

***AMERICAN GAS ASSOCIATION***

***RISK MANAGEMENT CONFERENCE***

***THE CAPITAL MARKETS: INSURANCE INDUSTRY ALLY OR  
COMPETITOR?***

**William J. Kelly**

**Managing Director,  
J.P. Morgan**

**President,  
International Federation of  
Risk and Insurance Management  
Associations (IFRIMA)  
[www.rims.org/ifrima](http://www.rims.org/ifrima)**

**GOOD AFTERNOON,**

**I UNDERSTAND THAT THE ROLE OF A LUNCHEON SPEAKER IS MUCH LIKE THAT OF THE DECEASED AT AN OLD FASHIONED IRISH WAKE. WE NEED HIM THERE TO JUSTIFY THE PARTY BUT WE REALLY DON'T EXPECT HIM TO SAY VERY MUCH.**

**I BELIEVE MY FRIEND JOE RESTOULE OF NOVA MUST HAVE BEEN THINKING ALONG THESE LINES, WHEN HE ASKED ME TO SPEAK ABOUT THE CAPITAL MARKETS IN RELATION TO THE GAS AND ELECTRIC INDUSTRIES, AS I AM EXPERT IN NEITHER THE CAPITAL MARKETS NOR THE GAS AND ELECTRIC INDUSTRIES.**

**HOWEVER, AS A STUDENT OF CORPORATE INSURANCE, I WELCOME THE OPPORTUNITY TO OFFER SOME OBJECTIVE OBSERVATIONS ON CAPITAL MARKET INSURANCE INITIATIVES.**

**THIS AFTERNOON I WOULD LIKE TO BEGIN BY DISCUSSING CURRENT TRENDS IN THE UTILITY INDUSTRY. WITHIN THAT CONTEXT, WE CAN INVESTIGATE SECURITIZATION IN GENERAL AND AS SPECIFICALLY TAILORED FOR UTILITIES. I THINK WE WILL THEN BE IN A POSITION TO REFLECT UPON THE QUESTION OF THE CAPITAL MARKETS AS FRIEND OR FOE.**

**AS I INVESTIGATED CURRENT TRENDS IN THE GAS AND ELECTRIC INDUSTRIES, I WAS SURPRISED TO FIND HOW CLOSELY THEY PARALLEL THE MAJOR DEVELOPMENTS IN FINANCIAL SERVICES.**

**I REFER TO DEREGULATION, INCREASED COMPETITION, CONSOLIDATION AND OVERSEAS EXPANSION.**

**IN TERMS OF DEREGULATION, TODAY ALMOST 70% OF THE NATURAL GAS SOLD IN THIS COUNTRY CAN BE PURCHASED FROM NON-UTILITY SUPPLIERS. IN FINANCIAL SERVICES, DEREGULATION CONTINUES TO BLUR OLD DISTINCTIONS AMONG BANKS, SECURITIES DEALERS, AND INSURANCE COMPANIES. INDEED THAT TREND FORMS THE BASIS OF OUR DISCUSSION THIS AFTERNOON.**

**IN THIS DEREGULATED ENVIRONMENT, FIRMS SEEK EVERY COMPETITIVE ADVANTAGE, PERHAPS THE MOST CRITICAL BEING THE ACHIEVEMENT OF SCALE THROUGH CONSOLIDATION. THIS TREND IS MANIFEST WHETHER WE ARE FOCUSING ON PSI RESOURCES MERGING WITH CINCINNATI GAS, CHEMICAL BANK ACQUIRING CHASE, OR RECENT ACTIVITY IN THE INSURANCE BROKERAGE INDUSTRY.**

**IT ALSO NOW APPEARS THAT ALMOST EVERY SECTOR OF BUSINESS SEES ITS FUTURE IN TERMS OF OVERSEAS EXPANSION, PARTICULARLY IN EMERGING MARKETS. THE NEED FOR CRITICAL INFRASTRUCTURE PROJECTS AND THE POTENTIAL FOR GROWING INDIVIDUAL WEALTH ARE WELL RECOGNIZED. JUST THIS YEAR, THE NATURAL GAS INDUSTRY INSTITUTIONALIZED ITS COMMITMENT TO OVERSEAS EXPANSION BY CREATING THE INTERNATIONAL GAS CENTER (IGC). THE ANNOUNCED PURPOSE**

**OF THE IGC IS TO PROMOTE INTERNATIONAL PARTNERSHIP AMONG ALL SECTORS OF THE INDUSTRY. ACCORDING TO THE CHAIRMAN OF ENRON “THERE’S NO NEED TO KEEP THE COMPETITION OUT BECAUSE THERE ARE MORE PROJECTS IN NEED OF PARTNERS THAN THERE ARE PARTNERS TO FILL THE NEED.”**

