

CONVERGENCE

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In the year 2000, will insurance buyers purchase protection through investment banks using catastrophe bonds, derivative contracts or other financial vehicles? Will treasurers look to insurance companies to protect against fluctuations in foreign currencies and other financial risks? With insurance and capital markets headed full speed toward a so-called convergence, the answer to both questions appears to be yes, but to what extent, only time will tell.

This article is an introduction, the first in a series focusing on the convergence of the insurance and capital markets. The intent of the series is to demystify many of the aspects surrounding this convergence, to explain some current insurance-risk capital market transactions, to identify some of the players and to examine the potential impact on insurers, brokers and insureds.

Convergence Defined

The *Merriam Webster Dictionary* defines *convergence* as “the act of converging and especially moving toward union or uniformity.” This accurately describes the insurance and capital markets as each begins to enter certain sectors of the other’s business.

For example, insurance companies now issue insurance contracts for certain risks, such as financial risks, that were previously managed or hedged using capital market instruments. On the other hand, investment banks transfer to the capital market certain risks that previously were insured or managed by insurance or reinsurance companies. This mutual turf encroachment is evident in the number of transactions that have been completed by both competing markets over the last twenty-four months.

Insurance Markets

Insurance companies are invading the realm of financial risk managers. One example of the insurance market nipping at the capital market can be found in the much-touted Honeywell integrated insurance program (Carolyn T. Greer, “Who Needs Derivatives?” *Forbes*, April 21, 1997). The deal entailed a multi-line insurance program that provided coverage for certain property and casualty risks, as well as a basket of foreign currencies. Under the integrated risk scenario, the insurer issued a contract that covered decreases in the value of the basket of foreign currencies and certain p/c losses above a predetermined retention level. Ideally, the program will result in savings over the existing insurance costs for the p/c risks and the hedging costs for the foreign exchange risk.

Clearly, insurance companies have begun to challenge investment banks by “insuring” foreign exchange and other financial risks. But continued movement onto the financial risk side is contingent on the acceptance of integrated risk programs by buyers, the state of the insurance market, the clearing of accounting hurdles (e.g., Financial Accounting Standard Number 133) and the resolution of turf battles between insurance risk and financial risk managers.

Capital Markets

Investment banks and other financial institutions are likewise hungry for new insurance-related business. For example, over the past two years, a number of catastrophic insurance risks have been transferred to the capital markets through insurance-linked securities. One vehicle used by insurance and reinsurance companies to transfer earthquake, wind-storm and other catastrophic risks to the capital markets is the catastrophe (CAT) bond. Under the CAT bond scenario, investors purchase the

The insurance and capital markets are moving closer together. The point where they meet is full of opportunity.

An introduction to a series of articles that will explore the subject in depth.

bond and exchange a principal payment now for future coupon (interest) and principal payments. These payments are contingent on loss experience or the occurrence of a specified catastrophic event. If the bond is not triggered, the investor receives full coupon and principal payments over the life of the bond. If the bond is triggered, the investor may lose the right to future coupon payments, principal payments or both, depending on the type of bond. Organizations employing CAT bonds or similar instruments to transfer insurance risk to investors include USAA, Tokio Marine, Swiss Re, Reliance and Winterthur (*Investment Dealer's Digest*, December 21, 1998).

Other examples of capital market-related transactions include risk swaps, catastrophe equity put options, exchange-traded options and others. Future articles in this series will provide details and examples of CAT bonds and other insurance risk capital market transactions.

The Impact

Why are insurers and investment banks entering each other's businesses? From the insurer standpoint, the soft market has forced them to be creative in order to increase profits or maintain market share. They are looking to underwrite financial and business risks that historically have not been insurable. Additionally, insurers are exploring less expensive methods of risk transfer and seeking experience and market share in the new capital market transaction arena. The capital markets are looking for additional investment opportunities and a potential new asset class uncorrelated to the stock or bond market. And, convergence is an ideal model for the corporate trend toward enterprise risk management—managing uncorrelated business risk through a systematic, coordinated process.

But the more pertinent question at this point might be: What will convergence mean for the players in the insurance industry?

For insurance and reinsurance companies, convergence will likely mean additional competition from

nontraditional players such as investment banks and investors. Several, such as Lehman Brothers and Goldman Sachs, have already started insurance risk groups. Others have formulated similar operations or are in the due diligence stage. In the long run, convergence could result in insurers and reinsurers losing market share to insurance risk capital market transactions.

But there are also opportunities for insurers. Insurance companies such as AIG, X.L., CIGNA Risk Solutions and Zurich offer integrated insurance products that cover financial risk in direct competition with financial institutions. And many insurers and reinsurers have formed financial risk groups to compete in the insurance-linked securities market, including Swiss Re, Zurich, General Reinsurance, AIG and others. The ability to quickly adapt to these opportunities will ultimately determine the impact of convergence on a particular insurer.

For brokers, convergence also spells contest and possibility. The foray by investment banks into the insurance business includes using reinsurance brokerage operations to facilitate insurance risk transactions. These brokers could compete directly with insurance brokers on the reinsurance side of the business. Alternatively, Aon, Marsh and others have established specialty groups to play in the insurance-linked securities sandbox. Could both insurance brokers and investment banks foresee a new asset class in this risk? Insurance brokers will likely play a role in facilitating or originating insurance risk capital market transactions by packaging risks with specific characteristics to sell to interested buyers. This risk originator's role, similar to the role of mortgage bankers, could also be played by insurers. In the long term, insurance brokers could package and transfer risk to either market, whichever offers the more cost-effective alternative.

From the insured's perspective, changes include new product offerings from insurers and potential opportunities for the transfer of insurance-related risk using securities or

derivatives. Innovative offerings include the aforementioned integrated products for certain financial, business and weather risks, as well as other nontraditional products such as earnings protection.

The day has already passed when an insured packaged p/c risk for transfer to the capital markets (see details on page 25); the day when an insured combines p/c risk and *other* risks to transfer to the capital markets may not be too far away. In fact, Toyota recently initiated one incremental step toward such transactions. It transferred the residual value of certain leased assets to the capital markets. Although the residual value of leased assets is not p/c risk, the near term could bring the same type of thinking to the insurance arena.

For the moment, however, although insureds have shown significant interest in learning about and understanding the new integrated risk and capital market alternatives, very few have opted for these alternatives over traditional insurance in this soft market.

Future

What convergence ultimately means for the insurance industry remains to be seen. At this stage, increased competition, potential new business opportunities and additional risk transfer alternatives are already direct results of the trend.

Throughout this series we will examine in greater detail the impact of convergence on insurers, brokers and insureds. We will also highlight examples of specific capital market transactions and how they might play a role in an organization's risk management program with expert perspectives and experiences from both the capital and the insurance markets.

Hang on. The only thing certain about the convergence of these sectors is change.