



# **Rendez-Vous de Septembre 2008**

**Insurance Linked Securities  
as an Investment Class  
to Help Optimise Portfolio Returns**

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**LEHMAN BROTHERS**

# Introduction

## Key Messages

- ◆ Insurance Linked Securities (“ILS”) are a relatively new but rapidly growing asset class
- ◆ ILS can be used by investors to enhance their portfolio returns
  - Limited/lack of correlation with stocks and bonds enhances portfolio diversification
  - Higher spreads than comparable corporate and asset-backed securities result in higher portfolio yields
- ◆ Growing investor base and increasing investor demand provide more liquidity
- ◆ Resilience to current challenging market conditions demonstrates the diversification benefits carried by ILS

# Typical Insurance Linked Securities

## Non-Life ILS

### Catastrophe Bonds

- ◆ Typically, floating rate notes whose principal is written down if pre-defined natural catastrophe trigger conditions are met

### “Short-tail” P&C Bonds

- ◆ Typically, floating rate notes whose principal is written down if pre-determined loss ratios across a (re)insurer’s portfolio are exceeded

## Life ILS

### EV Monetisation

- ◆ Floating or fixed rate notes where future insurance profits on a portfolio of policies are used as the security for payment of coupon and repayment of principal

### Mortality Bonds

- ◆ Typically, floating rate notes whose principal is written down in a pre-defined scenario of extreme mortality

### Redundant Reserves

- ◆ Notes where the difference between the regulatory provisions and the true economic reserves is used as the security for payment of coupon and repayment of principal

### Life Settlements

- ◆ Notes where the difference between the sum assured and the policyholder settlement can be used as the security for payment of coupon and repayment of principal

# Using ILS to Optimise Returns

**Insurance Linked Securities could help optimise returns through their non-correlation with other asset classes and high coupons**

## Key Investment Characteristics of Insurance Linked Securities

### Uncorrelated Insurance Risks

- ◆ Insurance risks are largely uncorrelated to stocks and bonds
  - ILS provide returns which are uncorrelated with the returns on other investments in fixed income or equities
- ◆ In addition, ILS do not carry the risks associated with an investment in the equity or debt of a (re)insurance company



**Improved Portfolio  
Diversification**

### Potentially High Coupon

- ◆ ILS generally pay higher interest rates (in terms of spreads over funding rates) than comparably rated corporate instruments, as long as they are not triggered