**IN THIS DYNAMIC ENVIRONMENT OF UNPRECEDENTED DEREGULATION, CONSOLIDATION AND INTERNATIONAL EXPANSION WHAT DO THE CAPITAL MARKETS HAVE TO OFFER WITH RESPECT TO INSURANCE? THE POTENTIAL CONTRIBUTION BY THE CAPITAL MARKETS USUALLY AND PERHAPS UNNECESSARILY, FOCUSES SOLELY ON THE ISSUE OF SECURITIZATION. AS YOU KNOW, MORTGAGES, CREDIT CARD DEBT AND OTHER OBLIGATIONS HAVE BEEN SECURITIZED. THE DEBT IS SIMPLY AGGREGATED AND SOLD IN THE FORM OF SECURITIES.**

**THE SUGGESTION IS THAT SUCH SECURITIZATION CAN ALSO BE UTILIZED AS AN ALTERNATIVE TO INSURANCE AND REINSURANCE. PROPONENTS OF THESE ALTERNATIVES MAINTAIN THAT SUCH CAPITAL MARKET INVOLVEMENT IS NOT ONLY POSSIBLE BUT NECESSARY AND IN FACT DESIRABLE. THE BASIC ARGUMENT IS THAT THE INSURANCE INDUSTRY LACKS SUFFICIENT CAPITAL TO RESPOND TO CERTAIN POTENTIAL, QUANTIFIABLE CATASTROPHES, FOR EXAMPLE A HURRICANE, SUCH AS ANDREW, HITTING MIAMI. THIS SENSITIVITY AROSE AFTER HURRICANE ANDREW AND THE NORTHRIDGE**

**EARTHQUAKE. GIVEN THIS EXPERIENCE, THE INSURANCE INDUSTRY MAY BE SOMEWHAT LESS VULNERABLE TODAY, HAVING ACTED TO REDUCE CONCENTRATIONS OF EXPOSURE.**

**THE SUGGESTED SECURITIZATION IS ALSO SAID TO BE DESIRABLE BECAUSE IT ALLOWS THE CAPITAL MARKET INVESTORS TO EFFECTIVELY DIVERSIFY THEIR PORTFOLIOS. THIS ARGUMENT IS BASED ON THE FACT THAT THERE IS NO PERCEIVED CORRELATION BETWEEN CAPITAL MARKET EVENTS AND THE OCCURRENCE OF NATURAL DISASTERS.**

**THERE ARE SIGNIFICANT DIFFERENCES OF OPINION WITHIN THE INVESTMENT BANKING COMMUNITY ON THE POTENTIAL VALUE OF AND NEED FOR SECURITIZATION AS AN ALTERNATIVE TO INSURANCE AND REINSURANCE.**

**AT ONE END OF THE SPECTRUM, ARE INVESTMENT BANKING FIRMS WHICH HAVE RECENTLY ESTABLISHED REINSURANCE BROKERAGE SUBSIDIARIES TO SELL CAPITAL MARKET ALTERNATIVES TO TRADITIONAL INSURANCE AND REINSURANCE. NOT TO BE OUTDONE INSURANCE BROKERAGE FIRMS ARE HIRING FORMER INVESTMENT BANKERS AS EMPLOYEES SO THEY CAN COMPETE IN THIS ARENA. INSURERS ARE ALSO ESTABLISHING SPECIALIZED FINANCIAL PRODUCT SUBSIDIARIES.**

**HOWEVER, AT THE OTHER END OF THE SPECTRUM, ARE PERHAPS A GROWING NUMBER OF INVESTMENT BANKING FIRMS, WHICH**

**VIEW SECURITIZATION EFFORTS AS AN UNWARRANTED DIVERSION OF INTERNAL RESOURCES; RESOURCES THAT CAN BE MORE PRODUCTIVELY EMPLOYED IN TRADITIONAL INVESTMENT BANKING ACTIVITIES. EXECUTIVES AT THESE FIRMS SUGGEST THAT SECURITIZATION, AS AN ALTERNATIVE TO INSURANCE, IS AN ELEGANT SOLUTION TO A NON-EXISTENT PROBLEM. ITS THEIR FEELING THAT IF THE INSURANCE INDUSTRY NEEDS CAPITAL AND THE INVESTOR NEEDS DIVERSITY, THEN INVESTMENTS SHOULD BE MADE IN THE EQUITY OF REINSURERS EITHER EXISTING OR NEWLY ESTABLISHED.**

