

Capital and finance: My name is Bond

BRAVE Partners always thought that the \$3bn cost estimates for the Deepwater oil spill were too low. With Obama now extracting \$20bn from BP into a fund with pointed comments that this did not cap their liability, the firm seems justified. The losses, however, do not stop with BP. Chevron is facing losses from the crisis too.

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Business interruption

Business interruption, or BI as it is known in the market, is coming into sharp focus. First the Icelandic volcano grounded flights around the world with a huge knock-on effect – even into refining and other industries, as highlighted in the commentary “Blowing your top”. Now the Deepwater Horizon oil spill is not just a problem for BP. The resulting six month ban on deepwater drilling is having a major impact on other oil companies with significant proportions of their reserves in that type of location. Chevron is perhaps the best known of these.

Moreover, Norway has suspended issuing additional deep sea drilling licenses until the Deepwater spill is fully investigated.

Regulation

Moreover, the BP spill has prompted various US politicians to review the \$75m limit on financial loss liability enshrined in the Oil Pollution Act. BP has already conceded that its liability for financial loss is almost certain to exceed the \$75m and even established a \$20bn fund. Even at this level, some pundits (such as CNBC’s Jim Cramer) are calling for more (\$48bn in Cramer’s case). BP’s action, however, has not halted the politicians in their quest to review this limit. Some simply wish to remove the limit altogether, whereas others would like to see it increased to \$1bn.

The usually business-wise rational and respected Jim Cramer, seems to have veered towards populism with his call for a \$48bn fund from BP to pay for financial losses caused by the Deepwater Horizon spill.

Insurance

Most of the oil majors do not buy insurance. These companies are simply much larger than the largest insurers and reinsurers. This makes the oil companies more able to absorb losses and thus the value of paying premiums (in fact the whole concept of insurance) goes out of the window. Insurance is bought to cover losses that the buyer cannot withstand, but the insurance company can.

It is not clear why BP needed a rating for its captive insurance company. However, the interesting revelation from the ratings report is that there is a \$700m per event claim limit.

As bad as it can get

The question is – how bad can things get? Certainly BP might have sought to buy more insurance should it have known that the US would seek \$20bn or more from it. The answer to this, at least from the BP perspective, can be found in some of the ratings agency reports on Jupiter Insurance Limited.

Captivating

Jupiter Insurance Limited is a Guernsey Insurance company that is wholly owned by BP and only underwrites business for BP. Whilst this might seem a little superfluous, there are good reasons for self insuring through a captive. The reasoning for a captive aside, the interesting statistic revealed in the ratings report is the fact that Jupiter has a \$700m per event claim limit. In short BP thought that \$700m is as bad as it can get for any one single loss event.

A drop in the ocean

So, BP did not insure with a \$700m view of; “how bad can it get”. Now that view has shifted to \$20bn+, it would seem that BP would need more insurance – a lot more insurance.

It is not only BP that needs a lot more insurance. The rumblings from politicians in the USA about removing the liability limits on oil spills, outlined above, is making the London insurance market nervous. As Global Broker and Underwriter reports:

One senior Lloyd’s underwriter said: “The fact is that if they do change the figure there will not be the available capacity to meet the demands of the markets. It has been expressed to the US legislators but the matter is in their hands. I do not think we can have made our position any clearer.”

Solvency II

Moreover, the advent of Solvency II will require insurers to hold capital against 1:100 loss events and between Exxon-Valdez, Amoco-Cadiz and Deepwater Horizon, large oil spills are looking like they fall within the 1:100 year time horizon.

Limitless financial liability will increase both demand for insurance cover and the capital required to support it; thus reducing supply.

Back to B.I.-sics

As noted in the opening paragraphs: oil companies are not just suffering directly from the Deepwater Horizon oil spill; there are knock on effects which amount to business interruption, or BI. BI is hard to ensure. It requires a very detailed knowledge of the business of the insured. Moreover, it is fraught with moral hazard. The insured has a much better idea of what can go wrong and why than the insurer.

“Looking at every aspect of the Deepwater Horizon spill and knock on effects leads BRAVE Partners to conclude that the solution lies in the capital markets.

Any transaction will require an insurance partner (or partners) for their knowledge and expertise and possibly to provide fill in covers.

However, the scale and simplicity of cover that is required as a base case is only available in capital markets.”

Christopher Cloke-Browne
Managing Partner
BRAVE Partners LLP

BI cover

Pure business interruption cover is now being sought in the capital markets through what are called parametric cat[astrophe] bonds.

Cat bonds provide access to the large risk capacity in the capital markets. In exchange, the buyer often has to give up some of the bespoke tailoring that insurance offers for simplicity and transparency. One classic BI cat bond was Midori issued by JR East, on the largest rail companies in Japan. The bond paid specified amounts if earthquakes of certain magnitudes occurred in certain zones around Tokyo.

There is no guarantee as to what JR East would lose for each event, but given the bond notional was around \$325m it is likely that JR East's losses from the major earthquake events would be much larger. The bond was also to cover BI, not the physical damage to the track. In this case the BI was caused by the loss in revenues that would occur post a major earthquake because the trains would not run on the damaged tracks – so there would be no ticket sales.

So, to put it all together; the energy liability insurance markets needs a lot more capacity – and capacity that could include some type of business interruption cover.

My name is bond – Cat Bond

BRAVE Partners suggests that the cat bond markets hold the solution to the issues facing the energy insurance market today.

Insurers can often be skeptical, even fearful, of capital markets bringing capacity. In some cases, they are correct. Just because they are paranoid, does not mean that some aren't out to get them. In this case, the insurers should embrace the capital markets. The capital markets will need the insurers and their current capacity. The insurers are smarter, more nimble and more knowledgeable about the risks. In this instance, the capital markets really would just be bringing simple, transparent, but naïve capacity. The insurers would need to temper and machine it into what the clients really want.

BRAVE Partners services

BRAVE Partners is developing ideas and structures that can bring the required capacity to the energy liability markets whilst providing an attractive, transparent capital markets investment.

The firm welcomes dialogue on this issue from all parties. BRAVE Partners believes that it is a substantial industry issue.

Interaction

If you enjoyed this commentary and would like to receive a weekly update by E-Mail, then please contact BRAVE Partners on commentary@bravepartners.com

If you would like to comment on the content of this piece, then please send an E-Mail to discussions@bravepartners.com

BRAVE Partners has established the "[Deepwater Horizon – insurance industry group](#)" on LinkedIn.

- 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 begun to discuss a variety of options and ideas with both insurers and capital markets.
- The firm believes that the Deepwater Horizon oil spill has opened up a substantial industry issue.
- We welcome all views and conversations on the topic.

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