Storm Surge

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Strategies Reinsurance

When Greg Hagood arrived in Bermuda in 1999, most hedge fund managers paid little attention to hurricane warnings unless a storm was bearing down on their vacation homes. For Hagood, 38, weighing the odds of the timing, location and severity of hurricanes and other natural disasters represented an escape. Two years earlier he had joined Frank Majors, also 38, to found Nephila Capital in London. Nephila, which relocated to Hamilton, Bermuda, in 1999, manages hedge funds that invest exclusively in catastrophe and weather-related reinsurance.

Before helping to start the firm, Hagood had managed the mortgage servicing trading desk at Bear, Stearns & Co. in New York. But he was restless. To him, Wall Street was becoming commoditized; anyone could find the price of a stock or bond at the press of a button. Much more interesting was the work that his childhood friend Majors was doing for London's Willis Group Holdings in the catastrophe reinsurance market. Insurers use catastrophe reinsurance to lay off shares of their liabilities for the largest hurricanes, earthquakes, windstorms and typhoons. For Hagood, the business hearkened back to a time when insurance and reinsurance contracts were negotiated across the tables of London coffeehouses.

"Let's face it," Hagood says. "You won't find the price of Florida hurricane risk on a Bloomberg terminal."

When Nephila opened its doors a decade ago, there were relatively few hedge funds active in the reinsurance market, and many of those that were had been attracted not by tantalizing investment prospects but by tax advantages. As Nephila's 22 employees celebrate the firm's ten-year anniversary, however, they find themselves forced to share Bermuda's pink-hued beaches and subtropical weather with a growing number of hedge fund and private equity managers.

The newcomers have arrived in waves, following such catastrophic events as 9/11 and hurricanes Katrina, Rita and Wilma. In each case, reinsurance companies scaled back their businesses in the wake of massive insured losses. Also in each case, hedge funds and other aggressive investors flooded the market as the price for insurance coverage soared.

As the June kick-off of the 2007 hurricane season approaches, hedge funds' exposure to the reinsurance industry has never been higher. Capitalizing on a spike in reinsurance rates after the devastating hurricane season of 2005, hedge funds, private equity funds and other investors

poured capital into the industry. Many of these investments paid off big, thanks to an unusually mild hurricane season in 2006. Industry estimates place average returns at 20 to 25 percent. But winds may be shifting in a much less favorable direction for investors. Prices for reinsurance coverage have begun to fall, partly because of the fresh capacity brought online by all the new investment. Prices have also been affected by new laws intended to lower insurance rates in states hit by the 2005 hurricanes. In particular, legislation passed in Florida threatens to eliminate some of the reinsurance market's most lucrative investment opportunities. Perhaps even more troubling for hedge fund reinsurance investors is the coming storm season, which experts warn could be a busy one.

A single big storm in 2007 could turn reinsurance from a windfall to a disaster for the hedge fund industry. Since Katrina, more than $30 billion in capital has been raised in Bermuda to shore up catastrophe reinsurers. According to the estimate of one global reinsurance expert, about a third of that amount came from hedge funds. The list of managers investing in the market since 2005 includes Highfields Capital Management, Citadel Investment Group, Greenlight Capital and Eton Park Capital Management. These investors are taking on catastrophe reinsurance exposure through a variety of strategies and vehicles, ranging from the relatively simple purchase of so-called cat bonds to direct investment in start-up reinsurance companies.

Hagood has seen this tide of investors and capital rise and fall at least twice in his ten-year career in the reinsurance industry. Although falling coverage prices could be a sign that the current investment surge will soon begin to recede, Nephila's expertise in reinsurance underwriting and catastrophe modeling remains a powerful selling point (especially for investors wanting more exposure than multistrategy hedge funds will usually provide). "Look at it this way," he says. "You can have a 5 to 10 percent reinsurance portfolio weighting via a multistrategy firm, where reinsurance is a component part of its business. With us, it is 100 percent of our business."

HEDGE FUNDS ORIGINALLY came to Ber-muda mainly for the tax breaks. During the 1990s hedge fund managers set up reinsurance shops on the island to take advantage of laws that allowed individuals in the U.S. to gain tax-efficient hedge fund exposure by investing in insurance companies that in turn took positions in hedge funds. Bermuda's lack of a corporate income tax attracted them as well.

The hedge fund managers that entered the reinsurance market following the catastrophic events of 2001 and 2005 had more than tax treatment on their minds, however. They were attracted by the allure of an investment with the potential to deliver substantial returns largely uncorrelated to global stock and bond markets -- although it certainly didn't hurt that U.S. business placed directly with a Bermuda operating company is subject to an excise tax of only 4 percent for commercial insurance premiums and 1 percent on reinsurance premiums.