**THE ARGUMENTS WHICH ARE ADVANCED AGAINST THIS POSITION ARE THAT INVESTMENT IN THE EQUITY OF A COMPANY SUBJECTS THE INVESTOR TO MANY OTHER GENERAL BUSINESS RISKS AND THAT, FROM THE STANDPOINT OF THE INSURER, SECURITIZATION, UNLIKE TRADITIONAL REINSURANCE, ELIMINATES THE EXPOSURE TO THE CREDITWORTHINESS OF THE REINSURER. YOU MAY DRAW YOUR OWN CONCLUSIONS, HOWEVER, I DON'T FIND EITHER OF THESE ARGUMENTS PARTICULARLY COMPELLING, ESPECIALLY GIVEN OTHER ISSUES WITH RESPECT TO SECURITIZATION WHICH WE WILL DISCUSS.**

**BEFORE WE REVIEW A SPECIFIC TRANSACTION, I WOULD ALSO NOTE THAT DIVERSITY OF PORTFOLIO IS NOT AN END IN ITSELF, THE UNDERLYING INVESTMENT SHOULD BE SOUND. DIVERSITY ONLY ENSURES THAT THE INVESTOR WILL NOT LOSE EVERYTHING AT THE SAME TIME FOR THE SAME REASON.**

**IN ADDITION, THE FACT THAT THERE IS NO CORRELATION BETWEEN THE OCCURRENCE OF NATURAL DISASTERS AND CAPITAL MARKET ACTIVITY CAN ALSO BE VIEWED NEGATIVELY. CERTAIN INVESTMENTS, IN RELATION TO EACH OTHER WITHIN AN OVERALL PORTFOLIO, CAN EFFECTIVELY CONSTITUTE A ZERO SUM GAME. BY THIS I MEAN THAT CERTAIN VALUES WILL CHANGE IN INVERSE RELATIONSHIP TO EACH OTHER. FOR EXAMPLE PRECIOUS METAL VALUES MAY RISE AS STOCKS FALL OR A CERTAIN FOREIGN CURRENCY MAY MOVE IN INVERSE RELATION TO ANOTHER. THESE RELATIONSHIPS PRESENT MANY NATURAL, VIRTUALLY AUTOMATIC HEDGES OF ONE RISK RELATIVE TO ANOTHER. THE SECURITIZATION OF NATURAL DISASTER EXPOSURE DOES NOT OFFER THESE HEDGING OPPORTUNITIES. IN ADDITION, LOSSES IN THE FINANCIAL MARKETS ARE OFTEN SHORT TERM PAPER LOSSES RECOUPED OVER TIME. IN THE EVENT OF A NATURAL DISASTER, THE ACTUAL LOSS IS SUSTAINED AND RECOGNIZED IN THE SHORT TERM.**

**EVEN THOSE INVESTORS WHO ARE INTERESTED IN SUCH INVESTMENTS CAN BE TURNED OFF BY THE SCARCITY OF SUCH DEALS. INVESTORS WOULD PREFER TO HAVE SOME INVOLVEMENT IN A WIDE VARIETY OF SUCH OFFERINGS, RATHER THAN ONE MAJOR COMMITMENT. CATASTROPHE BONDS CAN ALSO BE MORE EXPENSIVE THAN REINSURANCE AND FAR MORE RIGID BECAUSE OF DISCLOSURE REQUIREMENTS TO INVESTORS.**

**TO GIVE ALL THIS THEORY SOME REALITY, LETS LOOK AT A RECENT SECURITIZATION. USAA SOLD \$477 MILLION IN CATASTROPHE BONDS. THE BASIS ON WHICH THE DEAL WAS OFFERED IS RELATIVELY SIMPLE, INVOLVING THREE POSSIBILITIES. IF A HURRICANE OCCURS WHICH CAUSES USAA TO SUSTAIN A LOSS IN EXCESS OF 1.5 BILLION DOLLARS, INVESTORS LOSE THE ENTIRE PRINCIPAL AND WILL RECEIVE ONLY THE INTEREST OF 11.8%, A FEW POINTS HIGHER THAN THAT PAID BY COMPARABLY RATED BONDS. IF USAA SUSTAINS A LOSS BETWEEN 1 AND 1.5 BILLION DOLLARS, INVESTORS WILL LOSE A PORTION BUT NOT ALL OF THE PRINCIPLE. FINALLY IF NO LOSS IN EXCESS OF \$1 BILLION IS INCURRED THE INVESTORS WILL ENJOY FULL PRINCIPAL AND INTEREST.**

