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Insurance-linked securities

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Climate change to drive capital into reviving ILS market

ILS will continue to attract specialised investors, but cannot prevent some risks becoming uninsurable, experts say

Although securitisation has shaped the history of global finance so far this century, insurance was relatively slow to embrace it, *writes Ben Margulies*.

Re/insurers still consider insurance-linked securities (ILS) a form of "alternative capital", a specialised mechanism employed mainly by reinsurers to fund natural catastrophe coverage.

Despite its relative novelty, ILS has become an increasingly important source of capital. According to Aon's ILS Annual Report 2022, alternative capital provided 16% of reinsurance capital in the first half of 2022, four times the proportion it did in 2006. An infrastructure has emerged around the securities, with Bermuda offering itself as the world's core ILS market and a small number of investors specialising in the asset class.

Although ILS mainly supports one market, that market – natural disaster coverage – is effectively doomed to expand. As climate change makes ever more taxing demands on the insurance sector, the market for these securities is destined to grow steadily.

New money, old methods, older problems
Securitisation dates back at least to the 19th century. But for insurers, the conversion of policies into tradable assets began with a series of natural disasters in the 1990s. In 1992, Hurricane Andrew struck the US states of

The aftermath of 1992's Hurricane Andrew in Dade county, Florida

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Florida and Louisiana. As Swiss Re said in a 2011 paper, insurers lost $17bn in Florida alone, forcing several firms out of business and limiting available cover.

"[ILS], specifically catastrophe bonds, emerged as an attractive source of capacity for the industry and a diversifying asset for investors," the Swiss Re paper continued.

Colin Scagell, partner at law firm Mayer Brown, says much of the growth in the ILS market has been "event-driven", meaning specific disasters have pushed insurers to seek more capital via equities markets. He cites the September 11, 2001 terror attacks, the string of hurricanes that struck the US in 2005 (most notably Katrina) and the global financial crisis as such events.

In a 2021 white paper, Milliman principal actuary, Christopher Clarke, describes four main forms of ILS structures: collateralised reinsurance contracts, which are similar to other reinsurance deals; catastrophe bonds; industry loss warranties, which Clarke describes as "essentially a form of parametric insurance"; and sidecars, which draw in third-party investors to a reinsurance contract.

Scagell says catastrophe bonds usually involve the investor providing funding in the form of high-quality collateral, usually government debt like US Treasuries. The investor's returns come from the coupon on the bonds plus the premiums. Should a catastrophe bond be triggered, the principal is lost in part or – most often – in full. Typically, ILS provides funding to cover natural disasters and activities like lotteries because these can be modelled very accurately, Scagell says.

Jonathan Reiss, managing director at Strategic Risk Solutions, a third-party manager of insurance vehicles, adds "ILS matches [or] tries to very closely match the peril you want to have exposure to". Investors are only exposed to insurance risks, whereas with other asset-backed securities they would face a more complex web of credit and systemic risks.

Paul Schultz, chief executive of Aon Securities, says this also makes ILS a "non-correlating asset class" that is "interest-rate agnostic", cushioning it from the vagaries of the business cycle and monetary policy changes.

Andy Palmer, head of ILS structuring for Europe, the Middle East and Africa and Asia-Pacific at Swiss Re, says "there is certainly transparency about what risk is being taken on", partly because of the reliable modelling and partly because the number of parties involved is relatively small. The underlying funding source for the coupons – a single reinsurance agreement supporting underlying policies – is generally more uniform than that for securitised structures backed by mortgages or loans, he adds.

That said, Clarke points out ILS is "certainly risky", but investors usually diversify their stakes. He adds "ILS is not necessarily more or less risky than other types of asset-backed securities", but investors may stumble if they do not fully understand the asset class.

Angus Duncan, partner in the London office of Hunton Andrews Kurth, says "catastrophe bonds typically give rise to higher transaction costs than more traditional forms of reinsurance".

"Catastrophe bonds require specialised legal advice and structures, a credit rating and stock exchange registration, modelling expenses and other transaction costs associated with a marketed securities issuance. The economic incentive to issue a catastrophe bond will be driven by differential pricing in the Lloyd's market," Duncan continues.

"However, issuers may feel the need to keep issuing the bonds even in softer markets to keep relationships with key catastrophe bond investors from atrophying," Duncan says.

Who sells and how much?

In its last quarterly report of 2023, Aon Securities declared "insurers and reinsurers leveraged alternative capital in 2023 more than any year in the history of the re/insurance market". The report said "alternative capital crossed the $100bn threshold" last year, with more than 7% growth year-on-year. Schultz tells *Insurance Day* the traditional reinsurance market was about $600bn by comparison.

Schultz says the ILS market had been flat – "maybe even with a slight decline" – in the four or five years before 2023. Figures from Aon's 2022 annual report showed the "alternative market" contracted by slightly more than 3% between 2018 and 2021and fell again between 2021 and the first half of 2022.

