Insurance: Run off with the recoverables

It never ceases to surprise how reactive, rather than proactive a market can be. Two years ago, when the world looked good and prices were cheap, the very idea of buying credit protection on reinsurance recoverables was seen as a waste of money. Today, as balance sheets deteriorate and ratings slide, companies and insurers are once again looking at the credit risk of their recoverable in depth. The BRAVE partners have considerable and unique experience in this area.

The inevitable jokes have emerged about how Bernie made off with the money. Those with insurance or reinsurance are currently concerned about the day that their providers run off with their claims.

Insurance and reinsurance

Any form of insurance is ultimately just a promise to pay, it is not a transfer of the liability. One of the key marketing points for an insurance company is its financial strength – that is its ability to pay claims.

Credit risk of insurance

The worst case for anyone insured is to turn to their insurer in times of losses for a payment to find that their insurer is unable to pay. As insurance events rise and insurer and reinsurer strength deteriorates, the demand for credit protection against reinsurance recoverables also rises.

Previous product demand

The last time that there was strong demand for credit protection on reinsurance recoverables was in late 2005 and 2006. This was the period straight after two consecutive, highly active hurricane seasons. Companies with property catastrophe exposure had taken big losses and it was not clear if all would survive. In fact all did not survive, PX Re being the highest profile victim.

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Current demand

Current demand will be driven by two factors. Firstly, insurer balance sheets are weaker. There are a variety of reasons for this. Many have been affected by asset losses in their investment portfolio. However, others have further problems. The large variable annuity writers, such as Hartford and Prudential, have had their capital eroded by incomplete hedging on the embedded guarantees. AIG and Swiss Re have losses on credit guarantees and XL Capital has all of the above and some more.

This financial weakness comes at a time of rising claims. Hurricane Ike created more losses than anticipated. Tornadoes are becoming a constant drain on insurers' and reinsurers' resources. In other markets, losses are coming to the forefront. The professional indemnity market agrees that there are large losses, but to date no one has put up their hand to say that it is their company on the receiving end. AIG and XL Capital are known to be leading players in the market though. The aviation market has had a series of losses too.

The environment is ripe for demand for credit protection on reinsurance recoverables. Exposure to recoverable is rising. In particular exposure is some of the longer tailed casualty lines that are more credit sensitive. Short tailed property exposure is less credit sensitive because the claim is know and paid quickly. It is easier to take a view on the ability of an insurer to pay. Casualty exposure that might take five or ten years to settle has much more credit risk, as the state of a carrier five years into the future is far less certain.

Supply of credit protection

The current economic downturn is a result of the credit crunch. Credit is in short supply because those willing to take credit risk are in short supply. That is not to say that finding a third party to guarantee insurance obligations is impossible in the current environment, but it is certain that it will be harder and more expensive than it was in 2006 and 2007. Those years were not cheap and easy, you only have to ask Aspen and Hanover Re who did get deals done.

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Some credit investors did well out of the credit crunch calling the market superbly and collecting a fortune from a short ABS position. Those investors have now gone long the market – that is they are taking credit risk again, but very select risk and very high prices. These investors know that easy money from cheap credit assets will not last too much longer, so they are looking for the next opportunity. Complex, structured risk is very much on the agenda. A well structured recoverable deal might fit the criteria well.

Some names will not be covered

Whilst, there is likely to be some capacity for a well structured deal on a diverse pool of names, there are some names on which it will be almost impossible to obtain cover. AIG is one that springs to mind. There is some positive news from AIG. Asset sales seem to be back on, but prices are not great. A recent report from Citibank suggests that there is no residual value in the common equity. The great question is whether the commercial debt will be repaid in full. The Federal Government support of AIG has become too politically unpopular to continue. Uncle Sam wants his money back and is enforcing his seniority and repayment rights hard. BRAVE Partners believes that Uncles Sam will emerge with his money, but the firm (and the market judging by the price of AIG debt) have doubts about everyone else.

Critical factors in a deal

On the face of it all a buyer seeking to protect against the credit risk of their insurer needs to do is to buy a credit default swap on the carrier. The detail shows that this is not an appropriate strategy. In particular:

- The CDS tends to be on a holding company or finance company. Insurance or reinsurance tends to be written by an operating company. There is a basis risk between the two.
- The CDS does not cover some events that an insurance buyer would consider a risk, such as run-off.
- Credit investors will want reasonably short term finality on the risk. A typical credit investor will not wait around for ten years or more for a casualty claim to be settled in the US courts.
- Credit investors want credit risk not willingness to pay risk. The risk transferred to the capital markets has to be as clearly as possible the risk of the inability to pay of the insurer, not the risk of the willingness to pay. A credit investor does not want to participate in a coverage dispute. As the BRAVE partners commentary piece "Brace!", also available on this website, outlines, coverage disputes can be on quite subtle and intricate issues.
- Underinsurance and insured notionals.

Structuring to the issues

The BRAVE partners have detailed knowledge and involvement in a successful third party guarantee structure for reinsurance recoverables. The issues above were ultimately resolved by:

- Providing a bespoke insurance contract covering a loss from the inability of an insurer or reinsurers to pay a valid claim.
- A double trigger structure. The first set of triggers places the insurance contract on risk if there has been distinct and significant deterioration in the solvency of the insurer. The second set of triggers ensured that the contract only paid if the insurer was unable to pay a valid claim.

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- *A close out or settlement structure that included unresolved claims and IBNR. This allowed a final maturity of eight years at the worst on the structure.*
- *Clearly defined insured amounts and mechanisms, similar to homeowners and other insurance, to ensure that the credit coverage was not a first loss if the buyer under insured.*

- *Insurer and reinsurer credit risk is back on the buyers' agenda.*
- *The BRAVE partners have been highly involved in constructing successful transactions to mitigate reinsurer credit risk.*
- *BRAVE Partners can advise on methods for mitigating credit risk on insurance and reinsurance.*
- *BRAVE Partners through its network of contacts can provide high quality advice on managing insurance and reinsurance recoverable.*

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Performance of the structure

The structure outlined above has precisely the desired reaction to PX Re's demise. PX Re satisfied the first credit risk trigger, putting the contract on risk. However, the third party cover did not make any payment on PX Re because the company continued to honour its claims until they were all paid in full. In fact at one stage while PX Re fought to keep business it is rumoured that it was paying 150% of claims, that is pre-funding IBNR, in order to demonstrate its paying ability. Ultimately the rating agencies finished PX Re off by downgrading it to a rating where it could not attract business.

BRAVE Partners services

The BRAVE Partners have considerable experience in structuring third party guarantees for insurance and reinsurance recoverables. Through the BRAVE Partners' network of contacts, the firm has access to significant expertise in dealing with the collection of insurance and reinsurance from impaired and distressed companies.