According to Nephila's Hagood, the 9/11 attacks produced severe dislocations in compensation coverage, aviation liability coverage and property insurance and reinsurance coverage. Bradley Kading, president of the Association of Bermuda Insurers & Reinsurers, explains that the combination of enormous insured losses from the World Trade Center tragedy and the

subsequent stock market sell-off created severe capacity shortages. As coverage pricing soared, hedge funds saw a new opportunity, and a badly needed source of capital emerged.

That cycle was repeated in 2005, when three powerful hurricanes generated insured losses of $57 billion. Katrina did most of the damage ($40.7 billion worth) and reinsurance companies such as Swiss Re, Munich Re and the Berkshire Hathaway Reinsurance Group, as well as syndicates at Lloyd's of London and many Bermuda companies, soaked up roughly $23 billion of the losses. Afterward these traditional reinsurers scaled back their businesses, sometimes eradicating a third of their portfolios or more, particularly for hurricane risk along the U.S. coastline. As a result, rate increases for North Atlantic property/catastrophe risks averaged 75 percent from the January 2005 to July 2006 reinsurance renewal seasons.

This surge in pricing attracted so much new capital that people in the industry dubbed the many reinsurance companies that sprang up during the period as the "Class of '05." (The spate of start-ups launched after 9/11 was known as the Class of '01.) Included in the Class of '05 were New Castle Reinsurance Co. and Ariel Reinsurance, each of which was capitalized in whole or part by hedge funds and private equity funds.

Citadel Investment of Chicago formed New Castle Re with an initial $500 million capitalization. (Citadel already had an existing Bermuda-based catastrophe, or "cat," company, CIG Re, which provides collateralized coverage to insurance companies.) Ariel Re began operations with $1 billion in capital provided by an investor group made up of Blackstone Group, Texas Pacific Group, Thomas H. Lee Partners, Oak Hill Capital Partners, Olympus Partners, Bain Capital, SAB Capital and Eton Park. (Like Citadel, New Yorkbased hedge fund firm Eton Park has also invested in a special reinsurance vehicle that underwrites catastrophe coverage on a fully collateralized basis.)

In addition to funding start-ups, hedge funds and other investors seeking reinsurance opportunities after 2005 put money into special-purpose reinsurance vehicles, commonly known as sidecars. In a sidecar arrangement, a reinsurer agrees to share with investors a percentage of all premiums and losses arising from a book of business. These agreements are short-term and fully collateralized, meaning that the sidecar's investors set aside sufficient funds, in the form of either a letter of credit or trust fund, to ensure that the vehicle can meet any claims that arise. This differentiates sidecars from traditional insurance underwriters, whose clients must rely largely on rating agencies to assess the provider's security and ability to cover claims.

A typical sidecar structure was used in the formation of Cyrus Reinsurance, a special-purpose reinsurance vehicle whose investors include Boston-based multistrategy hedge fund Highfields Capital. At the end of 2005, Bermuda-based XL Re and Cyrus Re inked a deal in which Cyrus Re assumed a share of the property catastrophe risks taken on by XL through its operations in Bermuda, continental Europe, Dublin and Toronto. The deal, which spanned two underwriting years and could be extended by mutual consent, enabled XL to access $535 million in new insurance and reinsurance underwriting capacity at a time when traditional sources of reinsurance were disappearing.

Although collateralized vehicles are not without their drawbacks, they do offer investors one important benefit: flexibility. In particular, investors can expand or contract their underwriting commitments without regard for the rating agency rules that govern capitalization levels for reinsurers. Rating agencies tightened these rules considerably after the major storm losses of 2005. These restrictions increased demand for reinsurance capital at a time when it was already in very short supply. It was into this void that hedge funds stepped with what one manager termed "surge capital" -- capital invested in collateralized vehicles that can be scaled up or down depending on market conditions.

But a word to the wise: Although investors can adjust their sidecar capital commitments with relative freedom, exit strategies are not as clear-cut as they might appear. Gregory Hendrick, president and chief underwriting officer at Bermuda-based XL Re, says some hedge fund managers have serious misconceptions about the business.

Hendrick, 41, explains that toward the end of 2006, more than one hedge fund informally approached XL about a risk-sharing arrangement along the lines of the one XL devised with Cyrus Re. He says the managers did not understand that, even though many of the sidecar agreements that sprang up in 2005 were structured to remain in place for only a year or two, these fully collateralized deals can tie up investor capital for a much longer period of time. "If there's no insured event, no problem," Hendrick says. "We'll release the collateral. But if there is an event, the sidecar collateral stays in the trust fund until claims are settled. At the end of two years, we may have $1 million in claims that will take another 24 months to pay out. Things don't just end, they have to wind down."

