THE MYSTERIOUS WAYS OF STRUCTURED INSURANCE.
CROSS-SECTION RISK TRANSFER AND CRISSES, FROM FINANCIAL TO PURE RISK SECURITIZATION

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Structured Insurance is mainly the result of the so called Alternative Risk Transfer, that is the process through which insurance companies, and non financial firms afterwards, forward to the market the quota share of pure risk they wouldn’t or couldn’t keep (Life-insurance Securitization and CAT bonds issuing are good examples, this time). Recent experience of western economies demonstrated that, whenever transparency levels lower, and supervision is stressed by financial innovation, it leaves enough space for information asymmetries concentrate risks within groups of unaware investors. An effective control of information asymmetries seems to be the focus, together with a way back to the specialization of functions that convergence of Insurance and Financial markets destroyed during the last decades, so making the cross-sector risk transfer.

Keywords: Structured Insurance, Structured Finance, risk transfer, risk securitization.

Introduction

During the last few years the most of developed economies experienced great changes, and a series of financial reforms took place in the financial sphere; at the same time they were victims of some of heaviest financial storms and crises of the history. That was the period when the most of financial innovations and new instruments were invented and spread over the markets, the period of financial derivatives, and the season of the cross-sector risk transfer (between banks and insurance companies, for instance). In other words, the age of “Structured Finance”, which dreamed up financial instruments more and more difficult to understand, and designed new ways and alternative channels to transfer the risk.

The aim of this contribution is the attempt to explain which mechanisms boost financial instability through these new instruments.

Structured finance versus structured insurance

Let’s start by looking at the differences between what we usually call “Structured Finance” and what we call, on the other hand, “Structured Insurance”. The diagram illustrates these differences in terms of the needs they originate from, aims and instruments.

What is Structured Finance ? That is the process by which firms and financial intermediaries raise funds in a nontraditional way, altering their risk profile in the process. In other words, SF is the way the firms raise funds in a manner that is independent of their fundamental creditworthiness, thus enabling them to raise funds at a cost which is independent of their overall risk profile as well. Securitization is a good example of how banks would get free themselves from bad loans, by securitizing them in order to sell consequent bonds to the market by mean of a SPV. This way they shift risk off-balance, so obtaining a better risk profile and some sort of credit enhancement (this is also the first kind of securitization appeared on the scene many years ago).

In general, we may describe Structured Finance as a process which is devoted to allow Credit and Financial Risk shifting or Hedging, and to provide a wider range of speculative opportunities for counterpart investors. That’s a matter of speculative risk.
Structured Insurance, on the other hand, is mainly the result of the so-called Alternative Risk Transfer, that is, the process through which insurance companies and non-financial firms forward, forward to the market the quota share of pure risk they wouldn’t or couldn’t keep (Life-insurance Securitization and CAT bonds issuing are good examples, this time). Again, resulting bonds may represent an interesting investment opportunity for buyers. That’s a matter of pure risk, anyway.

So that we have speculative (credit/financial) risk, on the one hand, which is a prerogative of banks and enterprises chiefly, and pure risk on the other hand, which is a prerogative of insurance sector (see below).

**A taxonomy of risks and actors**

The taxonomy of risks is virtually endless, as we may distinguish not only pure and speculative
The mysterious ways of structured insurance

risk (as we have just done), but also static and dynamic risk, particular and fundamental, financial and non-financial risk, and more specifically credit risk for banks, and technical or actuarial risk for insurance companies.

The figure summarizes risks, actors and strategies.

The following graph is rather to illustrate the Traditional Way of risks routing between actors, what we call “Managed Finance” (in contrast with the New Way Structured Finance would constitute). It assumes that Credit Risk Securitization is part of “tradition”, as you can see, whereas no alternative risk transfer is working yet.

The new paradigms and the market

The first evidence that something is changing, as Structured Finance does become established, is the reciprocal contamination between different kinds of intermediaries; specifically Banks and Insurers. If Traditional Way assumes that Banks deal with credit and speculative risk, and Insurers with pure risk, the New Way traces a completely different scenery, where about everything becomes possible. Hybrid policies ensue, capable to serve investment and speculative needs, besides their (core) security function; as well as in the opposite field new financial instruments try to face precautionary
intends. At the same time, banks begin to act as policies sellers (*Bancassurance*), and Insurers – few years later – begin to act as retail bankers (*Insurbanking*).

