HOW TO PROMOTE EFFICIENCY

CAPITAL CONTINGENCY IS JUST THE THING TO HELP TREASURERS AND INSURANCE RISK MANAGERS KEEP THEIR FIRMS ON THE RIGHT FINANCIAL TRACK, SAYS **HENRY KUS, DAVID COLAROSSI** AND **LEE MULLER** OF CHUBB FINANCIAL SOLUTIONS

As organisations strive to maximise efficiency, many corporate treasury and insurance departments are combining under common management, creating new synergies and opportunities. This article spotlights one such opportunity – contingent capital – examining how the corporate treasurer and insurance risk manager can leverage their combined knowledge and core competencies by accessing contingent capital – and optimise overall financing efficiency.

A MATTER OF PERSPECTIVE. The difficulties facing both the treasurer and the insurance risk manager in today's environment are reflected in the observations one typically hears from each. While the jargon used by each may differ, the ultimate challenges are very much the same, namely:

- lack of available liquidity;
- lack of capital/risk transfer capacity;
- more exclusions/covenants; and
- higher costs.

Corporate financing and insurance capacity need to be opportunistically sourced and applied with precision. When credit was easy to obtain and insurance markets were soft, corporations could afford to over-indulge on financial and risk transfer capacity. As markets have contracted, however, such luxury has become impractical and unaffordable. Traditional products that address low frequency, high severity risks may no longer offered by insurers, banks or the capital markets at a cost that CFOs and risk managers can tolerate.

Contingent capital is specifically designed to address these risks at a cost that makes sense. However, in order to maximise the efficiencies, the product should be applied to risks that are remote in frequency and significant in severity, but not highly correlated with the viability of the company.

The probability of a company drawing on the contingent capital should be quantifiable and remote. Even if remote, though, a 'drawing event' which is closely correlated with the viability of the company diminishes any cost efficiency. Contingent capital can be offered at a more efficient cost because it is capital held against specific risks of a company rather than all risks of a company. However, if the specific risk is highly correlated with the total risk of the company, the cost benefit is lost.

Perhaps this is clearer if we look at the extreme. For any capital investment, debt or equity, the risk an investor takes is default and recovery. If we make the conservative assumption of zero recovery, then we can assume that 'default' represents the total risk of an investment in the securities of the company. Therefore, the risk of a contingent capital facility with a default trigger is 100% correlated with the total risk of the company. If this were the case, the cost of such a facility would be similar to the cost or required return on a direct capital investment. The contingent capital, in this case, would be priced like more traditional products, such as letters of credit and credit default swaps, etc.

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If, instead of a default trigger, the contingent capital facility had a trigger that would shield the facility from some potential default scenarios, then the price of that facility would decrease commensurately with the decreased risk. For example, a facility that can only be drawn after a property loss could provide preferred equity capital to a company in need of solvency support after such an event. However, such a loss, though significant, may have little correlation with the prospects of the company.

There are many scenarios where this company could go bankrupt without ever triggering the facility. In this case, the contingent capital facility is providing capital support specifically for the property risks of the company rather than all risks of the company and, as such, will be less expensive than other more traditional types of capital support. To be clear, a contingent capital facility will be drawn under adverse circumstances, but it is priced more efficiently because it cannot be drawn under all adverse circumstances.

CONTINGENT CAPITAL APPLIED. Such circumstances are not as rare as you might think. Just take a look at the last decade. Extreme economic volatility, unexpected declines in the financial markets, natural catastrophes, operational risks, credit events and terrorism each could present CFOs and risk managers with extraordinary losses that do not come from core operations, but could have a significant impact on the viability of the company, in terms of capital or merely market perception.

Consider a company that may have had significant credit exposures to the European airline sector. Following 11 September 2001, the market punished anyone with such exposures. The company's business prospects may still have been good, but its solvency position and the market's perception could easily have impaired the company's ability to do business. If the company could announce that it has bought protection against such events by putting a contingent capital facility in place – one that would protect the company's capital base from a loss because of the potential default of an airline – it would likely alleviate the markets' concerns.

Even if all airline exposures could not be covered because some airlines were too close to default (that is, too likely to occur), the transaction would limit exposure and likely receive the same favourable response. In such an example, the remoteness of the event and low correlation with the core business could result in efficient pricing.

Another compelling application of contingent capital is in connection with the captive insurance industry. The current insurance/reinsurance environment, with increased deductibles, lower loss limits and more exclusions, has increased the amount of risk that a captive or parent company is now forced to retain. Insurance risk managers may wish to retain all of this additional risk in the captive. However, increased capital requirements must then be addressed. In this financial environment where capital costs are at a premium, many financial managers balk at increasing their capital investment in the captive, having no desire to commit scarce capital to cover remote business risks.

Instead of the parent company making an up-front capital investment in the captive, a provider of contingent capital (usually a re/insurer) can commit to provide 'qualifying' capital to a captive in the event that the captive suffers an insurance loss in excess of a predetermined threshold. In other words, an insurance loss would trigger capital from the (re)insurer on pre-agreed terms, therefore managing the increased risk at the captive without requiring a further capital infusion by the parent.

The practical advantages to be gained by managing such risk through a captive insurance company backed in part with contingent capital are several:

- Since insurance issues are dealt with through the captive insurance company, there is little impact on the accounting, tax and legal treatment experienced by the parent company. The parent benefits from an optimised insurance programme.
- The parent and its captive are well positioned for future insurance market cycles. As traditional capacity becomes available at acceptable pricing, captives can substitute traditional risk transfer for contingent capital. Alternatively, as markets harden, companies have a facility that does not hold them hostage to rising prices.
- Since capital cannot be transferred to and from the captive without triggering a multitude of tax and regulatory issues, contingent capital minimises the risk of overcapitalisation of the captive.

CAPITAL: THE INVENTORY OF THE NEW MILLENNIUM. These are but a few examples of how contingent capital can be a beneficial risk and capital management tool. Contingent capital could be and has been applied to situations as varied as economic downturns, financial market volatility, regulatory capital relief, unexpected municipal cashflow shortfalls, residual markets and catastrophic property and/or credit scenarios.

In the extreme, it could be argued that all capital not related to core operations should be contingent. Banks and investors provide capital to companies based solely on the credit worthiness and earnings power of those companies. In these volatile times, the cost of such capital can be prohibitive. So what if a company held only enough paid-in capital necessary for core operations at a level consistent with expected results?

What if all capital required for unexpected events, deviations from the norm, were provided on a contingent basis at a cost consistent with its form (debt or equity) but, as with contingent capital, adjusted for its likelihood of use and correlation with the company's credit condition? The result would be lean, more profitable companies with significantly reduced costs and with no significant increase in their risk profiles.

Can we reasonably expect these 'virtual capital' companies to appear any time soon? Not likely. But just as many industries over the past 20 years have purged large physical inventories from their balance sheets, wouldn't it make sense for companies to consider purging their balance sheets of large capital inventories as well? Contingent capital may serve this purpose.

For companies seeking to enhance financial efficiency and exercise prudent risk management through this difficult financial and insurance cycle, contingent capital is an effective tool that merits careful consideration.

Henry Kus is Managing Director of Chubb Financial Solutions Representative Services Ltd.
hkuss@chubb.com

David Colarossi is Vice President of Chubb Financial Solutions
dcolarossi@chubb.com

Lee Muller, Managing Director of Chubb Financial Solutions
lsmuller@chubb.com

www.chubbfsi.com