**THE RATING OF THESE BONDS IS BASED ENTIRELY UPON THE APPLICATION OF A COMPUTER MODEL. USING THIS MODEL, A DETERMINATION WAS MADE THAT FOR USAA TO HAVE A LOSS IN EXCESS OF 1.5 BILLION DOLLARS, THE TOTAL LOSS IN THE STATE OF FLORIDA WOULD HAVE TO EXCEED 20 BILLION DOLLARS. THE MODEL FURTHER PROJECTED THAT SUCH A LOSS WOULD OCCUR ONLY ONCE IN 100 YEARS.**

**COMPUTER MODELS ARE EXCELLENT TOOLS, WHICH ARE EXTENSIVELY UTILIZED IN THE FINANCIAL SERVICE INDUSTRY. HOWEVER, MODELING REMAINS AN IMPRECISE SCIENTIFIC APPLICATION. MODELS INHERENTLY RELY UPON CERTAIN**

**ASSUMPTIONS WHILE REJECTING OTHERS. THIS PARTICULAR APPLICATION MAY BE MORE SUSPECT BECAUSE OF THE LIMITED STATISTICAL UNIVERSE OF INFORMATION AVAILABLE WITH RESPECT TO CATASTROPHIC PROPERTY LOSSES.**

**CONSIDER THE NUMBER OF SUPPOSEDLY FIVE HUNDRED YEAR FLOODS WHICH HAVE OCCURRED IN THE RECENT PAST. AN AREA WITHIN THE PROVINCE OF QUEBEC LAST YEAR EXPERIENCED A 10,000 YEAR FLOOD. THERE HAS ALSO BEEN RECENT DISCUSSION WITH RESPECT TO CHANGES IN THE WEATHER PATTERN CALLED EL NIÑO. THE SPECULATION IS THAT THESE CHANGES ARE ALREADY CAUSING UNPRECEDENTED ATMOSPHERIC ACTIVITY THAT WILL PLACE ANY ACTUARIAL PROJECTION BASED ON THE PAST IN QUESTION.**

**ALTHOUGH MODELS ARE BECOMING MORE SOPHISTICATED, I REMAIN SKEPTICAL ABOUT HYPOTHETICAL CATASTROPHIC LOSS PROJECTIONS PRIOR TO AN EVENT, WHEN ASSESSMENT AFTER AN ACTUAL EVENT SEEMS SO DIFFICULT. HOW MANY TIMES AND BY HOW MUCH WERE THE ORIGINAL NORTHRIDGE AND ANDREW DAMAGE ESTIMATES INCREASED OVER TIME?**

**GIVEN ALL THIS UNCERTAINTY IT IS NOT SURPRISING THAT THE FEW SECURITIZATIONS WHICH HAVE OCCURRED HAVE ATTRACTED ONLY PROFESSIONAL INVESTORS WITH VERY LARGE PORTFOLIOS, WHO COULD, IN FACT, AFFORD TO LOSE THEIR ENTIRE INVESTMENT.**

**THERE ARE THOSE WHO SUGGEST THAT THE TYPE OF SECURITIZATION DONE BY USAA IS NO DIFFERENT THAN THE SECURITIZATION OF MORTGAGES OR CAR LOANS, HOWEVER, THERE IS A RADICAL DIFFERENCE IN TERMS OF SPREAD OF RISK: THIS IS ALL ABOUT ONE EVENT.**

**AFTER NATIONWIDE'S ISSUANCE OF ACT OF GOD BONDS IN 1994 THERE WAS INTENSE INTEREST IN THE POTENTIAL FOR SECURITIZATION TO BECOME A SUBSTITUTE FOR REINSURANCE. HOWEVER, SINCE THAT TIME ONLY A FEW DEALS HAVE ACTUALLY TAKEN PLACE. SWISS RE SOLD 137 MILLION IN BONDS LINKED TO THE CALIFORNIA EARTHQUAKE EXPOSURE AND HANOVER RE HAD EXECUTED A PORTFOLIO LINKED SWAP WITH NORTH AMERICAN INVESTORS. THERE HAS ALSO BEEN SOME RECENT ACTIVITY IN CONNECTION WITH THE CALIFORNIA AND FLORIDA STATE CATASTROPHE FUNDING.**

**THE CATASTROPHIC BONDS WHICH WE HAVE DISCUSSED ARE ONLY ONE EXAMPLE OF POTENTIAL CAPITAL MARKET INVOLVEMENT AS AN ADDITION OR ALTERNATIVE TO INSURANCE AND REINSURANCE. THERE ARE ALSO CONTINGENT EQUITY ARRANGEMENTS, WHEREIN AN INVESTOR AGREES TO PURCHASE EQUITY ON A PREDETERMINED BASIS IN THE EVENT OF A SPECIFIC CATASTROPHIC LOSS, SO THAT INSURERS AND REINSURERS CAN MAINTAIN SURPLUS/EQUITY. THE DOWNSIDE OF THESE ARRANGEMENTS IS THE POTENTIAL FOR THE DILUTION**