The whole process, starting at the mid nineties, speeds up during the last few years, and brings a series of novelties; namely …

1) An increased role of the market in subscription of both financial and pure risk, as Securitization involves/contaminates insurance sector also;

2) A “cross-sector, or diagonal risk transfer, as financial risks become insurable to some extent, and pure risks enter financial portfolios in order to obtain a better diversification;

3) New intermediaries emerge, whose function is just to manage instruments conceived to unload balance-sheets of firms and intermediaries through Securitization (the *Special Purpose Vehicles*);

4) New instruments, new markets and a considerable development of OTC markets;

5) Higher complexity level as far as terms and conditions, as “linked instruments” spread over;

6) A reduction of the transparency, which emphasizes asymmetric information consequences;
7) A late reaction of supervision, whose inadequacy to control side effects of innovation becomes manifest.

This is also when the “words of Structured Finance” get around everywhere: linked, baked, covered, collateralized, securitized, insured, alternative, transformed, repackaged, replicated, synthetic, contingent, hybrid, OTC, parallel, gray, and more. None of them reassuring; all of them arousing a lack of transparency, in some way.

The next figure illustrates the new scenery deriving from Structured (instead of Managed) Finance. If you compare it with the preceding one, you may verify a massive shifting of risks (core risks in some cases, especially for intermediaries) to the market, through Securitization.

**Inside the jungle of threats**

Many of the changes we have been describing till now did not produce the benefits one could have expected. That was mostly because these innovations, that were born as hedging instruments or means to improve diversification opportunities, or increase market efficiency, have been used for different purposes.

They became full-relief speculative instruments in fact, often baked by puzzling or problematic assets (as bad loans, junk bonds, or other inscrutable structured products). Moreover, they became very attractive, as they guaranteed high returns against a risk whose size was difficult to evaluate, owing to the information asymmetry. They have been “plain-sailing” investments as long as markets were performing for the better; but they revealed themselves losing money thingamabobs, as markets fell into crises.

**The past.** You know the story of mortgage debts, CDOs, CDSs, Synthetic CDOs et cetera, I wouldn’t you get bored; let me just recall the “failure way” and the channel for crises propagation.
And you also know how is that an unaware policy holder, seeking for pure-risk protection, remains with a burden of underestimated financial risks he wouldn’t face. That is what happened with linked products (unit, index, and other).

The Future. Let’s imagine, now, what kind of systemic risks is ahead. I would give you just two examples: the first is concerned with the Insurance Linked Securities; the second with the so called “Life Settlement”.

As far as non-life sector, ILS (CAT bonds for instance) have been always described as a powerful instrument to allow diversification, since pure risks outcomes result uncorrelated with financial dynamics. That’s true. So, where is the risk?!

Well, a proper use of these instruments, e.g. till them are issued by Insurance Companies and sold to Institutional Investors, doesn’t constitute any problem. But a problem which is exactly the same we have been witnessing with subprime loans could emerge if those pure-risk indexed, securitized instruments are sold by industrial firms (in order to alternatively transfer the risk) to retail, unaware again, investors. And it seems quite probable, as financial engineers are now redirecting their interest from credit and financial risks to pure risk, in order to structure their nested, asset baked instruments.

In the life sector, on the other hand, we have again some sort of threatening securitization, and this is what they call Life Settlement. With the LS, a LS Provider gives a whole-life policy holder the possibility to opt out and get the discounted value of the policy cash, before death. The policy holder has no more to pay premiums, and he can alternatively allocate his money to heirs, or invest it as he wishes. The provider, who gains the right to be paid on policy holder death, securitizes a series of these policies, raised from (how to call them !??) “hopefully moribund” people, and resulting securities are sold to the market or used to index derivatives.

There is probably no need to go on with our example, to understand what kind of risk is hidden in such an instrument. It’s worthwhile to focus on the following paradox, anyway.

Let’s imagine that the policy holder would invest his discounted value buying structured, asset baked products, where the assets are units of a securitized portfolio of life policies, including his own settled policy … that would be as one would bet on its own death ( ! ).

Conclusions

So, what conclusions we may draw from the above discussed arguments !?

Recent experience of western economies demonstrated that, whenever transparency levels lower, and supervision is stressed by financial innovation, it leaves enough space for information asymmetries concentrate risks within groups of unaware investors. And these risks may serve to index asset baked retail products. These instability pockets, some sort of cushions for intermediaries who wouldn’t keep their own core-business risk, may remain “silent” for even long periods, but they are sooner or later destined to blow up, and spread over financial markets their adverse consequences.

An effective control of information asymmetries seems to be the focus, together with a way back to the specialization of functions that convergence of Insurance and Financial markets destroyed during
the last decades, so making the cross-sector risk transfer a priority which has probably to be rethought over.

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