

Catastrophe bonds are no longer 'the next big thing'. They have arrived, made their presence known and are here to stay. And we can be extremely proud in the Cayman Islands that the jurisdiction has astutely positioned itself as the premier offshore domicile for these ever-evolving transactions.

Catastrophe bonds – bridging the liquidity gap

by Simon Owen

These vehicles are a clear demonstration of the substantial benefits that can be achieved through the co-operation of two of the world's oldest and most influential financial services markets; the banking and insurance industries. In addition, the 'risk hedging' element of cat bond transactions has now attracted yet another influential industry familiar to the Cayman Islands, with hedge funds increasingly seeing participation in cat bonds transactions as being an invaluable method of creating much needed diversity in their investment portfolios.

However, despite the potential above average returns that fixed-income investors can earn from these transactions, it is important to remember that they also stand to lose their entire principal if the pre-defined loss conditions are met.

A brief history

Cat bonds have been used by some of the world's largest insurance and reinsurance companies since the mid 1990s, the first being a significant transaction involving AIG and Hannover Re.

Growth continued steadily until the collapse of Lehman Brothers in September 2008, causing a period of unwelcome disarray and uncertainty in the industry. Lehman's role as a counterparty in a number of cat bonds highlighted the relevance of credit risk in such transactions, starting a much needed shake-up in relation to collateralisation issues. As a result, posted collateral now tends to be in the form of US treasuries and AAA rated securities, hence restoring confidence amongst purchasers and investors alike. Tri-party arrangements requiring ongoing asset top-ups are also increasingly being used to further mitigate credit risk.

Despite the lull in business in the immediate aftermath of Lehman's downfall, it is now widely estimated that since 1997 cat bonds have provided over US\$30 billion of risk limit, with a sizeable percentage of that total being provided through recent transactions. In 2009 alone, 19 cat bonds were completed.

Why are catastrophe bonds now so widely used?

Essentially, the primary function of a cat bond is to provide catastrophe coverage to the likes of insurers, reinsurers, governments, municipalities and other potential beneficiaries that could be sizeably affected by catastrophic natural events. However, unlike the coverage available from the traditional reinsurance markets, cat bonds offer extremely liquid solutions, often providing payments in the hundreds of millions of dollars

within five business days of the occurrence of a covered event.

They have continued to evolve and grow in numbers. Since Hurricane Katrina, cat bonds have become increasingly popular and are considered to be an effective vehicle to provide creditworthy and liquidity for heavily aggregated risks. They take a variety of forms, including the following:

- Indemnity
- Parametric
- PCS Indexed
- Modelled
- Hybrid

The primary difference between the cat bond products is the type of 'trigger'. Generally, all of the above fall into one of two categories: indemnity and non-indemnity cat bonds.


Indemnity triggers can be likened to securitised reinsurance. They are triggered by actual losses in line with the specifics of the transaction. Many insurance and reinsurance companies prefer indemnity bonds. The more traditional structure ensures a lower level of risk because of the direct correlation between their underwriting results and the potential bond payment.

In contrast, non-indemnity cat bonds are far more speculative and take a number of different forms. For example, 'parametric' triggers are significantly more straightforward and are based on the parameters of a catastrophic event occurrence, such as a Category 5 hurricane hitting a pre-determined area. 'Modeled' triggers are generally based on a detailed study of what a potential loss might be to the issuer, including the effect of business interruption and damage. 'Indexed' triggers are normally linked to an industry loss as calculated by ISO Property Claims Services (PCS) or a similar agency. However, it is important to note that some indexes are far more parametric, with one such example being the Hurricane Index used on the Chicago Mercantile Exchange, which uses wind velocity as a measuring tool.

Realistic case study – Cayman Islands

In order to provide some further insight into the workings of catastrophe

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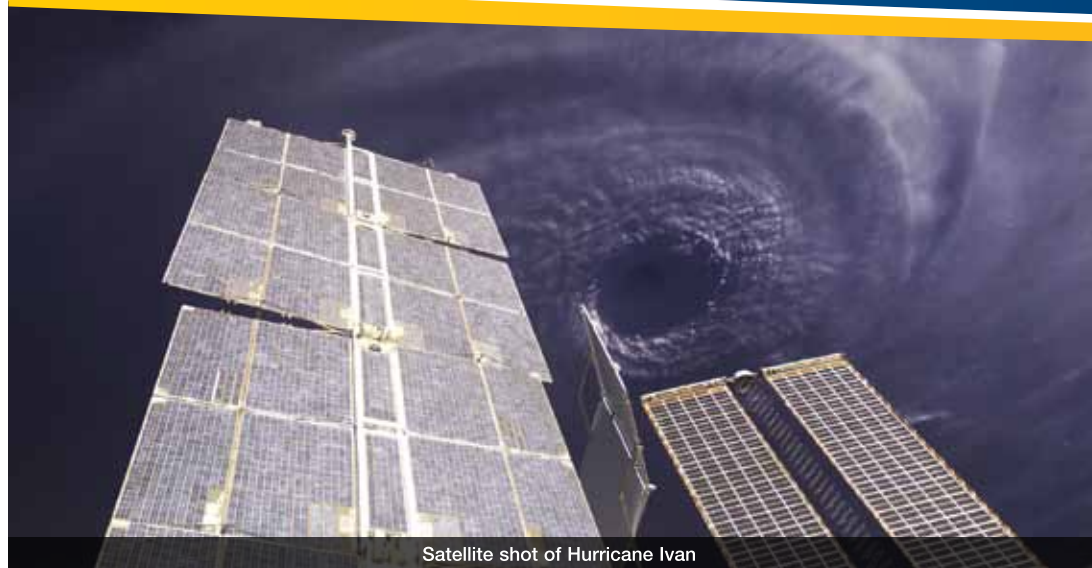
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Satellite shot of Hurricane Ivan

bonds as solutions in a realistic disaster scenario, it is worth considering how the Cayman Islands government, the industry's preferred transactional domicile of such, could actually benefit, from an actual purchaser's perspective.

