claims would be for liability and not the physical damage to plant and machinery. Due to a number of extension mechanisms, whilst off the event risk, the bond can still be exposed to adverse claims development up to June 8, 2010.

Just the demo

The UK has just been through a general election. This has brought out all of the old jokes about marketing where everything looks great as opposed to the actual situation. Whilst the partners at BRAVE Partners have never seen the formal pitch for the Avalon Re bond, their (then) colleagues who bought it did make a few descriptions that sounded like “just the demo”. The view put forward as: “it doesn’t matter if a whole rig completely blows up – that is not covered. There has to be a massive oil spill and the loss has to go over

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A rig explosion does matter

In short it does matter if a rig explodes because the consequences are usually substantial liability claims. During a quiet conversation over a glass of wine with a lawyer friend of BRAVE Partners, we came to the conclusion that once all of the class actions from tour operators and fishermen are finished the total liability claim is likely to be around \$12bn. The rig, even at a value of \$500m to \$1bn is the small part of the claim. The liability starts with the eleven crew members who are tragically “missing” and carries on through all of the pollution and other damage.

Boot on the throat of BP

BP is one of the largest companies in the world and has the capital and capacity to absorb large claims. However, there the claims that arise from the Gulf of Mexico rig explosion are likely to be extremely

So whilst the US Government “boot on the throat” of BP” is probably, much like the wrestling on American TV, something of a choreographed sequence in a battle of the titans – it does raise a serious issue. Whilst BP is down, does it make sense for the company to have a partner to help cover the claims – in wrestling terms this would be something of a tag team. If BP is down with a boot on its throat – now would be the time to tag in a partner.

high and possibly compounded. The US Administration has not been shy in explaining where it sees the money to pay for this event coming from. BRAVE partner, Christopher Cloke-Browne, was in New York as the oil slick started to reach the Louisiana coastline. President Obama was immediately on the news channels, explicitly stating that BP was responsible, so BP would pay. Moreover, Robert Gibbs, the White House Spokesman, even went so far as to use the phrase: “keep our boot on the throat of BP”. This slightly unfortunate turn of phrase was rapidly clarified as a colloquism used in certain parts of the USA, when the business channels, such as CNBC, picked up on it.

Tag team

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Insurance securitisation of liability risks

The Avalon Re cat bond was groundbreaking. It is the first securitisation of third party liability risk. However, the performance and characteristics of Avalon Re make it likely to be the first and ONLY securitisation of third party liability risks. Avalon Re did not go well for investors. Not only were investors exposed to events that they might not have contemplated, but they also ended up with their cash stuck in a zombie like structure where the claims had not been fully established or worked through,

so no one was sure as to whether certain tranches of the bond were in default or not. All of these features unnerve capital markets investors.

The insurance meets capital markets hangover

The securitisation and transfer of insurance risks to capital markets is a compelling business activity. The capital markets give access to a deep and fluid pool of capital to absorb ever greater insurance risks. One of the interesting thoughts that develops from the BP issue is that there are no insurance companies that are anything like the size of BP. So for these large catastrophic events, is BP really well served by insurance? In contrast, the capital markets finance not only BP, but several other huge organisations, as well as a myriad of smaller firms. As a consequence the capital markets, almost by definition, are larger than BP.

The issue that investment banks, brokers and other structurers and intermediaries face when seeking to transfer insurance risk to capital markets is that there the two markets have a completely different outlook on risk. Neither party is deluded or wrong, the simple fact is that the markets have just traditionally operated in different ways. Insurance markets are used to dealing with broad, relatively ill defined risks that require careful analysis. As a result insurance is slow to pay a loss. The industry needs time for a loss to develop, the circumstances to be analysed and a conclusion to be drawn. The insurer likes to keep the cash, which can be invested to generate income to mitigate the eventual loss.

In contrast, capital markets are more geared to taking very precisely defined risks that require less broad analysis, because of the tight definition. The professional investors in the market then plan their strategy period by period. A professional investor wants clear finality and certainty at a particular point in time, even if the answer is a loss. At each period the investor will move on, looking at where to deploy his investment capital.

Bridging the divide

The BRAVE partners believe that the firm is well placed to bridge the divide between insurance markets and capital markets. To quote the CEO of a Lloyds Managing agent: "Everyone comes in here and tells me what capital markets investors want. What about what I want?!" BRAVE Partners believes that the firm can give the insurance industry more of what they want whilst keeping the capital markets investors happy as well.

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Often the compromises are subtle and appear counter-intuitive. The BRAVE partners recently met with The Society of Lloyds to discuss a financing mechanism for Lloyds risk capital. The structure seems to work well for syndicates from a Lloyds perspective and in fact, it works better when structured towards investor demands for certainty – when this is done up front as part of the overall structure.

BRAVE Partners services

BRAVE Partners has considerable experience and expertise in both banking and insurance markets.

The firm has a track record of creating risk transfer structures that provide high quality protection for the purchaser, but are also transparent and acceptable to an investor, or risk taker.

Interaction

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- The Gulf of Mexico oil spill highlights the need for capital markets capacity to be brought to bear on the casualty insurance markets.
- BRAVE Partners has the skills and experience to analyse and structure a capital markets risk transfer product that would be acceptable to both insureds and investors.

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