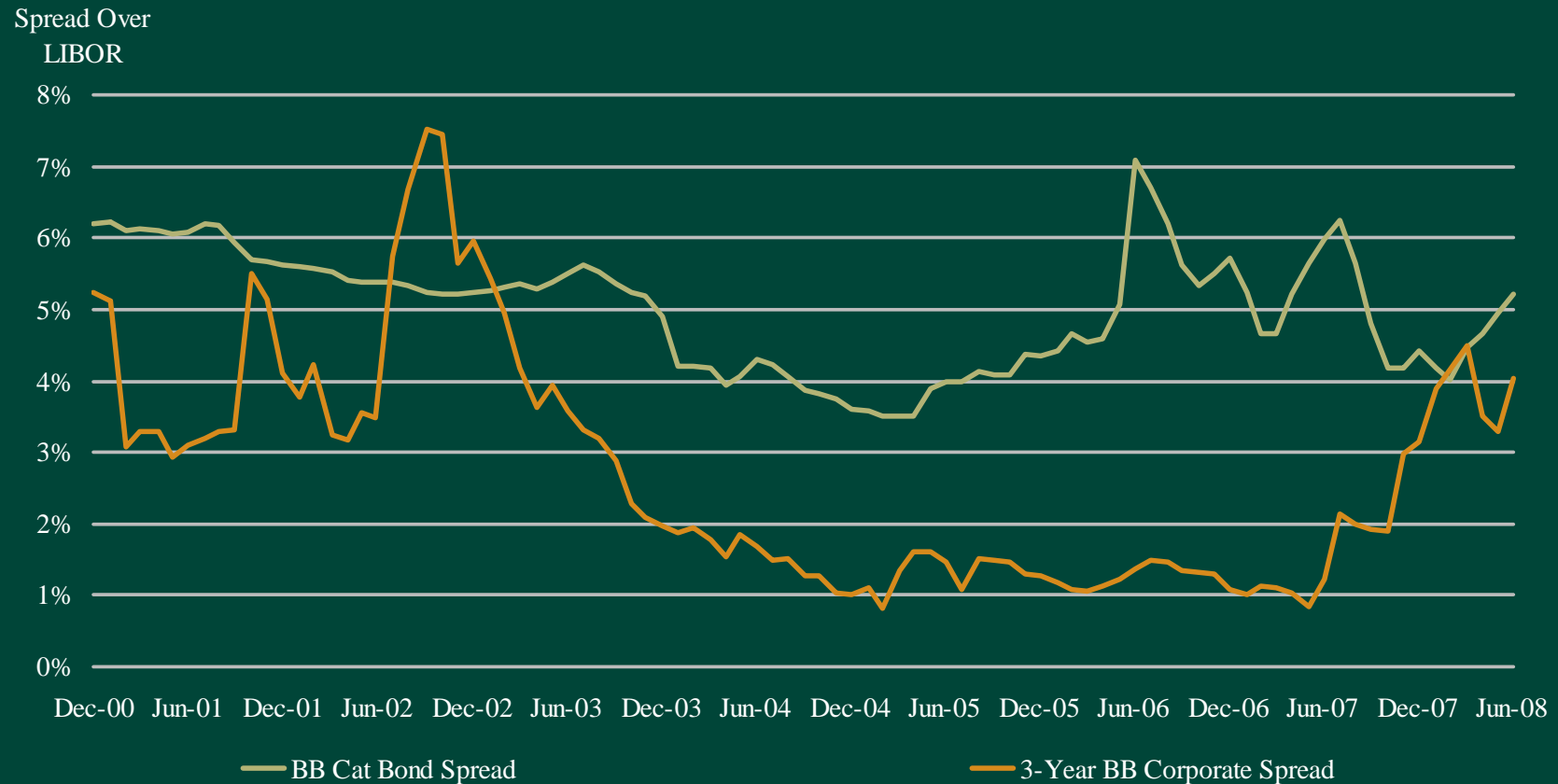
**Higher Portfolio Yield**

**Enhancement in Portfolio Return**

# Example of ILS Non-Correlation

The catastrophe bond market has proven to be uncorrelated with other financial assets, even during the subprime crisis

Average BB Catastrophe Bond Spreads<sup>(1)</sup> vs. BB 3-Year Corporate Spreads<sup>(2)</sup>



1. Source: Lehman Brothers trading desk.
2. Source: Lehman Brothers Fixed Income Analytics.

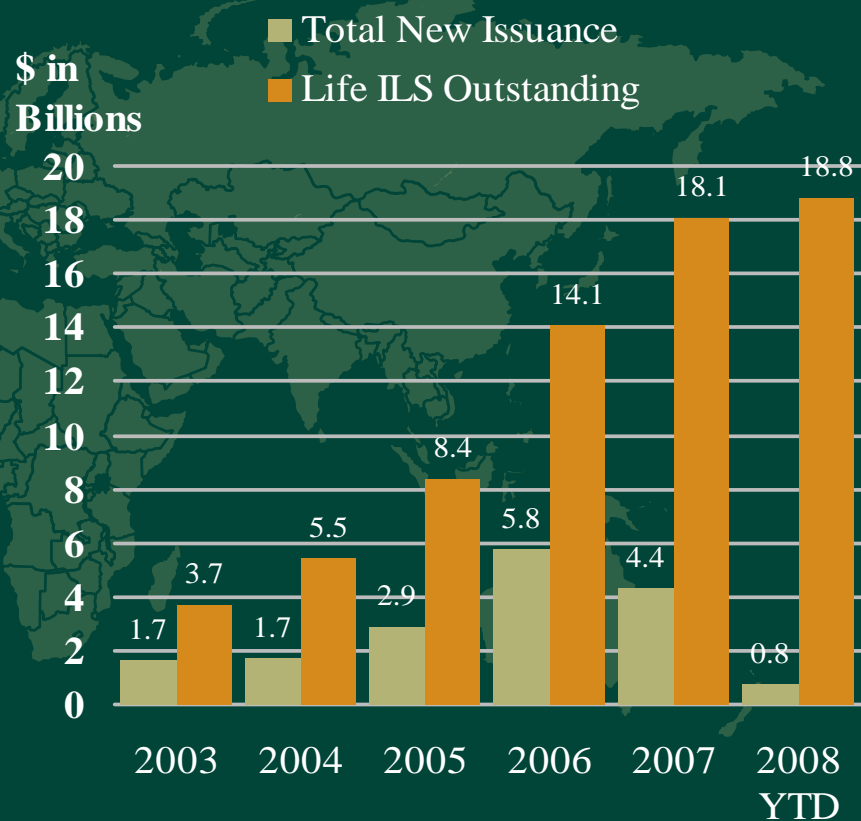
# Market Size Overview

**Both life and non-life ILS have shown a rapid growth over the last few years. Non-life ILS issuance continued even during the current market turmoil**