**OF CAPITAL AND CONTROL. THEY CAN ALSO BE EXPENSIVE, WHILE NOT PROVIDING INSURANCE ACCOUNTING ADVANTAGES. IN ADDITION, THERE IS A THIN MARKET IN INDEX TRADING, AS WELL AS CREDIT ENHANCEMENT INSURANCE.**

**THUS FAR WE HAVE ONLY CONSIDERED THE ISSUE OF SECURITIZATION THROUGH THE CAPITAL MARKETS AS AN ALTERNATIVE TO INSURANCE. THERE ARE SOME INTERESTING NEW PRODUCTS NOW BEING OFFERED AS AN INSURANCE ALTERNATIVE TO THE CAPITAL MARKETS. THESE PRODUCTS COMBINE ELEMENTS OF RISKS TRADITIONALLY ADDRESSED THROUGH INSURANCE WITH OTHER RISKS USUALLY ADDRESSED IN THE CAPITAL MARKETS.**

**ACCORDING TO A RECENT ARTICLE IN FORBES, HONEYWELL IS TURNING FROM THE CAPITAL MARKET TOOL OF DERIVATIVES TO A RELIANCE ON INSURANCE. MORE THAN A THIRD OF HONEYWELL'S \$770 MILLION IN OPERATING PROFIT IS GENERATED ABROAD, PRIMARILY IN BELGIUM, GERMANY AND CANADA. IN THE PAST HONEYWELL MANAGED ITS CURRENCY RISK THROUGH THE FOREIGN EXCHANGE AREAS OF MAJOR BANKS, CARRYING \$1.1 BILLION IN FOREIGN EXCHANGE CONTRACTS IN 1996.**

**THIS YEAR HONEYWELL IS REPORTEDLY DISCONTINUING ITS USE OF DERIVATIVES IN FAVOR OF A SINGLE THREE YEAR INSURANCE POLICY COVERING PROPERTY, LIABILITY, WORKERS**

**COMPENSATION AND CURRENCY EXPOSURES. THE ARRANGEMENT IS REPORTED TO BE SUBJECT TO A RETENTION OF FROM 25 TO 30 MILLION DOLLARS. THIS MAY REPRESENT AN INTRIGUING COMBINATION OF PREVIOUSLY UNRELATED RISKS THAT MAY GROW IN POPULARITY OVER TIME. ALTERNATIVELY, IT MAY ONLY BE REFLECTIVE OF GEORGE CARLIN'S OPINION THAT, IF YOU NAIL TWO THINGS TOGETHER THAT HAVE NEVER BEEN NAILED TOGETHER BEFORE, SOMEONE WILL BUY IT FROM YOU. IT WILL BE INTERESTING TO SEE HOW THESE PRODUCTS DEVELOP.**

**ONE SUBJECT WE HAVE NOT YET TOUCHED UPON IS THE ROLE OF THE INSURANCE BROKER IN THESE ALTERNATIVE TRANSACTIONS. IT IS INTERESTING TO NOTE THAT IN SECURITIES UNDERWRITING AND SYNDICATED LENDING THERE IS NO INTERMEDIARY, AS SUCH. INVESTMENT BANKS BID AND THE WINNERS MANAGE THE DEAL. I SUGGEST THAT YOU CAREFULLY REVIEW THE PROPOSED BROKER ROLE AND COMPENSATION STRUCTURE IN ANY ALTERNATIVE TYPE OF OFFERING.**

**I WAS RECENTLY PRESENTED WITH ONE BALANCE SHEET PROTECTION, SECURITIZATION PROPOSAL THAT INCLUDED OVER 90 MILLION DOLLARS IN COMPENSATION TO THE BROKER ALONE, OVER THE PROPOSED 10 YEAR PERIOD. THIS WAS EXCLUSIVE OF MONEY MANAGEMENT FEES, FACILITY MANAGEMENT FEES, PLACEMENT FEES AND OTHER EXPENSES, WHICH BROUGHT TO**

**OVERALL FEE STRUCTURE TO APPROXIMATELY \$170 MILLION OVER THE 10 YEAR LIFE OF THE PROPOSAL NOT INCLUDING PREMIUMS. INSURANCE BROKERS MAY ASPIRE TO BE INVESTMENT BANKERS BUT WE CAN NOT LOSE SITE OF THE ACTUAL VALUE ADDED AND INSIST ON REALISTIC FEE STRUCTURES.**

