

# Capital and finance: Monoline monoline

There has been a step change (for the worse) in monoline insurance businesses. The credit monolines have been in the headlines, but other monoline businesses have run into problems. In the UK the monoline bulk annuity provider Paternoster is rumoured to have been told to cease writing business by the regulator. BRAVE Partners believes that a multiline financial risks insurance business is the path forward to catch several attractive opportunities. Some lateral thinking on business lines goes a long way.

February 12, 2010

We have been improving our vocabulary at BRAVE Partners. The spell checker consistently changed the word 'monoline' into 'monocline'. Looking up monocline – a step-like fold in rock strata consisting of a zone of steeper dip within an otherwise horizontal or gently-dipping sequence – it seemed appropriate to put the two together.

## Monoline buinesses

"Picking up dimes in front of a steam roller" is the memorable summary of the credit monoline buiness often quote by a good friend of BRAVE Partners who was the successful CEO of a Bermuda company.

## Market presence

From their beginning, guarantying municipal bonds, the credit monolines grew to a powerful position in the capital markets. They dominated the markets for many years. Banks would flock to to them with their latest structure, looking for a AAA "wrap". Instantly – well for a fee – a large piece of a structured securitisation could become AAA. All it took was for the ratings agencies to say that the wrapped piece of the deal attached at an 'A', or better, rating level.

## Zero loss underwriting

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### Capital and expertise

The phrase “capital and expertise” has become a mantra at BRAVE Partners. The commentary has revealed before that this phrase is adopted from a senior board member at Allianz commenting on its, then subsidiary, Dresdner Bank: “There is nothing fundamentally wrong with Dresdner. All it lacks is capital and expertise”. The statement is particularly amusing because capital and expertise are about all there are to a financial services business.

The monolines, however, were a classic example of lack of capital and expertise. They lacked capital because their business model allowed them to take on a very high operational leverage. They lacked expertise because their business breadth expanded almost without limit. From municipal bonds, monolines got into: credit securitisations, aircraft securitisations, mortgage securitisations, life insurance securitisations (with collateral pools consisting of just about anything) and a whole host more. In many ways the more things that they did, the more leverage that they could take because their capital models that drove their ratings would give credit for risk diversification. It is interesting to note that about the only surviving monoline, Assured Guaranty, is the one company that never achieved the 9 ‘A’s rating (‘AAA’ from each of the top three agencies). Assured Guaranty stuck to their knitting (ie did not stray out of their areas of expertise) and consequently did not get nasty surprises in the credit crunch.

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### Multiline divine

Ratings agencies have always felt more comfortable with rating multiline insurance businesses. The rating agency penalty for the risk concentrations that arose from monoline business was increasing; particularly after the 2004 and 2005 hurricane seasons, which culminated in hurricane Katrina. This showed that P&C companies with large property catastrophe exposures were vulnerable to major events. Not many went bankrupt – and those that did often did so due to other problems – but more would have gone bankrupt, if it were not for the ease with which they could raise equity on investor anticipation of much harder rates.

From 2006 onwards; the P&C insurance game has been about diversification and multi-line businesses. This is one of the drivers of the current M&A activity in Bermuda where the remaining property catastrophe players, such as IPC Re, are merging into more diversified players. See [Mirror Mirror](#), the BRAVE Partners predictions for 2010 for more commentary.

### Stick to your knitting

The argument against diversification is one of expertise. There would seem to be a contradiction in the commentary so far. On the one hand we argue that the monolines diversified too much and that Assured Guaranty was saved by sticking to its knitting. On the other hand we are arguing that insurance businesses must diversify to achieve good ratings.

### Expertise

The fulcrum between the two questions – to diversify, or not to diversify – is expertise. The solution is expertise. A classic example of lack of expertise is revealed in the recent headline from the, excellent publication, The Insurance Insider: “Axis takes Q4 hit for Blue City credit loss”. As the summary from The Insurance Insider states:

“Axis Capital's decision to underwrite the performance of \$399mn of bonds financing an ambitious luxury development in the Oman desert has contributed to political risk and credit losses that added almost 20 points to its insurance business's fourth quarter combined ratio.”

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The story caused one market expert to comment: “... Blue City, where they did not understand the underlying financials of property volumes/pricing in the Middle East to actual buyers etc.”

### Themes

BRAVE Partners is a strong proponent of diversification through business themes. There are several themes that can be successfully – and right now highly profitably – exploited within financial risks insurance business. You could almost look upon creating business themes as a word association activity.

Start with a common issue that BRAVE Partners observes: many financial guaranty businesses are currently having issues with maintaining clients without posting collateral and, as a secondary issue, maintaining their ratings. Ratings are a secondary issue for financial guaranty businesses because most counterparties do not trust a rating on structured deals, even a ‘AAA’ rating. Recent events have shown ‘AAA’ ratings on structured deals to be less than a perfect indication of the risk.

