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### **The new financiers**

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#### **The business of financing large companies is converging with the business of insuring them**

THIS June, a brave American power firm invested in electricity supply in Colombia. Raising finance for the venture was always going to be hard, since project-finance lending to Latin America had all but dried up. So the company borrowed in two tranches: it hired Bank of America to arrange a senior loan, and an outfit called Centre to arrange, as well as guarantee, a subordinated loan. The structure inspired enough confidence for other banks to join. In July, Centre was at it again, this time backing a risky loan to help Alterra, America's largest nursing-home operator, to buy 20 homes for Alzheimer's victims. Then Centre financed the purchase of aeroplanes by Canadian Airlines and, in August, a management buy-out in Britain. Who are these enterprising bankers? Not, in fact, bankers at all, but part of Zurich, a giant Swiss insurance company.

Putting Colombian power plants to one side, consider Mickey Mouse in Japan. Like thousands of companies that straddle fault-lines in, say, Turkey or California, Tokyo Disneyland had to buy earthquake insurance this year. It arranged the cover not through an insurance company but through Goldman Sachs, a blue-chip Wall Street investment bank. With Goldman's help, Disney issued \$200m worth of bonds—on the understanding that if there is an earthquake, it will not pay them back. It was the first such transaction that did not involve an insurer.

Insurers doubling as banks, banks acting like insurers—it has a familiar ring to it. But this is deceptive. So far "convergence" has been a buzzword only for retail banks, with bricks-and-mortar branches, and retail insurers peddling home insurance or pension annuities. In boardrooms, this trend is referred to either in French, as *bancassurance*, or in German, as *Allfinanz*, and has already spawned mega-mergers such as that in America between Citibank and Travelers to form Citigroup last year. But the real convergence may be that under way at the wholesale end of the finance business.

In retail finance, convergence is based on supposed distribution synergies—the ability to cross-sell insurance to bank customers, or banking services to insurance policyholders. But in wholesale finance, convergence is a function of the increasing overlap between financial risks, such as interest-rate movements or credit defaults, and insurance risks, such as workers' compensation liabilities. Large corporate clients no longer always look for a bank to help with the first and an insurer to take care of the second. Rather, more and more want global expertise in capital management for all eventualities. Reinsurers and investment banks, in particular, both find that they can provide it.

This would explain recurring rumours about link-ups between, say, Goldman and Aon, the world's second-largest insurance broker, or Merrill Lynch and AIG, the world's most valuable insurer. It certainly motivated Swiss Re, the world's second-largest reinsurer, to buy Fox-Pitt, Kelton, an investment bank, earlier this year. Walter Kielholz, Swiss Re's chief executive, has long argued that the wholesale finance industries will converge, and for entirely different reasons from those pulling their retail cousins together.

#### **The history of ART**

The industry's catch-all acronym for the forces driving wholesale financiers into convergence is ART, or "alternative risk transfer". Applied to anything with an air of unconventionality, the label is in many

ways misleading. In the 1970s, it referred to so-called "captive" insurers. These are subsidiaries that large companies set up to pool all of their own risks in one place. Upon closer examination, they are neither "alternative", nor do they "transfer" risk. Their whole point is to retain, rather than lay off, risks that occur frequently, because this works out cheaper for the company. Far from being an innovation, retention is an ancient form of risk financing. Most modern insurance companies started in the 19th century as mutually owned risk-retention businesses.

By the 1980s, however, ART had become genuinely innovative. Following tradition and—according to some—common sense, insurers had always underwritten only losses that might occur in the future. But now they started "insuring" events that had already occurred, where only the timing of settlement was uncertain.

Say, for instance, a number of workers successfully sue their employer because they have been exposed to asbestos in the workplace. The employer must establish a reserve against future compensation payments. But it faces the risk that cash will go to the claimants sooner than expected, depriving the company of investment income. By insuring against this risk, the new policies (called "finite" because the overall exposure is limited) were the first to recognise explicitly the time value of money. In essence, they were not much different from deposit accounts with associated overdraft facilities. But they had the advantage that, being "insurance" rather than "deposits", the premiums were tax-deductible (at least until regulators cottoned on).

In recent years, the pace of innovation has shifted into higher gear. Banks have long recognised the benefits of combining many different—ie, uncorrelated—assets, such as loans, shares and bonds, to lower the aggregate risk of their portfolio. Working on that principle, insurers have started bundling traditional and non-traditional risks—exchange-rate, business interruption, fire, and so on—and selling their clients protection against all of them with so-called "multi-trigger" policies.

Having thus widened their definition of risk, they then teamed up with investment banks to devise new sources of capital to pledge against it. Traditionally, insurance capital was what was paid up by the shareholders of insurance companies. But in future it may include savings stored in banks, pension funds and mutual funds.

Broadly, this works in two ways. The capital can be paid up, as when a pension fund buys Tokyo Disneyland's bonds. The proceeds then sit in a cash hoard in case they are needed. Or the capital can be contingent, as when a pension fund sells a so-called CatEPut (short for Catastrophe Equity Put Option). This is a derivative contract giving the insured the right to sell new shares at a fixed price, with the investor pledging to buy them in the event of a catastrophe.

So far, the hype about ART exceeds the reality. By volume, ART accounts for a sliver of the commercial insurance market: 8% if you count captives, 2% if you do not, according to Sigma, a Swiss Re publication. Chris Hitchings, an insurance analyst at Commerzbank, suggests that ART stands for "alternative road transport", because it is like cars without engines, needlessly complex for snob appeal, which mainly "sit in the driveway impressing visitors or neighbours."

Still, the visitors and neighbours are awfully impressed. Take, for instance, Swiss Re, which, with Centre, Goldman Sachs and a few others, is widely seen as a pioneer of ART. Its shares trade at about twice book value. By contrast, Munich Re, its larger rival, is worth less than its book value, in part because investors (perhaps wrongly) think it is lagging behind in ART.

But the bigger point is that ART is an area of overlap between the businesses of banking and insurance, and that this overlap will grow. "Historically," says Prakash Shimpi, a capital-markets expert at Swiss Re, "there has been a securities market for paid-up capital and an insurance market for contingent events. That historical division is being overcome." As the worlds of wholesale banking and finance merge, what will its bosses call the new industry? *Bancassurance* is spoken for. Mr Shimpi likes "insurative", with its hint of "derivative". What about "finance"?