**I WANT TO ALERT YOU TO A NEW SECURITIZATION PRODUCT SPECIFICALLY DESIGNED FOR THE UTILITY INDUSTRY. IT IS NOT BEING OFFERED AS AN ALTERNATIVE TO INSURANCE BUT AS A FUNDING MECHANISM. THE AIG IS CERTAINLY ONE OF THE MOST INNOVATIVE LEADERS IN THE INDUSTRY AND WITH THIS PRODUCT HAS PERHAPS BROUGHT UNDERWRITING ALMOST TO THE LEVEL OF ALCHEMY. THE PROGRAM IS CALLED STRANDED ASSET PROTECTION.**

**AS I UNDERSTAND IT, WITHIN THIS ENVIRONMENT OF DEREGULATION, THERE IS AN ANTICIPATED TRANSITION TO MARKET BASED UTILITY PRICING AS OPPOSED TO THE CURRENT FORMULA METHOD USED BY REGULATORS. IT IS ANTICIPATED THAT THIS CHANGE WILL RESULT IN A DECLINE OF THE UNDERLYING VALUE OF UTILITY ASSETS. THIS DECLINE IN ASSET VALUE RESULTS FROM THE FACT THAT THE MARKET PRICE OF ELECTRICITY WOULD BE LOWER IN A FREE MARKET THAN IT IS UNDER THE CURRENT REGULATORY SCHEME.**

**THESE SO CALLED STRANDED ASSETS AND COSTS ARE OF FOUR PRINCIPAL TYPES:**

- **STRANDED GENERATION ASSETS - THE ASSET VALUE WHICH IS THE DIFFERENCE BETWEEN THE BOOK VALUE AND THE MARKET VALUE OF A GENERATION PLANT.**
- **NON-UTILITY GENERATOR COSTS - UNECONOMICAL OR UNNEEDED PAYMENTS TO INDEPENDENT POWER PRODUCERS**
- **REGULATORY ASSETS - THOSE CREATED BY REGULATORY DECREE SUCH AS CAPITALIZED LOSSES**
- **DECOMMISSIONING LIABILITIES - THE COSTS ASSOCIATED WITH DECOMMISSIONING NUCLEAR AND FOSSIL FUELED POWER PLANTS.**

**MOODY'S ESTIMATES THAT THESE STRANDED ASSETS AND COSTS NATIONWIDE TOTAL APPROXIMATELY \$135 BILLION DOLLARS.**

**SINCE, UNDER EXISTING LAWS, UTILITIES ARE NOT GUARANTEED FULL RECOVERY OF THE COST OF DOING BUSINESS, THEY FACE THE POSSIBILITY THAT CERTAIN COSTS WILL NOT BE RECOVERABLE OVER TIME. AIG IS SUGGESTING THAT, UNDER SECURITIZATION LAWS, THIS RISK CAN BE**

**REMOVED BY CREATING A PRIVILEGED CLASS OF ASSETS (STRANDED ASSETS) WITH A PROTECTED REVENUE STREAM.**

**WITHOUT GOING INTO GREAT DETAIL IN THIS FORUM, THE PROPOSAL INVOLVES A QUALIFIED RATE ORDER, THE SECURITIZATION OF THE STRANDED ASSET POOL AND THE COLLECTION OF A COMPETITIVE TRANSITION CHARGE ESTABLISHED BY THE PUBLIC SERVICE COMMISSION OR STATE LEGISLATURE. AFTER FURTHER ACTIONS INVOLVING THE PLEDGING OF WHAT WOULD THUS BECOME PROTECTED, SYNTHETIC ASSETS, THE REVENUE STREAM FROM THE STRANDED ASSET POOL WOULD, ACCORDING TO THE PROPOSAL BE MORE CREDIT WORTHY THAN THE UNDERLYING UTILITY.**

**HENCE THE ALCHEMY TO WHICH I REFERRED, A PROPOSAL TO TURN WHAT WOULD OTHERWISE BE A WRITE-OFF INTO A SUPERIOR PROTECTED ASSET. THERE IS OBVIOUSLY MUCH MORE TO THIS PROPOSAL INCLUDING A DISCUSSION OF ACCOUNTING AND TAX RAMIFICATIONS BUT I THOUGHT YOU SHOULD AT LEAST BE AWARE OF THIS CONCEPT.**