### Clear synergies

For a financial guaranty business the clear business, synergies are to trade credit. There are numerous forms of trade credit insurance, perhaps the closest to home, and therefore the most attractive line, is aggregate first loss (AFL) business. AFL trade credit is an insurance targeted at the peak risks in a client's portfolio. Consequently, the business tends to focus on a smaller number of the larger credits, which is in line with financial guaranty business. The standard trade credit business is whole turnover (WTO) business. This business is far more focused on SMEs and smaller credit. It tends to rely on automatic rating systems and pool statistics, which is a different business mindset to financial guaranty business.

Moving on from trade credit, credit enhancement business is a logical next step; starting with credit enhancement of credit structures. However, the credit enhancement business soon moves on project finance and asset risk in ABS and other financing structures. Credit enhancement is the business of the, mainly defunct, monolines. Again BRAVE Partners believes that the combined expertise in a diversified financial risks business will significantly improve the underwriting at a credit enhancement business.

### Lateral thinking gets you further

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### Expertise

Residual value insurance is driven by future asset values. Asset values are driven by the demand for the assets from businesses – asset values are thus tied to business values and assessing business values in the future is an important part of fundamental credit analysis.

For example, aircraft residual values will be driven by demand for air travel. Airline finances are also driven by demand for air travel. Thus a view on the credit of airlines is also a view on the value of aircraft. There will be differences and nuances, which is why a credit business seeking to enter the RVI business will need to hire an expert team with a proven track record (not an onerous task in the current environment), but fundamental understanding by the management should not be a stretch.

### Synergies

The first synergy is that BRAVE Partners believes that RVI offers the greatest diversification. Asset values are clearly driven by economic conditions, as is the credit risk of financial guaranties. However, there are the following diversification factors:

- Diversification across time. RVI has highly specific windows in which an asset can be returned. The business is exposed to economic conditions at the time of the return of the asset and not at the time that the policy is written. RVI is not event exposed across the life of the policy life as is a financial guaranty.
- Diversification across risks. RVI has a built in inflation component. The insured asset values are not inflated. Consequently high inflation is advantageous to RVI as residual and scrap values increase.
- Diversification across geographies. Assets with low values in one region, might have significantly higher values in a different region. As air travel across Asia increases dramatically with a mobile workforce and a growing middle class, the demand for older aircraft in countries like China and India has increased significantly.

Moreover there are additional business synergies. One of the main attractions of RVI is the fact that the underwriter receives cash upfront, but is certain that there will not be a claim for many years. This means that the RVI underwriter is certain of owning cash for a long period. In short, the business provides cheap long term funding. This has two benefits that BRAVE Partners believes are under-exploited.

- The cash can be invested for the long term, thus producing superior returns and potentially supporting an asset management business.
- The cash can be used for other business purposes, including providing collateral for a financial guaranty business.

## Dislocation, dislocation, dislocation

In the housing obsessed UK, the mantra for choosing a property is location, location, location. For BRAVE Partners the mantra in choosing a business opportunity is dislocation, dislocation, dislocation. Financial markets are highly dislocated. The financial risks markets in the insurance business are proportionately

more dislocated. The surprising fact is that capital rich insurers and reinsurers are not exploiting this opportunity. P&C rates are falling, whereas financial risks rates are hardening. There have certainly been losses in financial risks exposures and more are expected. The BRAVE Partners website has reported the news headlines on Axis, Euler Hermes (Allianz) and Beazley. However, the losses from a category 5 hurricane through a densely populated area tend to encourage capital in that market – why not the equivalent for financial risks?

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## Follow the smart money

As BRAVE Partners was typing this commentary The Insurance Insider wires buzzed again: "Pat Ryan launches specialty MGA". The Insider reports:

"US-based start-up Ryan Specialty Group and its wholly-owned subsidiary UK-based Ryan Specialty (Europe) Limited are targeting a mid-year start up writing financial lines products including D&O, financial institutions and professional indemnity."

As the founder, and BRAVE Partners believes the single largest shareholder of AON, Pat Ryan has certainly hit an opportunity well in the past. BRAVE Partners believes that he is right on the money this time too.

## A business for today

BRAVE Partners has been monitoring the financial risks insurance sector for around nine months. The firm believes that the opportunity is now clear and present. There are a significant number of participants withdrawing, which means that teams and books of business are readily available.

## BRAVE Partners services

BRAVE Partners can advise investors, entrepreneurs and the owners of existing business on the optimal markets and strategies to create a diversified financial risks insurance business. The firm believes that this is the outstanding business opportunity within the financial risks sector.

## 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](mailto: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](mailto:discussions@bravepartners.com)

- Financial risks is an underserved market.
  - Banks are not only not taking on more risk, but actively looking to reduce their balance sheets.
  - The insurance market is traditionally small and a number of players have withdrawn.
  - Specialist monoline derivative companies are not accepted by the counterparties.
- BRAVE Partners believes that there is a clear and present need for financial risks insurance. Demand outstrips supply. It is a golden opportunity for a bold investor.

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