Clearly, being located in hurricane-prone area of the Caribbean, it would certainly be feasible to suggest that a parametric non-indemnity cat bond, triggered by the size of hurricane event, would potentially offer significant benefit to the Cayman Islands in a time of need. Similarly, this methodology could also be applied to earthquakes and other catastrophic events to be covered by a cat bond.

In such a scenario, the main advantage of a parametric structure is the ability to recover a payment that could be far greater than total reconstruction costs and other financial losses incurred, creating additional funds that could be used as a valuable stimulus in what could become a faltering economy.

Settlement within three business days of the related index report also provides invaluable liquidity and immediate access to funds in the immediate aftermath of a major disaster. There is, of course, also the possibility that total bond payment could be less than the actual financial loss incurred. However, this is more of an issue for traditional cat bond buyers (insurers and reinsurers) as opposed to governments and municipalities.

From a structural standpoint, the transaction could involve defining Cayman Islands by means of a 'box' delineated by latitude/longitude. This could include as much or as little of Cayman Islands offshore space as is worth paying to protect. The smaller the defined area, the less chance of the protection paying, and vice versa. This is essentially a cost-benefit optimisation issue that both modelling and the related counterparty would assist with.

Typically, the payout values of this type of protection are 'graduated'. This simply means that if a weak hurricane (Category 2 or 3) were to hit the Cayman Islands, the protection would payout less than a hit by a strong hurricane (Category 4 or 5).

Conversely, the payout can be linked to any event of any size which affects Cayman Islands (a digital or binary payout). However, it is important to note this would be a more expensive protection. It would also mean that the bank would have to canvass investors to determine how much limit (notional) they could bring on those terms.

Future growth and market trends

To put the need for these products into perspective, the US Climate Prediction Center cut its forecast on 5 August for this year's hurricane period to 14 to 20 named storms, down from 14 to 23 on slower-than-expected activity in the first two months of the season. The predicted 20 storms in 2010 year would make it the third-most-active season on record. To date, the most-active season saw 28 storms in 2005, when hurricanes Katrina and Rita tragically hit the Gulf of Mexico.

From an investor's standpoint, as the forecasted "extremely active" US hurricane season was scaled back, catastrophe bonds values rose for six straight weeks. The Swiss Re Cat Bond Price Return Index rose 0.5 per cent to 95.27 on 20 August, as investors increasingly speculated that insurers would, resultantly, be less likely to collect on the securities. It was the biggest benchmark increase (calculated weekly) seen for ten months.

Given that last year's hurricane season did not produce a named storm until mid-August, record gains of 5.2 per cent were witnessed. However, to demonstrate how adverse events affect prices, the same Swiss Re Index, which doesn't reflect interest payments, fell 7.3 per cent in 2008 as a result of Lehman's failure and the damage inflicted by hurricanes Ike and Gustav.

Cayman – the leading offshore catastrophe bond jurisdiction

Having only listed its first catastrophe bond in 2007, the Cayman Islands' has achieved a remarkable level of growth in the sector, surpassing Bermuda's previous achievements.

According to figures recently released by

Cayman Finance, the Cayman Islands is now the leading offshore jurisdiction for listed cat bond transactions, with over US\$7.7 billion being listed on the Cayman Islands Stock Exchange.

Cayman's success in this regard is testament to the jurisdiction's continuing ability to provide user-friendly solutions to complex and sophisticated transactions. The cooperation and excellent working relationship between the Cayman Islands' Monetary Authority (CIMA) and private sector professionals remains a key factor of that success.

The end product is typical of Cayman Islands' other success stories and further enhances its reputation as a financial services centre of excellence. Catastrophe bonds provide yet another example of suitably regulated and fully transparent structures. In summary, Cayman has, again, demonstrated to the business world that it has both the regulatory and commercial expertise to provide the world with a viable and efficient solution.

Moving forward, one of the sector's next potential challenges is creating economically viable ways to reduce minimum transaction sizes to effectively create 'mini-cat bond' structures to widen their usage and increase availability.

As we endeavour to achieve this and locate an innovative jurisdiction to assist and partner with us, we need look no further than the Cayman Islands.

BIO: AT A GLANCE

Simon Owen is the founder and Managing Director of Hyperion Risk Solutions (Cayman) Limited, a specialist (re)insurance intermediary providing liability and D&O insurance to offshore funds and offering consultancy services to other structures, such as catastrophe bonds. He has worked in the finance industry for over 18 years, specialising in investment strategies and insurance and reinsurance solutions.



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