Growing the core

(Re)insurer interest in CRTs is rising, but execution of unfunded transactions remains limited. **Corinne Smith** outlines the hurdles that still need to be overcome.

The participation of (re)insurers in the capital relief trades market is seeing continued growth, with an estimated 30 unfunded deals anticipated to close by year-end. Nevertheless, unfunded protection providers still only account for a market share in the single-digits. While (re) insurers undoubtedly have a long-term role to play in the significant risk transfer space, a number of hurdles need to be overcome for its potential to be realised.

"Recent activity does indicate that the placing of mezzanine credit risk into the insurance markets has become a more common feature of SRTs of late. Although there are perhaps a small group (less than 10) of (re)insurers currently participating in the SRT market on a regular basis, we are seeing a lot of interest from (re)insurers outside of this core group," confirms Riz Sheikh, head of portfolio and risk transfer solutions at BPL Global.

He adds: "There are over 70 (re)insurers active in the single-risk CRI market and many of them have been following developments in the SRT markets for a number of years. A big future driver for (re)insurer appetite will be the ability to generate a diversified income stream from an already familiar bank issuer."

Giuliano Giovannetti, md at Granular Investments, agrees that (re)insurers are showing more interest in CRTs. But he notes that the number of (re)insurers actually executing trades is still relatively limited.

"(Re)insurers remain very cautious about dealing with banks on the credit side, due to the financial crisis. In particular, asymmetry of information is a concern. Consequently, there is a need for education around financial guarantees and that the product demonstrates consistently good performance and minimal losses," Giovannetti says.

Riz Sheikh, BPL Global

Credit insurance represents around 1% of (re)insurers' portfolios. Given that credit is already a small segment, Giovannetti describes synthetic securitisation as "a drop in the ocean" for (re)insurers.

As such, it is crucial to get board-level buy-in. "Even if there is appetite to carry out a CRT, a (re) insurer needs the approval of the underwriting committee, which sees 50 other lines of business and may perceive other transactions as more relevant. There are always excuses not to do a deal, so it requires conviction and a champion higher up," Giovannetti explains.

The growing participation of the insurance market in capital relief trades is nonetheless a reflection of the increase in issuer demand for capital relief risk-taking capacity from both the funded and unfunded markets, according to Sheikh. "Bank issuers are increasingly looking to broaden and diversify SRT distribution channels, including into the insurance markets. During execution, bank issuers are willing to explore the efficiency of various SRT distribution options, including analysing the outcome of funded execution versus a mix of funded into the debt capital markets and unfunded execution into the insurance markets," he explains.

At the same time, from a (re)insurer perspective, the SRT product – especially at a senior mezzanine attachment point, due to loss expectations being more remote – can be appealing for a variety of reasons. For example, the ability to leverage existing bank client relationships and familiarity of a bank's origination and servicing processes from the single-risk credit risk insurance (CRI) product.

"Moving to provide portfolio-level solutions is, I think, a natural evolution for insurers already participating in the single-risk CRI market," Sheikh observes. "Furthermore, specific underlying loan eligibility criteria mean that a good credit quality portfolio is selected at inception. Therefore, the inherent credit risk in a portfolio can be understood and managed."

He suggests that senior mezz – at a 6%-plus attachment point, subject to asset class and appetite – is a natural place in the capital structure for (re)insurers to participate in the SRT market, at least for those seeking to enter the market and establish a long-term presence.

While unfunded CRTs are simpler than funded deals from a contractual perspective, Giovannetti indicates that in reality, banks have a natural tendency to accommodate hedge funds. One reason is that insurers typically need more time to get comfortable with a transaction than funds.

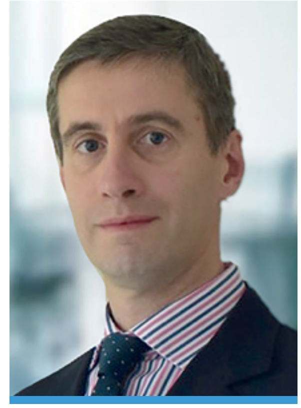
"There is potentially more (re)insurer appetite than deals, but the CRT industry needs to be able to execute consistently for this to materialise. It will take effort and dedication by banks to make their pipeline available: why should insurers invest in building the infrastructure for CRTs, if only a trickle of deals is available?" asks Giovannetti.

He cites the GSE CRT market in the US as an example of the potential for (re)insurer involvement. "Europe is moving slowly in the right direction, but it takes commitment from both sides. It's about building trust and confidence that execution can be successfully reached: CRTs should be a repeat game, so it's important to realise that you can't win at the expense of your counterparty."

"MOVING TO PROVIDE PORTFOLIO-LEVEL SOLUTIONS IS, I THINK, A NATURAL EVOLUTION FOR INSURERS ALREADY PARTICIPATING IN THE SINGLE-RISK CRI MARKET"

(Re)insurers already have the in-house actuarial and modelling capability to analyse portfolio credit quality and develop pricing models for CRTs, given their capital requirements. Where brokers can help is to facilitate (re)insurer development of specific CRT product expertise. That can include both providing general background on the product and regular updates on the market, as well as transaction-specific assistance on due diligence materials, regulatory requirements, structural features and enhanced data analytics on the portfolio and modelled loss outcomes.

"Insurance brokers can provide a variety of services to bank issuer clients, which can broadly be categorised as advisory, structuring, arranging and distribution," says Sheikh. "More specifically, as well as providing access to new (re)insurance



Giuliano Giovannetti, Granular Investments

capacity and managing syndication, a broker with the right expertise and broad access to the insurance markets can provide portfolio data analytics, model loss outcomes, facilitate due diligence of the issuer, review legal documentation and commercially negotiate terms. In order to effectively provide these services, a broker needs to have the in-house capability to ensure these transactions are being approached with the right blend of product expertise, deep insurance market knowledge and real transaction execution experience."

Meanwhile, as an intermediary, Granular Investments has a duty of care towards both (re)insurers and banks. But one particular value-add that the firm provides is to articulate upfront the concerns of a given (re)insurer, while explaining to them which aspects of a deal can be negotiated.

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