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THE POTENTIAL FOR NEW DERIVATIVES INSTRUMENTS TO COVER TERRORISM RISK

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Powerpoint presentation

This document is circulated for Session 2 of the Conference on Catastrophic Risks and Insurance, to be held on 22-23 November 2004 at the OECD Headquarters, 2 rue André Pascal, 75016 Paris, starting at 9:00 a.m.

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The Potential for New Derivatives Instruments to Cover Terrorism Risk

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The Bond Market Association

- Represents securities firms and banks in the global fixed income markets
- Advocacy on Legal, Regulatory, Legislative and Market Practice Issues
- Member of CIAT
Overview

- Credit Derivatives Market and Credit Default Swaps
- Catastrophe Risk Swaps and Swaptions to Cover Terrorism Risk
- Challenges and Advantages
- TBMA Members’ Perspective
The Credit Derivatives Market As A Source of New Capacity

- Continued rapid growth
- $5.44 trillion in first half of 2004, expected to be $8.2 trillion by the end of 2006
- ISDA Documentation and Definitions
- Largest players are banks, securities firms, insurance companies and hedge funds
Credit Default Swaps

Step 1*

Borrower (step 1) (Debts R Us Inc.)

Loan/Bond $5m ‘IOU-1’

Interest Payments

Lender (step 1) & Buyer (step 2)
CDS protection
(Safe Investor Inc.)

Step 2

Provides $5m CDS Protection
(Reference Entity Debts R Us Inc.)

Premium (basis points)

Seller (step 2)
CDS protection
(Insurance Inc.)

Step 3

Credit Event

Protection Triggered
$5m ‘IOU-1’ loan to Insurance Inc.
Cash $5m to Safe Investor Inc.
Premium payments stop

*Step 1 is not strictly necessary. Money does not need to have been lent in order to buy CDS protection. In a credit event the protection holder can buy debt in the market to deliver under the contract.
Catastrophe Risk Swaps

- Potential source of new capacity for terrorism risk
- Used today by insurance companies to manage risk
- Can be documented either as reinsurance contract(s) or an ISDA derivative
Catastrophe Risk Swaps (Cont.)
Catastrophe Risk Swaps (Cont.)

Challenges:

• Regulatory restrictions – non-insurance company counterparties
• Designing triggers (especially for terrorism risk)
Defining Terrorism Risk Triggers

- Use the result of the terrorist event
- Business or revenue stream interruption
- Asset destruction or impairment measured by predetermined criteria
Catastrophe Risk Swaps (Cont.)

Advantages:

- Potentially large source of new capacity ($5.44 trillion)
- ISDA documentation: flexibility and speed
Swaptions

- Concept: Muni/public financing bond with an embedded option on terrorism risk swap

Major Obstacles:
- Majority of muni investors in U.S. are individual, retail investors
- Puts municipal issuer in position of pricing the risk
New Derivatives to Cover Terrorism Risk

- Need accepted models to assess/price terrorism risk first
- Accepted by ratings agencies and investors
- To measure/price risks accurately
- Current mismatch in perceived level of risk
New Derivatives to Cover Terrorism Risk (Cont.)

Other Challenges:

- Informational advantage
- Strategic behavior by terrorists
Conclusion

- Potential for new derivatives products and market to cover catastrophe risks exists

- But without a way to accurately model for terrorism risks, developing derivatives or other securities instruments to cover terrorism risk is probably not yet realistic