INVESTORS LOOKING FOR a simpler way to capitalize on reinsurance market dislocations often turn to cat bonds, perhaps the most common form of natural-disaster-related hedge fund investment. Cat bonds are used by insurers to protect themselves against particularly severe events that generate large losses. Trigger events -- hurricanes, typhoons, earthquakes or other natural disasters occurring within a given time frame in a clearly defined geographic area -- are specified in the reinsurance arrangements. If an event occurs, the insurance company can delay payment of the bond's interest and eventually make a call on the outstanding principal amount of the bond. Investors are attracted by the bonds' relatively high yields -- they typically carry spreads of 5 to 10 percent over LIBOR -- and the low correlations between losses in cat bonds and losses in broad stock or bond indexes. According to Gary Martucci, a credit analyst at Standard & Poor's in New York, S&P rated $4.5 billion of natural-peril cat bonds in 2006, its highest annual total ever.

The capital committed to reinsurance after 2005 produced impressive returns for hedge funds, private equity funds and other investors. However, by adding capacity, these deals also eased the price pressures that made reinsurance such an attractive play in the first place. "Pricing for reinsurance in January 2007 was off 15 to 20 percent from the July 2006 market peak," says Timothy Gardner, a managing director and global head of the specialty property practice at New Yorkbased reinsurance broker Guy Carpenter & Co.

Looking ahead to midyear 2007 renewals, which are generally completed on June 1 or July 1, Chicago-based Aon Re Global predicted in a first-quarter report that rates for complex commercial reinsurance risks would fall as much as 10 percent from their 2006 highs in the U.S., while pricing for personal lines reinsurance sought by insurers selling to homeowners would drop by as much as 20 percent. The firm stated that price pressures would be eased by a loss-free 2006 and the restoration of reinsurers' capital bases by way of nontraditional sources, including hedge funds, high-net-worth individuals, institutional money managers and the asset-backed-securities market.

Also contributing to the price erosion this year is the new Florida law. When the state legislature convened an emergency session on property insurance in January, its goal was to provide relief to residents who had seen insurance rates skyrocket after the devastating hurricane season of 2005. But the law passed in that session could have an unintended consequence: It might wash away some of the market's most lucrative investment opportunities.

Florida lawmakers voted to increase the amount of reinsurance coverage offered by the Florida Hurricane Catastrophe Fund, a state-controlled agency that acts as a reinsurer of Florida residential risks. In some cases, the new law will also allow the fund to sell reinsurance to such companies as Allstate and State Farm Insurance at below-market rates.

The law's passage more than doubled the amount of reinsurance available from the fund, from $16 billion to about $35 billion, says Paul Schultz, president of Aon Capital Markets in Chicago, an intermediary that links investors, including hedge funds, with insurance-related investments. "Expansion of the Florida hurricane cat fund will likely reduce external reinsurance purchases and take away what is a high-profit-margin business from some reinsurers and capital market investors," he says.

Schultz adds that a sizable share of the insured property values covered by catastrophe reinsurance is in Florida. With that business potentially removed from the mix, the kinds of investment opportunities that generated returns of 20 percent or more for some hedge fund managers in 2006 could become scarce.

THE NAME NEPHILA REFERS to a type of spider found on the island of Bermuda, among other places. Island legend has it that the Nephila spider can sense a hurricane's approach. To prepare for an oncoming storm, the spider weaves its web closer to ground level -- or so the legend says. The name seemed a natural fit for Hagood and Majors's company, which has taken on a third partner -- Barney Schauble joined the firm in 2004 from Goldman, Sachs & Co.'s insurance securitization business in New York -- and grown to $2.1 billion in assets under management from clients including pension funds, life insurers, endowments, foundations and funds of funds. Nephila also owns its own reinsurer, Poseidon Re.

Based on predictions from hurricane modeling experts, hedge fund managers may want to consider emulating the legendary spider and hunkering down for the coming season. Aon Impact Forecasting, a unit of Chicago-based Aon Corp. that provides catastrophe modeling and risk

assessment services, recently cited a report by Colorado State University's Philip Klotzbach and William Gray predicting that tropical activity will be 185 percent of normal during the 2007 Atlantic hurricane season. In their report the researchers note that in the average year there is a 52 percent chance that at least one category 3, 4 or 5 storm will strike the U.S. coastline. The researchers say that owing to warm sea surface temperatures and other meteorological conditions, there is a 74 percent chance that a hurricane of that magnitude will hit the U.S. in 2007.
Although the likelihood of such a storm hitting the East Coast, including Florida, typically averages 31 percent, the Colorado State researchers say the probability this year is 50 percent.

Unlike Nephila, many of the hedge fund managers that entered the reinsurance market after 2005 have yet to live through a heavy hurricane season, or even a single powerful storm, for that matter. Although the impact of one or more damaging hurricanes in 2007 could trigger losses for many funds, corresponding reinsurance company losses would presumably also result in another round of the coverage cutbacks and price increases that in the past provided fresh opportunities for hedge funds and other investors. But that cycle could be interrupted this time around if expansion of the Florida hurricane cat fund does indeed remove some of the U.S.'s priciest waterfront real estate -- and its high-margin reinsurance business -- from the mix for capital market investors. If that's the case, Nephila's employees might find Bermuda's beaches a little less crowded next year.