Catastrophe Bonds Amounts<sup>(1)</sup>



Life ILS Amounts<sup>(1)</sup>



1. Source: Lehman Brothers. Includes transactions priced as of July 31, 2008. Excludes sidecars and recourse deals.

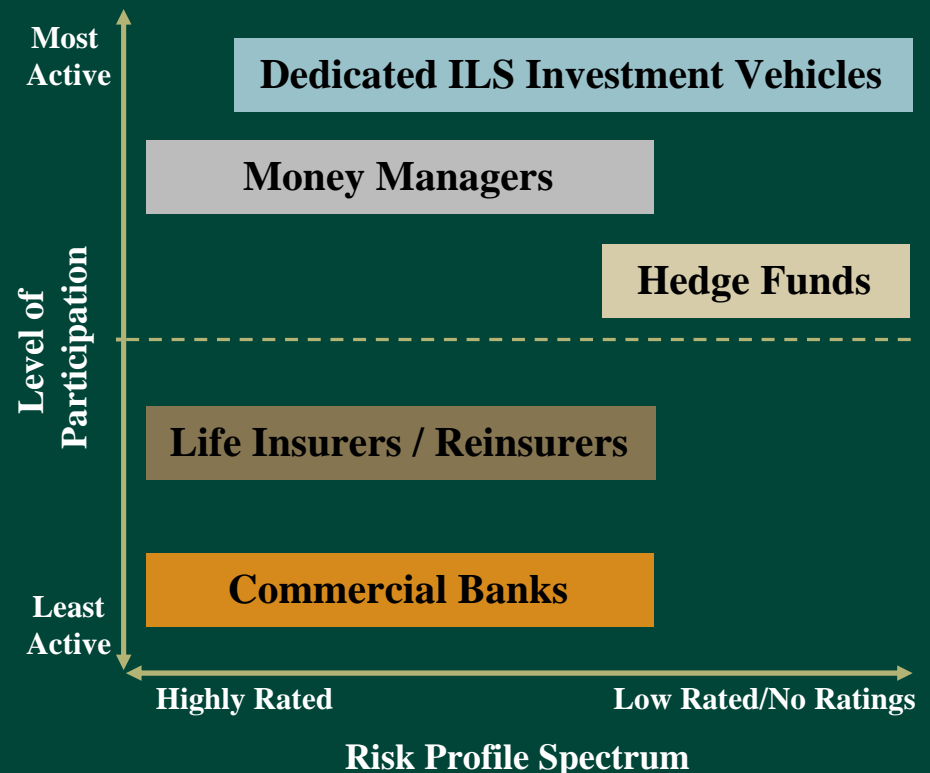
# ILS Investor Base

**New investors continue to be attracted to the ILS sector, with more new dedicated ILS investment vehicles being set-up**

## Investor Base

- ◆ Key categories of investors who participate in the ILS market include:
  - Hedge funds
  - Dedicated ILS investment vehicles
  - Money managers
  - Life insurers / Reinsurers
  - Commercial banks
  - Other investors
- ◆ New investment vehicles focusing on ILS continue to be launched:
  - Juniperus Capital Ltd launched on 27 May 2008
  - Amlin announced in May 2008 its intention to invest in a new venture focusing on ILS

## Investor Characteristics



*Source: Lehman Brothers.*

# Challenges for ILS Investors

## Market Size / Liquidity

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- ◆ The ILS market is small compared to
    - banking securitisation industry
    - total risk held by the (re)insurance industry
- However* →
- ◆ ILS is becoming a rapidly growing asset class
    - Increasing demand from investors
    - Resilience during current market conditions
  - ◆ Increasing liquidity in ILS
    - A growing and active secondary market

## Understanding Insurance Risks

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- ◆ Insurance business is perceived as
    - Opaque
    - Complicated
- However* →
- ◆ More data/info is available with ILS
  - ◆ ILS investors are becoming more sophisticated, utilising actuarial and insurance expertise

## Current Market Turmoil

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- ◆ Current challenging conditions could impact the growth of ILS
- However* →
- ◆ Capital markets have remained open to ILS issuance during the current turmoil



# Closing Remarks

## Key Conclusions

- ◆ ILS can be used by investors to enhance portfolio returns
  - Efficient portfolio diversification
  - Higher portfolio yields
- ◆ Limited/lack of correlation with economic issues demonstrated by resilience of ILS to current market conditions
- ◆ Improved liquidity of ILS resulting from growing investor base and active secondary market

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