In his white paper, Clarke cites several natural disasters that depressed returns in the ILS market, which meant insurers had to hold larger stores of collateral against losses. Reiss says a number of ILS managers failed to model many relevant risks, notably from wildfires and the Covid-19 pandemic.

As a result of their "poor behaviour", there is now a "much greater investor appreciation of the difference between good-quality and not good-quality ILS managers and also products", Reiss continues.

Schultz says models must reflect real-world market conditions and the people managing them need to keep abreast of changes and enjoy investors' confidence.

Both insurers and reinsurers try to attract capital by issuing ILS. Peter DiFiore, managing director at Neuberger Berman, says "insurance companies [both regional and national – for example, USAA and Allstate] account for the largest volume of catastrophe bond issuance at 50% of the market, while reinsurers account for around 20% of the market".

DiFiore says some public sector bodies, such as the US National Flood Insurance Program and the World Bank, also use catastrophe bonds. He adds "more idiosyncratic participants" are also using ILS, including Google parent company, Alphabet, which has used securities to fund earthquake cover. "Essentially, anyone with exposure to global natural catastrophes could be a catastrophe bond issuer, which will continue to drive the growth of this market," he says.

Palmer says Swiss Re is itself the "largest sponsor of ILS across all markets historically". It is also the only reinsurer that issues ILS, assists other businesses in setting up ILS structures and manages funds that invest in the asset class.

Reiss says it has become harder to establish new re/insurers and for these firms to find capital and overcome regulatory burdens. Because it is more difficult to obtain insurance capital through equity or debt, ILS becomes an attractive alternative.

The ILS market is largely concentrated in Bermuda. In October 2023, *Artemis* reported almost 92% of ILS worldwide traded on the Bermuda Stock Exchange.

Scagell says the ILS market is concentrated in Bermuda because the island is already home to a large reinsurance sector. The jurisdiction has an effective regulatory structure and local legislation allows ILS vehicles to be set up quickly and securely.

In some cases, "sponsors and cedants" prefer to do deals nearer to home, Scagell says. EU firms may choose to issue ILS in Ireland to stay within the European jurisdiction, while Asian insurers may go to Singapore for the same respective reason. London has developed the London Bridge platform to attract ILS business to the UK.

Who buys ILS?

Scagell says the ILS market is restricted to institutional investors: pension funds, hedge funds, family offices, sovereign wealth funds and sometimes dedicated ILS funds. Several specialised funds, generally emerging in the 2000s, help connect ILS issuers with investors, Scagell adds. Other investors, like the Ontario Teachers' Pension Plan, buy ILS directly.

Palmer estimates about 70% of catastrophe bonds go to "dedicated ILS fund managers", adding Swiss Re has funds of this sort. Another 20% go to "multi-strategy asset managers", with another 5% to 10% purchased by re/insurers.

"It's a very specialist market… it requires quite a lot of insurance expertise such as modelling capabilities," Duncan says. "Catastrophe bonds need to be marketed carefully because, in some jurisdictions, investment in a catastrophe bond may mean an investor is at risk of

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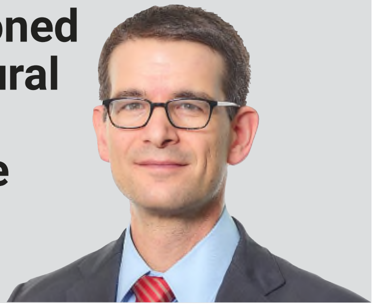
Bill Dubinsky, Gallagher Securities



being treated as carrying on insurance business, which requires specific regulatory approval in that market.”

Clarke points out some investors seek to invest in ILS out of environmental or social responsibility concerns. “For example, catastrophe bonds can help communities recover more quickly from disasters by providing immediate funding,” he says.

Scagell estimates ILS provides around 25% to 30% of capital in the reinsurance sector. However, it makes up only a small fraction of the portfolios of those that invest in them and a small fraction of capital available in equities markets.

Tempestuous future

Experts tend to agree the ILS market will continue to expand. Bill Dubinsky, chief executive of Gallagher Securities, says “ILS is on the upswing and that seems well positioned to continue”, adding he expects a second consecutive record year for the catastrophe bond sector.

“The market is expanding beyond natural catastrophe and life and health into cyber risks and casualty and we expect that to continue in the coming years too,” Dubinsky says, although he points out: “The most complex risks tend to stay in the traditional reinsurance market.”

Palmer says the main constraint on the size of the market is not the supply of capital, but the demand for coverage. There is “only so much [risk] it economically makes sense to transfer” via ILS.

One category of ILS that is likely to attract more capital is cyber catastrophe bonds. In its report for the fourth quarter of 2023, Aon said $415m of cyber notional limit has been placed with catastrophe bond investors.

Because ILS primarily funds natural catastrophe coverage, climate change seems to assure growth in the sector. “I think with climate change and the need for more capacity… this is only going to go one way,” Scagell adds.

But there is a limit to how far ILS or even insurance as a whole can address the challenges of climate change. “If our planet becomes uninhabitable… there’s no insurance solution,” Reiss says. ■