**WITH ALL THE FUNDING OPTIONS PRESENTLY AVAILABLE, I SUGGEST THAT YOU DO NOT LOOK AT ANY ONE APPROACH IN ISOLATION. SIMULTANEOUSLY CONSIDER ALL AVAILABLE OPTIONS AND THE POTENTIAL COMBINATION OF METHODS, WHICH WOULD PROVIDE THE MOST BENEFIT FOR YOUR FIRM; KEEPING IN MIND THAT NO ONE VENDOR WHETHER INSURER,**

**REINSURER, BROKER, INVESTMENT BANKER OR CONSULTANT WILL BE IN A POSITION TO PROVIDE AN UNBIASED AND INFORMED PRESENTATION OF ALL SUCH OPTIONS.**

**CERTAIN APPROACHES MAY NOT REQUIRE ANY INTERMEDIARY AT ALL. I UNDERSTAND THAT A GAS COMPANY AND AN ELECTRICAL UTILITY ARE HEDGING THEIR TRANSMISSION RISK WITH EACH OTHER. THIS APPROACH INVOLVED THE GAS COMPANY ASSUMING SOME OF THE UTILITIES TRANSMISSIONS LINE EXPOSURE AND THE ELECTRIC UTILITY ASSUMING SOME OF THE GAS COMPANY'S PIPELINE RISK.**

**I ALSO SUGGEST THAT YOU NEVER DISREGARD THE POTENTIAL VALUE OF THE TRADITIONAL INSURANCE MARKET AS A SOURCE OF COST EFFECTIVE PURE RISK TRANSFER. THE INSURANCE INDUSTRY IS SENSITIVE TO CRITICISMS THAT ITS PRODUCTS ARE BECOMING IRRELEVANT TO ITS CLIENT'S MOST SIGNIFICANT EXPOSURES. DESPITE THE ALLEGED UNDER CAPITALIZATION, THE MARKET IS AWASH IN OVER CAPACITY AND ANXIOUS TO ENTERTAIN NEW PRODUCT IDEAS ON A VERY COST EFFECTIVE BASIS.**

**I RECENTLY CONCLUDED A TEN MONTH INITIATIVE WHICH BROUGHT ABOUT THE CREATION OF A NEW FORM OF EXCESS CATASTROPHE INSURANCE, WHICH FOR THE FIRST TIME INCLUDED TRUE INSURANCE COVERAGE FOR LOSSES ARISING OUT OF UNAUTHORIZED ACTS. THE NEW PROGRAM TO WHICH I**

**REFER IS SOLELY ON AN EXCESS BASIS ATTACHING OVER PREVIOUSLY UNINSURED RETENTIONS OR EXISTING POLICIES. IT, THEREFORE, COMPLETELY AVOIDS THE POTENTIAL DOWNSIDE OF CURRENTLY OFFERED MULTI-YEAR BLENDED PROGRAMS ON THE PRIMARY LEVEL, WHICH OFTEN UNECONOMICALLY INCREASE PRIMARY RETENTIONS, ELIMINATE OCCURRENCE COVERAGE AND SHARPLY REDUCE THE DIVERSITY OF INSURER PARTICIPATION AT THE PRIMARY LEVEL. BY DIVERSITY I MEAN A STRUCTURE WHEREIN ANY ONE LOSS AFFECTS ONLY ONE POLICY RATHER THAN THE ENTIRE BASIS OF COVERAGE.**

**I WAS ASKED TO ADDRESS THE QUESTION OF WHETHER THE CAPITAL MARKETS ARE AN ALLY OR A COMPETITOR OF THE INSURANCE INDUSTRY. AS WE HAVE DISCUSSED, THE MAJOR BENEFICIARIES OF THE FEW DEALS THUS FAR ARRANGED ARE INSURANCE AND REINSURANCE COMPANIES. I BELIEVE THIS IS, IN PART, BECAUSE INSURERS AND REINSURERS HAVE THE EXTENSIVE PORTFOLIOS OF RISK THAT CAN MAKE THESE DEALS WORK, WHEREAS INDIVIDUAL FIRMS OR EVEN OTHER WHOLE INDUSTRIES MAY NOT. FOR EXAMPLE, A MAJOR CAPITAL MARKETS INSURANCE INITIATIVE HAS BEEN PURSUED WITH THE PHARMACEUTICAL INDUSTRY FOR SOME TIME AND TO DATE HAS PROVED UNSUCCESSFUL.**

**WHETHER OR NOT IT IS A NECESSARY OR ATTRACTIVE ALTERNATIVE, THERE IS CLEARLY POTENTIAL FOR THE GROWTH OF CAPITAL MARKET INVOLVEMENT THROUGH SECURITIZATION**

