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Structured Finance & Insurance

The ART of Managing Capital and Risk

CHRISTOPHER L. CULP

Contents

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Foreword

Wherefore ART Thou? The Importance of Principle-Based Structured Finance

Whenever I get a chance to speak to one of Chris's MBA classes at the University of Chicago, I enjoy the look on his students' faces when I start spouting Shakespeare's views on risk management and corporate finance. For practitioners of structured finance and alternative risk transfer (ART), many of his quotes are quite instructive. For example:

Eye of newt, and toe of frog,

Wool of bat, and tongue of dog,

Adder's fork, and blind-worm's sting,

Lizard's leg, and howlet's wing,—

For a charm of powerful trouble,

Like a hell-broth boil and bubble.

Macbeth's witches truly appear to be our first structured finance specialists. At least that is what some may conclude when reading about the efforts of managers and their financial advisers to practice structured finance and ART as a sort of alchemy—turning debt into insurance, taking liabilities off balance sheet, or accelerating earnings to cover known losses. We can't "bid farewell to magic" (Tempest, Act V, Scene I), but we can establish the fundamentals on which the proper solutions are structured to address fundamental capital and risk management issues.

In Parts One and Two of this book, Chris lays out the building blocks of finance and risk management drawing on corporate finance theory and applied research that has been developed over the past 30 years. These tools are then sharpened in Parts Three and Four as we move from theory to applications involving project finance, securitization, and the convergence between insurance and capital markets solutions such as catastrophe bonds and committed capital. Chris brings together two different worlds—the world of corporate finance and the world of insurance—and explains how the tools, while they may look different, are based on the same fundamentals.

These worlds are complicated on their own. When practitioners bring them together they often create Byzantine structures to address accounting, regulatory, tax, and corporate finance drivers that might lead even the most astute shareholder or analyst to proclaim:

Sir, I am vexed;

Bear with my weakness; my old brain is troubled.

(Tempest, Act IV, Scene I)

This is why simple principles are important. Shakespeare's entreaty "To thine own self be true" (Hamlet, Act I, Scene III) can be used by any manager to question whether the structured transaction is a means for obscuring or addressing underlying risks. Structured transactions—whether they securitize assets, cover difficult-to-insure risks, or access capital markets investors more efficiently—are of questionable value if management cannot explain clearly why considerable time and resources were spent to structure such solutions.

Often, the decision to structure a solution is a type of “To be or not to be” question. Does management of an airline company believe its shareholders wish it to be in the transportation business or the fuel speculation business? To what degree should the future oil price be hedged, for how long, and at what cost? Chris explains the fundamental principles to answer these questions and goes one step further by explaining the confusion shareholders face if they do not know or understand management’s risk management strategy.

Of course, it is because companies can never be “secure from worldly chances and mishaps” (Titus Andronicus) that risk management has a role. It is equally important that risk managers understand that shareholders expect management to take risks. Without taking risk, management cannot create value. It is the balancing act between risk and ruin that Chris concentrates on in such detail by keeping our attention focus on both capital and risk management.

To some financial advisers, ART transactions once appeared as the perfect means to address both core and noncore risks. It was thought that one master insurance policy could cover both insurance and financial risks. Management could use structured insurance transactions as a kind of “cookie jar” to dip into whenever they needed just the right amount of earnings to cover unexpected losses. Chris points out (for example, in Chapters 23 and 24) how this could occur if management and its financial advisers did not apply two important principles:

1. ART transactions should not be used to cover core business risks.

2. ART transactions should not allow management a cookie jar to obscure the true reasons for unexpected losses.

When ART transactions are transparent, are focused on noncore risks, and avoid creating cookie jars for management, we get back to the fundamental purpose of these products.

In the coming years, we will see insurance and capital markets applications come closer together as capital markets investors and insurance underwriters will accept a common language for risk and risk analysis. In Chapter 22, Chris describes why and how capital markets investors have been tapped to take on insurance-based risks through catastrophe bonds and how insurance underwriters have learned to appreciate that they can participate in the recovery of their clients if they provide capital instead of insurance after an insurable event.

To bring these two markets together into effective and responsible structures, it is important to understand how they differ. Students of corporate finance and risk management require this understanding in order to avoid concluding that an insurance or financial solution is just “a rose by any other name.” The characteristics of a debt obligation or the payment of an insurance premium are critically important differences that Chris describes using common sense and clarity. Hopefully, structured finance practitioners as well as future risk managers will read these chapters carefully and understand that:

You are a councillor. . . .

Use your authority. If you cannot,

give thanks you have lived so long. . . .

(Tempest, Act I, Scene I)

Structured solutions are a critical element in our sophisticated financial and insurance markets. Used properly, they provide firms with greater financial flexibility and shareholders with greater confidence that management is focusing on the firm's core business rather than being exposed to unmanageable risks. Chris helps to bring needed clarity to the profession of structured finance and the responsibility management has to ensure that shareholders understand the value that structured transactions can create for the firm.

Shakespeare put this best when he admonished us to "Leave not wrack behind." Had he been able to read Chris's book, he may even have added that structured finance was "such stuff as dreams are made on."

Tom Skwarek

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