

Capital and Financing: If it wasn't...

When the earth was struck by a meteor it wiped out the dinosaurs, allowing the small nifty, adaptable mammals to emerge, thrive and ultimately dominate. The same process could be underway in financial services. In particular there is no reason why the insurance industry cannot build on the small, talented teams that insure financial risks to build a business that would ultimately challenge the investment banks.

Recently a number of investors in financial risks have been sitting shaking their heads in a somewhat punch drunk, or at least hung-over, manner and murmuring: "If it wasn't for ..." Everyone has their scapegoat – even the BRAVE partners.

Digging through the wreckage, BRAVE Partners has been finding some astute teams who have been taking financial risks for a decade or more. These teams and businesses have not only survived the financial crisis they are thriving on the back of it.

Where there's muck there's brass

Residual value risk is one business line that is thriving. There are about three great teams in this business. On the face of it, the business is simple. A residual value insurance contract exchanges an up-front premium for the right for the buyer to sell an asset to the insurer at a particular specified time in the future for a price set today. Just to add the standard financial option language and make the contract really sound like that which it is; a European put option on an asset. In this case the previous sentence should be extended to add "the right, but not the obligation".

Residual value insurance has remained a small niche within the insurance markets for two reasons. First, Lloyds underwrote a lot of computer residual values in the 1970s. With the benefit of hindsight, the result is now predictable.

Letting loose with the stamp

Residual value insurance has remained a small niche within the insurance markets for two reasons. First, Lloyds underwrote a lot of computer residual values in the 1970s. With the benefit of hindsight, the result is now predictable. However, BRAVE Partners does not seek to poke fun at the underwriters. A quick internet search will pull up many examples of inaccurate predictions relating to the computer market, such as:

"Computers in the future may weigh no more than 1.5 tons."

-- Popular Mechanics, forecasting the relentless march of science, 1949

"There is no reason anyone would want a computer in their home."

Predicting high tech assets can be tricky

"Computers in the future may weigh no more than 1.5 tons."

-- Popular Mechanics, forecasting the relentless march of science, 1949

"There is no reason anyone would want a computer in their home."

-- Ken Olson, president, chairman and founder of Digital Equipment Corp., 1977

"I think there's a world market for about five computers."

-- Thomas Watson, chairman of IBM, 1952

-- Ken Olson, president, chairman and founder of Digital Equipment Corp., 1977

"I think there's a world market for about five computers."

-- Thomas Watson, chairman of IBM, 1952

Although many of these predictions are negative, so maybe Lloyds should have done some more research before underwriting computer values.

Secondly, the lenders, often the major banks, often took on the residual value risk of the assets that they financed to increase revenues and market share.

It is all about the banks

As with all things financial in the current environment, it is all about the banks. Bank balance sheets are currently oversized and the banks are seeking to reduce them. There are few willing takers of asset risk in the current market.

Special forces

The few specialist residual value insurance teams are now swamped. Business is booming as banks are not only reluctant to lend without this risk insured, they are also actively looking to reduce the risk taken onto their own books during the boom years. Bank mergers, of which there were a few during the last eighteen months, further compound the issue as merged banks find themselves with very large concentrated portfolios of asset risks.

An opportunity

BRAVE Partners believes that there is a growing opportunity to establish a financial risks insurance business.

A financial risks insurance business would cover all of the currently out of favour financial risks, such as: credit, residual value, performance, project completion. The market has shifted considerably from the hey-day of the monoline. Now a visit to the monline industry is accomplished in a quick trip to the Liverpool Street area.

A business not a sequel

Detractors of this plan will point to a smoldering hole and clearing mushroom cloud on Curzon Street, London. This was the London office of AIG Financial Products and the likely scene of many of the acts that led up to the substantial USA Government support. BRAVE Partners is not advocating a sequel of these events.

Sophistication meets discipline

The residual value teams within the market are financially sophisticated, but with the long term discipline of insurance underwriting. These businesses have consistently succeeded over a decade or more and they have done so by analyzing and understanding the risks. The first question that any of the underwriters asks is: “what can I do with the asset if I get it back?” This alternative use and scrap value

analysis is detailed and sophisticated. Again there is wisdom in the underwriters’ analysis: “if I get a ship back, then it is not a ship anymore. If it still were a ship, then I would not get it back.” So far this rigour and discipline has protected the insurers through a cycle or two. The industry shows sophistication and wisdom that was perhaps lacking on Curzon Street.

The survival of Assured Guaranty in the monoline sector and Primus Guaranty in the credit derivative product company sector are testament to the fact that leveraged credit risk did not universally end in disaster. These businesses are in the process of rebuilding in a world where the initial reaction to their model is one of disbelief. Both are making great strides – primarily because their businesses are underpinned by talent.

Shine on

BRAVE Partners believes that financial risks insurance has the opportunity to grow. The insurance industry has weathered the financial crisis well – emerging as perhaps the dominant business model.

However, a recent report by the UK Treasury entitled: “Risk, reward and responsibility: the financial sector and society” has not

differentiated insurance from banking to the extent that the industry would like. Global Broker & Underwriter reports:

Peter Vipond, the Association of British Insurers’ Director of Financial Regulation and Tax, said: “Yet again, the Government is suggesting sweeping reforms of the financial sector with no recognition of the differences between banking and other financial organisations. Insurers and banks have very different business models and should be treated in the same way. Insurers did not cause the financial crisis and have emerged from it with their business intact and with no disruption to its customers.”

The insurance industry learnt their lesson in the 1980s on allowing business to package up and pass on risk and allowing business to take profits before risks ran off from the LMX spiral and a variety of related company failures. The insurance industry has become one of sophisticated and disciplined risk taking – something that the banking sector was once renowned for.

Peter Vipond, the Association of British Insurers’ Director of Financial Regulation and Tax, said: “Yet again, the Government is suggesting sweeping reforms of the financial sector with no recognition of the differences between banking and other financial organisations. Insurers and banks have very different business models and should be treated in the same way. Insurers did not cause the financial crisis and have emerged from it with their business intact and with no disruption to its customers.”

Global Broker & Underwriter Magazine

BRAVE Partners services

BRAVE Partners is working with a number of entities that are seeking to establish or expand financial risk insurance businesses. The firm has found each team to be talented and sophisticated. Each business model is robust and well analysed. Moreover, their current business environments are highly favourable. Simply put: financial risks insurance is one of the few insurance lines where BRAVE Partners currently sees what the firm constantly seeks: a supply – demand imbalance. The business is unloved by Lloyds: “it’s those darned computers again” and even the Treasury does not seem to be showing them much respect either.

BRAVE Partners even got an admittedly amusing, but characteristic response to a post on LinkedIn.

LinkedIn post: Chris Cloke Browne is looking at financial risks insurance as an underserved market.

Response: Should that read under-reserved, underserved or undeserved?

BRAVE Partners believes that investors who pay this sector some attention could be onto some great returns. Not only is the business abundant and profitable today, there is a significant opportunity to build a major business franchise for the future.

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 is working with a number of teams and businesses on financial risks insurance.*
- *The firm believes that this business currently has great potential both as an opportunistic investment and for building a major franchise over time.*
- *BRAVE Partners believes that investors seeking returns should consider this business segment carefully.*

enquiries@bravepartners.com

www.bravepartners.com