AS AN ALTERNATIVE TO INSURANCE OR REINSURANCE. THIS IS ESPECIALLY SO IF SUCH SECURITIZATION COULD INVOLVE A MUCH BROADER SPREAD OF RISK THAN THAT REPRESENTED BY CATASTROPHE BONDS. CONCEPTUALLY I SEE NO REASON, OTHER THAN REGULATORY, WHICH WOULD PROHIBIT THE SECURITIZATION OF HOMEOWNERS OR AUTOMOBILE POLICIES. HOWEVER, WHAT KIND OF RETURN WOULD BE AVAILABLE TO INVESTORS IN SUCH ARRANGEMENTS? THE INSURANCE INDUSTRY OVERALL HAS NOT MADE AN UNDERWRITING PROFIT ON PROPERTY AND CASUALTY INSURANCE IN TWENTY YEARS AND HAS ONLY OFFSET THESE UNDERWRITING LOSSES BY THE RETURNS RECEIVED ON OTHER INVESTMENTS AVAILABLE IN THE CAPITAL MARKETS.

SOME SUGGEST THAT IT WILL TAKE MANY YEARS BEFORE THE NECESSARY INFRASTRUCTURE TO FACILITATE SUCH DEALS DEVELOPS. ONE OF THE MAJOR IMPEDIMENTS TO DATE HAS BEEN THE FACT THAT EACH PROPOSAL HAS BEEN UNIQUE.

THE QUESTION IS: HOW LONG WILL INVESTMENT BANKING FIRMS CONTINUE TO COMMIT SIGNIFICANT RESOURCES TO THE DEVELOPMENT OF SUCH VEHICLES, WITHOUT RECEIVING A MAJOR RETURN ON THAT INVESTMENT? WHEN DOES THE OPPORTUNITY COST OF DIVERTING RESOURCES THAT COULD OTHERWISE BE ENGAGED IN TRADITIONAL, LUCRATIVE ACTIVITY BECOME TOO GREAT? I THINK WE HAVE ALREADY SEEN A SIGNIFICANT REDUCTION IN THE LEVEL OF ENTHUSIASM AMONG

**INVESTMENT BANKS. IRONICALLY, IN THE CURRENT MARKET, IT MAY BE THAT THE INSURERS AND INSURANCE BROKERS, ANXIOUS TO SELL ANYTHING THAT IS NEW AND HOPEFULLY EXPENSIVE, WILL DRIVE THE DEVELOPMENT OF CAPITAL MARKET PRODUCTS RATHER THAN THE INVESTMENT BANKERS. THESE NEW PRODUCTS MAY SIMPLY REFLECT A BROADENING IN THE SCOPE OF THE FINANCIAL RISKS WHICH CAN BE ADDRESSED BY INSURANCE AND MAY WELL NOT INVOLVE EXTENSIVE SECURITIZATION.**

**THE INSURANCE INDUSTRY HAS CLEARLY IDENTIFIED FINANCIAL PRODUCTS AS POTENTIALLY INTEGRAL TO THE SERVICES IT WISHES TO PROVIDE, AS INSURERS INCREASE THE SCOPE OF RISKS ADDRESSED. AMERICAN RE IS BUILDING AM RE FINANCIAL PRODUCTS. SWISS RE HAS SET UP SWISS RE NEW MARKETS AND ALLIANZ IS ESTABLISHING AN ALTERNATIVE RISK FACILITY. CLEARLY THE MOTIVATION FOR THESE INITIATIVES IS NOT ONLY BASED ON PERCEIVED OPPORTUNITY BUT ALSO UPON THE FEAR OF BEING LEFT OUT OF A MARKET WHICH MAY DEVELOP.**

**I WOULD LIKE TO CLOSE BY QUOTING THE RISK MANAGER OF MARSHALL FIELD, ARTHUR HAWXHURST, IN HIS ADDRESS TO THE INSURANCE SOCIETY OF NEW YORK.**

**“INSURANCE CONDITIONS ARE DRIFTING INTO FEWER HANDS....AND THIS CONCENTRATION OF CAPITAL IN ONE WAY AND EXPANSION IN ANOTHER WILL ULTIMATELY BE FOR THE**

**BEST WELFARE OF ALL CONCERNED. THE (INSURANCE)  
BUSINESS WILL BE ELEVATED TO THAT OF BANKING...”**

**MR. HAWXHURST DELIVERED THIS ADDRESS ON APRIL 26, 1916  
EIGHTY ONE YEARS AGO. I BELIEVE WE WILL BE DISCUSSING  
THESE ISSUES FOR SOME TIME TO COME, AS THE MARKETPLACE  
SORTS OUT THE BEST SOLUTIONS.**

**THANK YOU.**